

Reforming the definitions of associated persons

*An officials' issues paper on suggested changes to the definitions of
associated persons in the Income Tax Act 2004*

March 2007

*Prepared by the Policy Advice Division of the Inland Revenue Department
and by the New Zealand Treasury*

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Reforming the definitions of associated persons – an officials' issues paper on suggested changes to the
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CONTENTS

Chapter 1	INTRODUCTION	1
	How to make a submission on the suggested changes	2
Chapter 2	CURRENT DEFINITIONS	4
	Overview of the existing definitions	4
	Application of definitions	6
	Historical development of the associated persons definitions	7
	Current state of associated persons definitions	7
Chapter 3	CLOSING THE LOOPHOLES	8
	Absence of a trustee-beneficiary test	8
	Absence of a trustee-settlor test	10
	Absence of a two trustees with a common settlor test	13
	Absence of a settlor-beneficiary test	14
	Absence of a universal tripartite test	15
	Aggregation of interests of associated persons in two companies and company-individual tests	19
Chapter 4	RATIONALISATION AND SIMPLIFICATION	23
	Multiplicity of definitions	23
	Definition of “relative”	24
	Replacement of “related person” definition with “associated persons” definition	26
	Repeal of section OD 1	27
	Clarifying application of section OD 7(1)(b) to corporate trustees	29
	Omit “income interests” test in section OD 8(3)(a)(ii)	29
	Removal of “habitually acting in concert” test	29
	Simplifying the second partnership test	30
	Relocation of employee-benefit trust exceptions	30
	Omit section OD 8(1)(h) test	31
	Omit section CD 5(1)(a)(iii)	31
	Section CD 14(9) amendment	31
	Section DB 33(2) amendment	32

Chapter 1

INTRODUCTION

- 1.1 New Zealand tax law often subjects transactions between associated persons to special scrutiny because these transactions can pose a substantial risk to the tax base. Transactions between associated persons are more likely to lead to tax practices that undermine the intent of our tax laws because of the closeness of the relationships of the persons involved.
- 1.2 There are four separate definitions of associated persons in the Income Tax Act 2004 which are used extensively in the Act, often in an anti-avoidance capacity. To date, there has been no comprehensive review of the definitions to ensure that the Act has a rational overall approach to defining “associated persons”.
- 1.3 This paper examines the definitions of associated persons in the Act with an emphasis on identifying their shortcomings, and outlines a number of possible solutions to address these shortcomings. These recommendations have two main themes.
- 1.4 The first group of changes would address the major weaknesses in the current general definition and the definition which applies for land sales. These weaknesses have significant base maintenance implications in areas such as the taxation of land sales, dividends and fringe benefits. For example, the associated persons definition which applies for land sales contains some major loopholes which allow land dealers, developers and builders to escape tax by operating through closely connected entities.
- 1.5 The second group of changes recommends replacing the four definitions of associated persons and other provisions employing a similar concept (such as the related persons definition in the dividend rules) with one standardised definition, with limited modifications for certain provisions. This would represent a significant rationalisation and make the associated persons concept in the Act more coherent.
- 1.6 There is no reason, in principle, why the weaknesses in the current definitions of associated persons should not be remedied.
- 1.7 The suggested reforms outlined in this paper are timely given increased concerns about the integrity of the income tax system. Inland Revenue’s *Briefing for the Incoming Minister of Revenue – 2005* highlighted how income splitting and tax sheltering are on the increase and are placing pressures on the personal tax rate structure. The company tax base is also at risk.

- 1.8 Tax base maintenance is an essential feature of the government's tax policy work programme, to counter tax avoidance and ensure a reliable flow of revenue to fund the government's expenditure commitments. Under a system of self-assessment, it is critical that taxpayers accept that the tax rules are broadly fair and even-handed. Activities such as tax sheltering have a corrosive effect on the tax system and the public's confidence in it. Taxpayer morale is undermined if there is a perception that others are not paying their share of tax. This perception, in turn, may adversely affect taxpayer behaviour.
- 1.9 The suggested changes outlined in this paper would close the loopholes in the Act's definitions of associated persons and are consistent with a key theme of the government's tax policy work programme – ensuring that the income tax system is robust.
- 1.10 The main differences between the standardised definition of associated persons outlined in this paper and the current general definition in section OD 7 would be:
- The weaknesses in the current general associated persons definition in relation to trusts would be addressed by having tests associating a trustee and beneficiary, trustee and settlor, two trustees with the same settlor, and a settlor and beneficiary.
 - The new definition would have more robust rules aggregating the interests of associates to prevent the tests associating two companies and a company and an individual being circumvented by the fragmentation of interests among close associates.
 - The new definition would have a tripartite test associating two persons if they are each associated with the same third person, thereby making the definition of associated persons as a whole more difficult to circumvent.
 - The associated persons test for relatives in the new definition could extend to two degrees of relationship only instead of four degrees, as section OD 7 does currently; this is an example where the current definition is too wide.
- 1.11 Once we have received feedback on the suggested changes and made recommendations to government, any resulting legislative changes would be included in a tax bill scheduled for introduction in November 2007. Any legislative changes would apply from the 2008–09 income year.

How to make a submission on the suggested changes

- 1.12 We would appreciate receiving any comments on the recommended changes by 11 May 2007.

1.13 Submissions should be sent to:

Associated persons project
C/- Deputy Commissioner, Policy
Policy Advice Division
Inland Revenue Department
P O Box 2198
Wellington
New Zealand

1.14 Alternatively, submissions can be made in electronic form, in which case “Associated persons project” should appear in the subject line. The electronic address is:

policy.webmaster@ird.govt.nz

1.15 Please note that submissions may be the subject of a request under the Official Information Act 1982. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. If there is any part of your submission that you consider could be properly withheld under that Act (for example, for reasons of privacy), please indicate this clearly in your submission.

Chapter 2

CURRENT DEFINITIONS

Overview of the existing definitions

- 2.1 There are four definitions of associated persons in the Income Tax Act 2004 which are used to determine whether persons are associated for the purposes of the operative provisions in the Act which use those definitions. Section OD 7 contains the general definition of associated persons, which is the definition that applies in the Act unless a specific definition applies. Three other definitions of associated persons are contained in section OD 8. These apply for the purposes of certain provisions in the Act and are referred to in this paper as specific associated persons definitions. Some of the specific definitions apply to mining companies and land transactions, for example.
- 2.2 The operative provisions in the Act which use the associated persons definitions recognise that while associated persons are legally separate entities, they may not be economically independent. Because of their relationship to each other, associated persons can often be regarded as single economic entities because of their community of interests. This community of interests may justify these persons not being treated as independent entities for tax purposes.
- 2.3 In principle, two persons can be regarded as associated for tax purposes if they do not deal with each other at arm's length. However, the Act does not contain a generic definition of associated persons based explicitly on non-arm's length considerations. Instead, the Act considers certain persons to be associated if they have particular relationships with one another. Conceptually, this presumptive approach can be regarded as treating persons in certain relationships as not dealing with each other on an arm's-length basis.
- 2.4 The connection necessary between two persons to justify treating them as associated can be divided into two main categories:
- having certain quantitative ownership thresholds in the case of the two companies (other than the control by any other means limb) and company-individual¹ tests; and
 - two persons have a defined status or legal relationship in relation to each other – for example, two relatives, a trustee and a beneficiary, or a settlor and a trustee.

¹ This is the shorthand term used in this paper for the test associating a company and a person other than a company.

2.5 Table 1 explains how persons can be associated in the Act.

TABLE 1
HOW PERSONS ARE ASSOCIATED

ASSOCIATED PERSONS TESTS	OD 7	OD 8(1)	OD 8(3)	OD 8(4)
1. Two companies	Group of persons with: <i>aggregate voting interests</i> of at least 50% in each company <i>aggregate market value interests</i> of at least 50% in each company (if a market value circumstance exists in either company) <i>control</i> of both companies by any other means	Group of persons with: <i>aggregate voting interests</i> of at least 50% in each company <i>aggregate market value interests</i> of at least 50% in each company (if a market value circumstance exists in either company) <i>control</i> of both companies by any other means	Group of persons with: <i>aggregate voting interests</i> of at least 50% in each company <i>aggregate market value interests</i> of at least 50% in each company (if a market value circumstance exists in either company) <i>control</i> of both companies by any other means <i>aggregate income interests</i> of at least 50% in each company	Group of persons with: <i>aggregate voting interests</i> of at least 50% in each company <i>aggregate market value interests</i> of at least 50% in each company (if a market value circumstance exists in either company) <i>control</i> of both companies by any other means
2. Company and non-company	<i>Voting interest</i> of at least 25% <i>Market value interest</i> of at least 25% (if a market value circumstance exists in the company)	<i>Voting interest</i> of at least 50% <i>Market value interest</i> of at least 50% (if a market value circumstance exists in the company)	<i>Income interest</i> of at least 50% -	<i>Voting interest</i> of at least 25% <i>Market value interest</i> of at least 25% (if a market value circumstance exists in the company)
3. Company and person associated with associate of company	-	-	Company and person associated with another person associated with company	-
4. Two relatives	Person and relative (to fourth degree)	Person and relative (to fourth degree)	Person and relative (to second degree)	Person and spouse, civil union partner, infant child, or trustee for spouse, civil union partner, infant child
5. Partnership and another person	Partnership and partner Partnership and person associated with partner	Partnership and partner Partnership and person associated with partner	Partnership and partner Partnership and person associated with partner	Partnership and partner Partnership and person associated with partner
6. Trustee and beneficiary	-	Yes	Yes, but not if employee beneficiaries	-
7. Two trustees	-	Trustees of trusts with common settlor	Trustees of trusts with common settlor, but not if employee beneficiaries	-
8. Trustee and settlor	-	-	Yes, but not if employee beneficiaries	-
9. Person and friendly society, charity, or non-profit body	-	Organisation and person or relative controlling	-	-
10. Two persons acting in concert	-	-	Habitually acting in concert in respect of section EX 5(1) matters	-

Application of definitions

- 2.6 As mentioned above, there are four definitions of associated persons in the Act which are used extensively throughout the Act to determine whether persons are associated for the purposes of the operative provisions in the Act. The application of these different associated persons definitions is summarised in Table 2.

TABLE 2
APPLICATION OF THE DIFFERENT ASSOCIATED PERSONS DEFINITIONS

Definition section	Operative provisions to which definition applies
OD 7	All situations not covered by the three following definitions (general definition)
OD 8(1)	<ul style="list-style-type: none">- Proceeds of share disposal by qualified foreign equity investor (section CW 11B)- Petroleum exploration expenditure and sale of property arrangement (section DT 2)- Disposal of petroleum mining assets to associates (sections DT 9 to DT 11 and section EJ 14)- Deductions allowed to persons associated with petroleum miners (section DT 15)- Avoidance provisions relating to petroleum mining (section GC 12)- Deductions for dispositions of timber between associated persons (section GD 15)
OD 8(3)	<ul style="list-style-type: none">- International tax rules (section OB 1)- Depreciation (Part EE)- Apportionment of interest costs if New Zealand taxpayer controlled by a single non-resident (Part FG)- Underlying foreign tax credits (Part LF)- Use of motor vehicles and FBT (sections CX 6 and CX 6B)- Conduit tax rules (sections FH 1, KH 2, NH 7, OE 7 and OE 8)- Debt sold at discount to associate of debtor (sections DB 10, EW 45 and EW 50)- Film reimbursement schemes (section DS 4)- Cost price option for valuing specified livestock bailed or leased between associated persons (section EC 10)- Depreciation deduction for assets acquired from associated person before 23 September 1997 (section EZ 11)- Sale of debt to associate of debtor (section EZ 38)- Premiums derived by non-resident general insurers treated as being derived from New Zealand (section FC 13)- Attribution rule for personal services (section GC 14B)- Cross-border arrangements between associated persons (section GD 13)- Liability for tax of company left with insufficient assets (section HK 11)- Eligibility requirements for portfolio investment entities (sections HL 6 and HL 9)- Foreign tax credit restriction (section LC 1)- Section LE 3 holding companies (section LE 3)- Definition of “returning share transfer” (section OB 1)
OD 8(4)	<ul style="list-style-type: none">- Income from land transactions (sections CB 5 to CB 21)- Relationship property transfers of land (section FF 6)

Historical development of the associated persons definitions

- 2.7 The general definition of associated persons in section OD 7 of the Act was originally enacted in 1968 as section 3A of the Land and Income Tax Act 1954,² with application from the start of the 1968–69 income year.
- 2.8 The separate definitions of associated persons have been implemented in an ad hoc manner since 1968 as part of other specific tax reforms. The section OD 8(1) definition was originally enacted in 1990 as section 214E(1) of the Income Tax Act 1976 as part of new petroleum mining rules. The section OD 8(3) definition was originally enacted in 1988 as section 245B of the Income Tax Act 1976 as part of the new controlled foreign company rules; and the definition in section OD 8(4) was originally enacted in 1973 as section 88AA(10) and (11) of the Land and Income Tax Act 1954 as part of new land sale rules. Since their original enactment, the definitions have undergone a number of changes before assuming their present form.
- 2.9 The specific definitions of associated persons are generally more comprehensive than the general definition in section OD 7. It would seem that the specific definitions were developed in response to perceived shortcomings in the general definition.

Current state of associated persons definitions

- 2.10 Currently, the Act has no coherent overall scheme for defining associated persons. There are a number of shortcomings in the current definitions of associated persons. For example, some definitions do not consider some obviously close relationships as being associated (for example, a trustee and a beneficiary). On the other hand, they treat some remote relationships as being so (for example, fourth-degree relatives). The current multiplicity of definitions and other provisions employing a similar concept (such as the company control definition in section OD 1) creates unnecessary complexity in the Act.
- 2.11 The associated persons concept in the Act would be significantly improved if these problems were resolved. The following chapters describe the problems and outline a number of possible solutions.

² By section 5 of the Land and Income Tax Amendment Act (No. 2) 1968.

CHAPTER 3

CLOSING THE LOOPHOLES

- 3.1 The general definition of associated persons in section OD 7 and the definition applying to land sales in section OD 8(4) are deficient compared with the other definitions because they do not treat certain categories of persons between whom there is a significant degree of connection as associated persons. Transactions between these categories of persons are more likely to be affected by non-arm's length considerations than other transactions. As a result, there are specific cases when loopholes in the definitions can give rise to base maintenance concerns. The new standardised definition of associated persons suggested in this paper would address these base maintenance concerns by closing these loopholes.
- 3.2 In particular, persons in the following relationships are currently not treated as associated under the general associated persons definition and the definition applying to land sales, although they would be associated under other associated persons definitions in the Act:
- a trustee of a trust and a person who has benefited or is eligible to benefit under that trust;
 - a trustee of a trust and a settlor of that trust;
 - a trustee of a trust and a trustee of another trust if there is a common settlor of both trusts;
 - any company and any person where the person is associated with another person who is associated with that company.
- 3.3 This chapter discusses the problems caused by loopholes in the current associated persons definitions and suggests how these loopholes can be closed.
- 3.4 The paper does not consider the potential application of section BG 1, the general anti-avoidance provision in the Act, to any of the examples discussed.

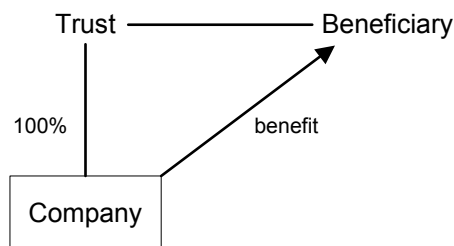
Absence of a trustee-beneficiary test

Problem

- 3.5 The current absence of a trustee-beneficiary test from the general definition of associated persons in section OD 7 would probably constitute that definition's most significant omission in test coverage. Transactions are often structured to take advantage of this loophole. In particular, many of the operative rules in the Act using the general associated persons definition can be readily circumvented by simply interposing a discretionary trust. The absence of a trustee-beneficiary test in the associated persons definition applying to land sales would also probably be the most significant omission in that definition's test coverage.

- 3.6 Set out below are examples of arrangements that exploit this absence of a trustee-beneficiary test in the general definition of associated persons and the definition applying to land sales.

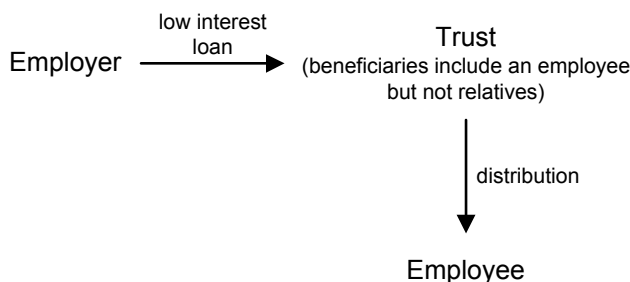
EXAMPLE 1



- 3.7 The arrangement in Example 1 involves the company providing a benefit to a beneficiary of its trustee shareholder. The company provides the benefit because the trustee is one of its shareholders. Even though section CD 5(1)(a)(ii) in the dividend rules is directed at payments to associated persons of shareholders, this simple arrangement avoids the dividend rules (the arrangement is also not caught by the trustee rule in section CD 5(1)(a)(iii)).

- 3.8 The arrangement in Example 2 involves an employer providing a low interest loan to a trust under which an employee is a beneficiary. Even though fringe benefit tax applies to fringe benefits provided to associated persons of employees this simple arrangement avoids this rule. Peculiarly, if the trust's beneficiaries included the employee's relatives then the arrangement would be caught.

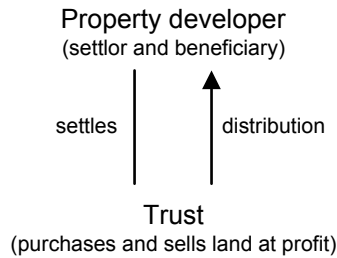
EXAMPLE 2



- 3.9 In Example 3, a property developer arranges for the trust (settled by the developer and under which the developer is a beneficiary) to acquire land. The property developer is not associated with the trust under section OD 8(4) so the trust is not automatically caught by the land sale provisions in subpart CB on the subsequent sale of the land.³

³ Each of the land sale taxation provisions applying to persons dealing in land, developing or dividing land, or building, contains an associated persons rule to prevent persons who carry on these activities from avoiding the principal provisions by operating through an associate.

EXAMPLE 3



Solution

- 3.10 It is clear from the examples that there is a sufficient connection between the trustees and beneficiaries of a trust to justify treating them as being associated.
- 3.11 We consider that a “trustee-beneficiary” test should become part of a standardised associated persons definition. This test would associate a trustee of a trust and a person who has benefited or is eligible to benefit under that trust.
- 3.12 The inclusion of a trustee-beneficiary test in a standardised associated persons definition would address the examples above:
- In Example 1, the company would be providing a benefit to an associated person (Beneficiary) of a shareholder (Trust) in the company. Accordingly, the company has provided a dividend to the beneficiary under section CD 5(1)(a)(ii).
 - In Example 2, the employer would be providing a fringe benefit (the low interest loan) to an associated person (Trust) of the employee and would therefore be subject to fringe benefit tax.
 - In Example 3, the trust would be an associated person of the property developer and therefore the proceeds from the sale of the land by the trust would be income of the trust under the land sale provisions in subpart CB.

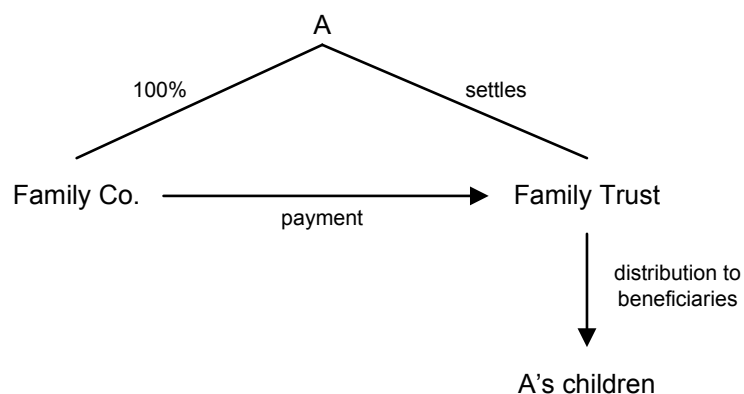
Absence of a trustee-settlor test

Problem

- 3.13 The absence of a test associating a trustee and a settlor of a trust is also a significant loophole in the general definition of associated persons and the definition applying for land sales. How the omission of this test constitutes a loophole is illustrated by the following examples.

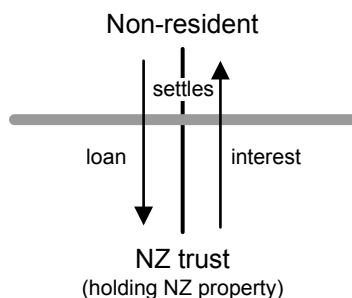
- 3.14 The dividend rules in sections CD 3 to CD 5 treat a payment made by a company to an associated person of a shareholder of the company as a dividend if that payment would have been a dividend if it had been made to the shareholder. These rules employ the section OD 7 associated persons definition. The ease with which this definition can be circumvented is shown in Example 4.

EXAMPLE 4



- 3.15 The payment in Example 4 from Family Co. to Family Trust is not currently caught as a dividend. Family Trust is not associated with A who is the sole shareholder of Family Co. because of the absence of a settlor-trustee associated persons test in section OD 7. Also, the trust extension rule in section CD 5(1)(a)(iii) does not apply as Family Co. has not made a payment to a trust under which A or A's spouse is a beneficiary (instead, A's children are the beneficiaries).

EXAMPLE 5



- 3.16 In Example 5, a non-resident settles a New Zealand trust (with a New Zealand-incorporated company as trustee) which owns New Zealand land and buildings. The non-resident is also a beneficiary of the trust. This investment by the trustee is funded by a loan from the non-resident settlor. The interest paid on this loan qualifies for the approved issuer levy (AIL) of two percent instead of being subject to the higher NRWT rate if the non-resident settlor is not associated with the New Zealand trustee. Because the section OD 7 definition is used in the AIL rules – and this definition is generally deficient in relation to arrangements involving trusts and, in particular, does not contain a test associating a settlor and a trustee of a trust – the interest qualifies for AIL treatment despite the in-substance association between the two parties.

Solution

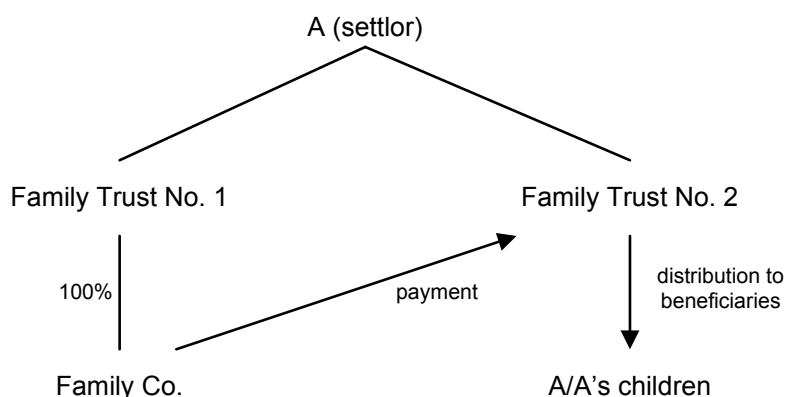
- 3.17 As with the “trustee-beneficiary” relationship, a trustee and a settlor of a trust have a sufficient degree of connection to justify treating them as associated persons. The current absence of this test in the general definition of associated persons in section OD 7 and the definition applying for land sales allows for schemes to be developed that exploit this gap.
- 3.18 The payment from Family Co. to Family Trust in Example 4 would be treated as a dividend under a standardised associated persons definition which would include a trustee-settlor test. Because A is the settlor of Family Trust, A and Family Trust would be associated persons under this test. Therefore, Family Co. would have made a payment to an associated person (Family Trust) of its shareholder (A) in terms of section CD 5(1)(a)(ii).
- 3.19 In Example 5, the non-resident would be associated with the New Zealand trustee under this arrangement if a test associating a settlor and a trustee of a trust applied. Accordingly, the interest derived by the non-resident from New Zealand would be subject to a higher rate of NRWT instead of AIL at two percent, which is the appropriate treatment.
- 3.20 A settlor of a trust and a trustee of that trust are currently treated as associated persons under section OD 8(3)(i). This test is unique to the section OD 8(3) definition of associated persons.
- 3.21 The term “settlor” has a wide meaning under the section OB 1 definition of that term. A settlor is defined to mean broadly any person who provides goods or services to a trust for less than market value or acquires goods or services from a trust for greater than market value. The definition of “settlor” is further extended by the provisions of section HH 1, the most significant of which are:
- When a company makes a settlement, any shareholder with an interest of 10 percent or more in that company is treated as a settlor in relation to that settlement as well as the company itself (section HH 1(2)).
 - When a trustee of a trust (the first trust) settles another trust (the second trust), the settlor of the second trust is treated as including any person who is a settlor of the first trust (section HH 1(3)).
 - When a person has any rights or powers in relation to a trustee or settlor of a trust which enable the person to require the trustee to treat the person (or any other person nominated by that person) as a beneficiary of that trust, the person is treated as a settlor of that trust.
- 3.22 The wide definition of “settlor” contained in section OB 1 of the Act should apply for the purposes of a standardised associated persons definition.

Absence of a two trustees with a common settlor test

Problem

- 3.23 The absence of a test associating trustees of two trusts if they have a common settlor in the general definition of associated persons in section OD 7 and the definition applying for land sales means that the operative provisions employing these definitions can be readily circumvented by the use of certain trust structures.
- 3.24 As mentioned earlier, the dividend rules in sections CD 3 to CD 5 treat any payment made by a company to an associated person of a shareholder of the company as a dividend if that payment would have been a dividend if it had been made to the shareholder; the section OD 7 general associated persons definition is used for this purpose. The dividend rules also contain a trust extension rule in section CD 5(1)(a)(iii) whereby any payment made by a company to a trust under which a shareholder of the company (or spouse or civil union partner of the shareholder) is a beneficiary is also treated as a dividend. The associated person and trust extensions in the dividend rules can be easily circumvented, in the absence of a two trustees (common settlor) test, by the following structure:

EXAMPLE 6



- 3.25 A settles Family Trust No. 1, which trust owns all of the shares in Family Co. A also settles Family Trust No. 2 whose discretionary beneficiaries include his children and A himself. Family Co. makes a payment to Family Trust No. 2.
- 3.26 Family Co. has not made a payment to an associated person of its shareholder, Family Trust No. 1, in terms of section CD 5(1)(a)(ii). The section OD 7 definition of associated persons would not cover this scenario and therefore the payment from Family Co. to Family Trust No. 2 is not treated as a dividend.

- 3.27 The trust extension to section CD 5 also does not apply as the shareholder of Family Co. is Family Trust No. 1 and not A (and Family Trust No. 1 is not a beneficiary of Family Trust No. 2).

Solution

- 3.28 Officials consider that there is a sufficient degree of connection between two trustees with a common settlor to justify treating them as associated. This would allow the current loophole to be closed.
- 3.29 If a standardised associated persons definition included a two trustees (common settlor) test the payment from Family Co. to Family Trust No. 2 in the example above would be treated as a dividend. The trustees of Family Trust No. 1 and Family Trust No. 2 would be associated because they have a common settlor (A). Section CD 5(1)(a)(ii) would therefore apply as Family Co. has made a payment to an associated person (Family Trust No. 2) of its shareholder (Family Trust No. 1).
- 3.30 Two associated persons definitions currently contain tests – sections OD 8(1)(f) and OD 8(3)(h) – which treat a trustee of a trust and a trustee of another trust as associated persons if both trusts have at least one settlor in common.

Absence of a settlor-beneficiary test

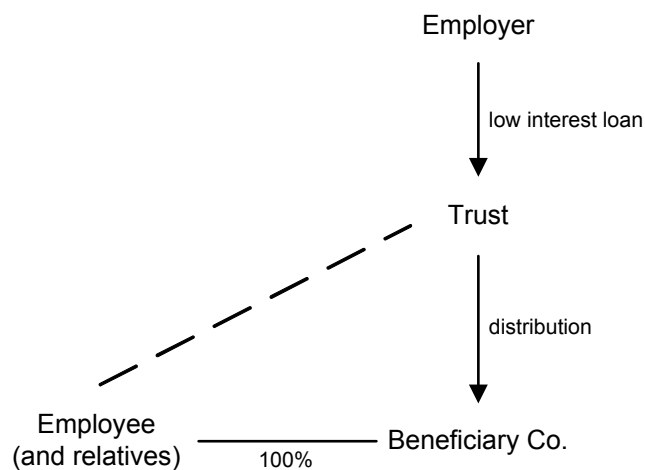
- 3.31 A settlor of a trust and a beneficiary under that trust should also be treated as associated persons under a standardised associated persons definition.
- 3.32 Given that there is a sufficient connection between a trustee and a beneficiary, as well as between a trustee and a settlor to justify treating them as associated persons, there should be a sufficient connection between a settlor and a beneficiary to justify treating them as associated persons as well. Such an associated persons test would also be consistent with the settlor focus of the trust taxation rules.
- 3.33 An overseas precedent for treating a settlor and a beneficiary as associated can be found in the definition of “related taxpayer” in section 1313(c)(3) of the United States Internal Revenue Code.
- 3.34 In any event, a settlor will be associated with a beneficiary under the trust if a new standardised definition of associated persons contains the “trustee-beneficiary” test, the “settlor-trustee” test and the modified tripartite test as proposed. By associating settlors with beneficiaries explicitly, the associated persons definition will be made more transparent.

Absence of a universal tripartite test

Problem

- 3.35 The absence of a test associating two persons if they are each associated with the same third person – referred to as the universal tripartite test – in a new standardised definition of associated persons could render other reforms suggested in this paper somewhat ineffective. Making changes to the treatment of parties to a trust (such as a trustee-beneficiary test) will catch many simple associated persons arrangements. However, those changes will not catch more elaborate arrangements.
- 3.36 For example, fringe benefit tax applies to fringe benefits provided to employees or associated persons (as defined in section OD 7) of employees. As illustrated by Example 2, this rule can currently be avoided by simply interposing a trust between the employer and employee. Under such an arrangement, a benefit provided to the trust (which can be later distributed to the employee as a beneficiary of the trust) is not currently provided to an associated person of the employee and therefore not subject to fringe benefit tax.
- 3.37 Putting in place a “trustee-beneficiary” test could help address these kinds of arrangements. It could, however, be possible to continue to avoid being associated by simply interposing one additional party – a company which acts as a beneficiary under the trust. The arrangement could take the following form:

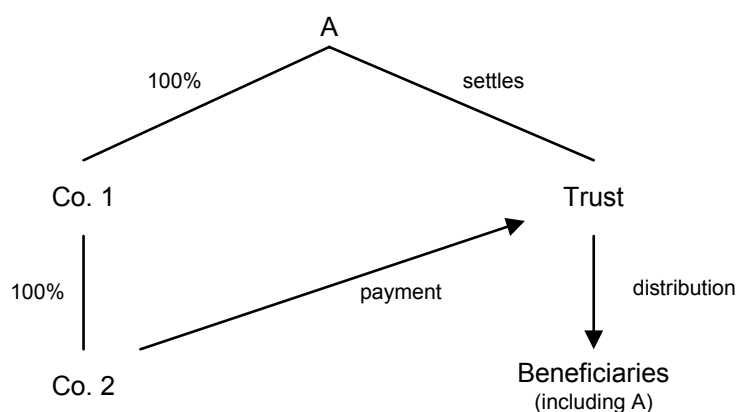
EXAMPLE 7



- 3.38 Under the arrangement, the benefit is provided to the trust, which is associated with Beneficiary Co. under the “trustee-beneficiary” test, but not with the employee.

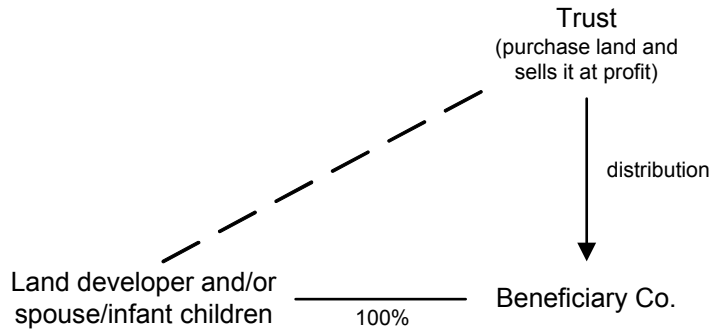
- 3.39 A tripartite test would associate the trust with the employee because they are both associated with Beneficiary Co. (the trust is associated with Beneficiary Co. under a trustee-beneficiary test and the employee is associated with Beneficiary Co. under the company-individual test). As a result, the employer would have to account for FBT.
- 3.40 This tripartite test would also apply if the trust and company in Example 7 were transposed – that is, the employer makes a low interest loan to a company owned by a trust, under which the employee was a beneficiary. Accordingly, the employer would still have to account for FBT.
- 3.41 Example 8 illustrates how the tripartite test would operate in the context of section CD 5(1)(a)(ii) which treats as a dividend any payment made by a company to an associated person of a shareholder of the company. This operative provision employs the section OD 7 definition of associated persons which does not currently contain a tripartite test. The example shows that without such a test payments made by a company can circumvent the associated persons rule (and the trust extension rule) in section CD 5.

EXAMPLE 8



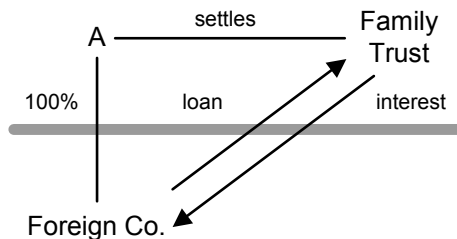
- 3.42 The payment from Co. 2 to the trust is not currently caught by the dividend rules but would be if a tripartite trust was employed. The trust is associated with A under the trustee-settlor test (assuming that test was also included in section OD 7). A is also associated with Co. 1 under the company-individual test (existing section OD 7(1)(b)). The trust would therefore be associated with Co. 1 (the shareholder of Co. 2) under the tripartite test because the trust is associated with A who is associated with Co. 1. Accordingly, in terms of section CD 5(1)(a)(ii), a payment has been made to an associated person (Trust) of a shareholder (Co.1) of Co. 2.
- 3.43 A tripartite test would also catch the land transaction arrangement shown in Example 9 which currently circumvents the section OD 8(4) definition of associated persons.

EXAMPLE 9



- 3.44 The arrangement in Example 9 is not caught by the existing section OD 8(4)(c), which treats two persons as being associated if one is the trustee of a trust under which the other person’s spouse, civil union partner or infant child is eligible to benefit. This is because Beneficiary Co., rather than the land developer’s spouse or infant children, is the beneficiary under the trust. However, the trust and the land developer would be associated under the universal tripartite test (in conjunction with a trustee-beneficiary test). This is because the trust and Beneficiary Co. are associated under the trustee-beneficiary test, and the land developer and Beneficiary Co. are associated under the company-individual test, resulting in the trust and land developer being associated. Therefore, any gain on the subsequent disposition of the investment property by the trust would be liable to tax under the associated persons rules in the land sale provisions in subpart CB.
- 3.45 The current company-based tripartite test in section OD 8(3)(c) would not be sufficient to catch the arrangement in Example 9 as neither the land developer nor the trust is a company.

EXAMPLE 10



- 3.46 A settles Family Trust with A’s spouse as trustee. The trust carries on business activities in New Zealand. Foreign Co, which is wholly owned by A and resident in a grey list jurisdiction, makes a loan to Family Trust. The interest paid on this loan qualifies for an approved issuer levy (AIL) of two percent instead of being subject to the higher NRWT rate which applies if the lender and borrower are associated. The loan is not caught by the associated persons restriction in the AIL rules because of shortcomings in the general associated persons definition in section OD 7, which is used in these rules. The correct outcome from a policy perspective is that the interest derived

from New Zealand by Foreign Co. is subject to NRWT instead of AIL because of the in-substance association between Family Trust and Foreign Co. These two parties would be associated if a tripartite test applied in conjunction with a trustee-settlor test: Family Trust would be associated with A under the trustee-settlor test and A would be associated with Foreign Co. under the company-individual test. Accordingly, Foreign Co. would be associated with Family Trust under the tripartite test.

Solution

- 3.47 Currently, section OD 8(3)(c) treats a company and any person as associated persons if the person is associated (under any of the tests in section OD 8(3)) with another person who is associated (but not under this particular test) with the company. In other words, A is associated with a company if B is associated with both that company and A. This test is unique to the section OD 8(3) definition of associated persons.
- 3.48 This test is also sometimes referred to as the “tripartite test” because of its triangular principle of operation whereby a company is considered to be associated with a person if that person is associated with another person who in turn is associated with the company. In other words, a company and a person are treated as associated if there is a common person with whom they are associated.
- 3.49 We consider that the section OD 8(3)(c) tripartite test should not be simply adopted in its current form. There is no reason, in principle, why the tripartite test should apply only in relation to companies; its general concept – that two persons are associated if they are each associated with the same third person – should apply universally.
- 3.50 Therefore we suggest that a universal tripartite test should be included in a standardised definition of associated persons. This test would associate any two persons if they are each associated with the same third person.
- 3.51 Having a tripartite test would make a standardised definition of associated persons as a whole much more difficult to circumvent. In particular, it would prevent the other associated persons tests being circumvented by arrangements using the interposition of relatives, companies, and trusts which are under the influence or control of the main protagonists.
- 3.52 Having a universal tripartite test in a new standardised definition of associated persons in the Income Tax Act 2004 would also be consistent with the approach used in the associated persons definition in the Goods and Services Tax Act 1985.

Modification for limited partnerships

- 3.53 There may be sound policy reasons for modifying the proposed tripartite test relating to the new limited partnership vehicles the government is considering introducing.

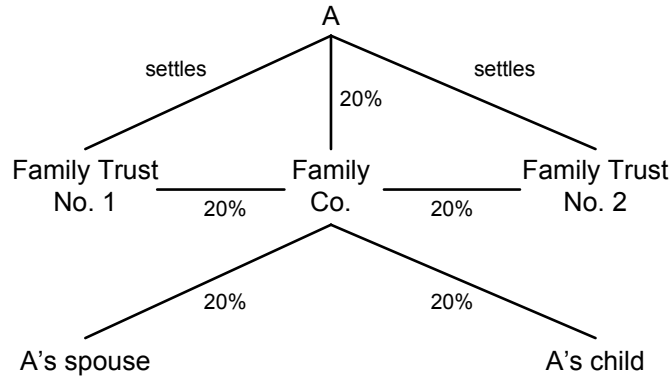
- 3.54 Limited partnership vehicles will be an important mechanism through which New Zealand will access foreign venture capital. Limited partnerships could have many unrelated limited partner investors (of varying size) resident in different jurisdictions around the world. Experience abroad indicates that limited partnerships are often widely held vehicles used to pool the investment funds of many different investors. Under the regulatory measures the government is currently considering, limited partners would have no ability to manage the partnership business or make operating decisions, and therefore they would be less able to use the limited partnership vehicle to circumvent the associated persons rules – for example, in relation to land transactions.
- 3.55 With land transactions, a universal tripartite test may result in the land dealing transactions of one partner tainting the other partners. Given the nature of the proposed limited partnership vehicle, and the inability of a limited partner to exercise control over it, the scope of this test in relation to limited partnerships may be wider than is necessary for base maintenance purposes. Accordingly, any tripartite test should be modified in the case of limited partnerships.
- 3.56 In some respects, such as in terms of liability, limited partners are more akin to shareholders in a company. It may therefore be appropriate to adopt a test based on the company-individual test in the current section OD 7(1)(b). Under such a test a limited partner would be associated with a limited partnership and other partners in the partnership only if that limited partner had a 25 percent or greater interest in the limited partnership.
- 3.57 Officials would like feedback on any other situations where it is considered that the scope of a universal tripartite test may be wider than is necessary for the purpose of protecting the tax base.

Aggregation of interests of associated persons in two companies and company-individual tests

Problem

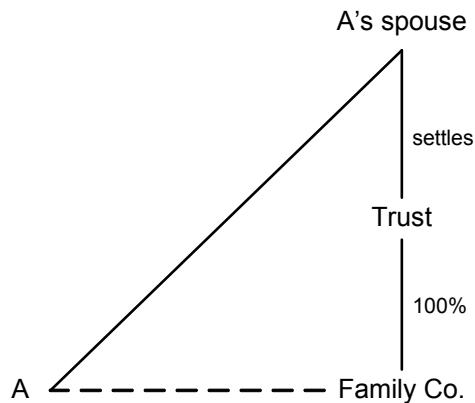
- 3.58 If the interests of associated persons are not aggregated the tests associating two companies and companies and individuals could be readily circumvented by the fragmentation of interests among associated persons to prevent these interest thresholds being reached. However, in-substance control of a company could be retained because of the relationship between associated persons. This is illustrated by Examples 11 to 13.

EXAMPLE 11



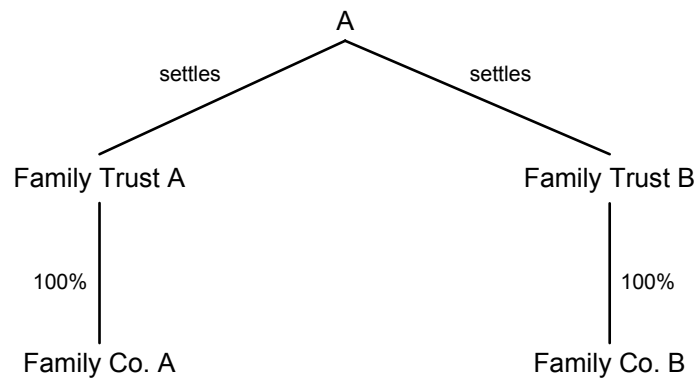
- 3.59 A settles Family Trusts No. 1 and No. 2 and arranges for each of them to hold 20 percent of the shares in Family Co. A also arranges for his spouse and child to hold 20 percent each in Family Co. A directly holds only 20 percent. Without a rule aggregating the interests held by associated persons A would not be associated with Family Co.

EXAMPLE 12



- 3.60 A's spouse settles Trust, which in turn owns all the shares in Family Co. The members of A's family are not identified as discretionary beneficiaries of the trust. The issue is whether A is associated with Family Co. under the company-individual associated persons test. Without a rule aggregating interests held by associated persons A would not be associated with Family Co. even though there is a large community of interest between them. However, A would be associated with Family Co. under the company-individual test if that test was buttressed by such an aggregation rule, in conjunction with tripartite and trustee-settlor tests. In particular, A would be treated for the purposes of the company-individual test as holding all the shares held by Trust in Family Co. This is because Trust is associated with A under the tripartite test: A is associated with her spouse under the relatives test and A's spouse is associated with Trust under the settlor-trustee test, which means that A is associated with Trust under the tripartite test.

EXAMPLE 13



- 3.61 A settles two family trusts which in turn each own all the shares in a family company. The issue is whether the two family companies are associated under the two companies associated persons test. Without a rule aggregating interests held by associated persons for the purposes of that test, the two family companies would not be associated despite the close community of interests between them. However, Family Co. A would be associated with Family Co. B if the two-companies test was buttressed by an aggregation rule in conjunction with the two trustees-common settlor test. Because the two family trusts are associated with each other under the two trustees-common settlor test, they would each be treated as holding each other's shares for the purposes of the two-companies test and accordingly the two family companies would be associated under that test.

Solution

- 3.62 In determining whether two companies or a company and an individual are associated, a person's voting or market value interests in a company should be aggregated with the voting or market value interests of associated persons.
- 3.63 Such an aggregation approach is appropriate in the context of the two companies and company-individual tests which are largely based on certain quantitative voting or market value interest thresholds.
- 3.64 The existing two companies and company-individual tests in section OD 7 already contain limited interest aggregation rules. However, these aggregation rules are not always complete or consistent. For example, interests held by a trustee of a trust under which a relative of a person is a discretionary beneficiary are aggregated with shares held directly by the person in determining whether two companies or a company and that person are associated. Surprisingly, interests held by a trustee of a trust under which a person (but not his or her relatives) is a discretionary beneficiary are not similarly aggregated with shares held directly by that person. A general aggregation rule in a standardised definition of associated persons would address this and similar anomalies.

- 3.65 We therefore consider there should be more robust rules aggregating the interests of associates to prevent the tests associating two companies and a company and an individual being circumvented by the fragmentation of interests among associated persons.
- 3.66 The suggested aggregation rule would be consistent with the approach used in the associated persons definition in section 2A(4) of the GST Act. For example, using the structure in Example 12, A (not GST-registered) sells land, which has not previously been in the GST net, to Family Co. in order to generate a second-hand goods input tax credit. This attempt would not succeed because it would be caught by the associated persons restriction applying to such credit: A and Family Co. are associated persons for GST purposes.
- 3.67 There are several international precedents for the type of aggregation rule proposed. For example, paragraph 4 of Schedule 28AA of the Income and Corporation Taxes Act 1988 (United Kingdom) provides that for purposes of determining whether a person has control over a company, there are attributed to that person any rights or powers held by persons connected with that person. This provision applies for purposes of the transfer pricing rules in the same Act.
- 3.68 Section 160E of the Income Tax Assessment Act 1936 (Australia) requires the interests of associated persons to be aggregated in determining whether a company and a person are associated for purposes of the capital gains provisions.
- 3.69 The definition of “related persons” in section 251(2) of the Income Tax Act 1985 (Canada) provides, *inter alia*, that an individual and a company are related persons for purposes of that Act if the individual is a member of a related group that controls the company; this has a similar aggregation effect.

Chapter 4

RATIONALISATION AND SIMPLIFICATION

- 4.1 No previous attempt has been made to provide a coherent overall approach to defining associated persons for income tax purposes. In addition to the loopholes discussed in Chapter 3, other shortcomings in the current definitions and related provisions include a lack of simplicity and coherency. The rationalisation of the current multiple associated persons definitions and other provisions which embody an associated persons concept would help to address these shortcomings.

Multiplicity of definitions

Problem

- 4.2 The associated persons definitions are spread out among four different provisions: sections OD 7, OD 8(1), OD 8(3) and OD 8(4). As shown in Table 1, each definition contains several associated persons tests which apply depending on the situation. Thus, persons in an arrangement are or are not associated depending on what associated persons definition is used. The current multiplicity of definitions is purely historical: the specific definitions were mainly conceived in response to shortcomings in the general definition. There are no convincing policy reasons for the current multiple definitions. They create unnecessary complexity which increases compliance and administrative costs.

Solution – standardised definition

- 4.3 Officials consider that any substantial improvement in the clarity of the associated persons definitions can only be achieved by reducing the number of definitions of associated persons. The most effective way to approach this task is to develop a single, standard definition of associated persons for the Act.
- 4.4 A standardised definition would incorporate solutions to various weaknesses, ambiguities, and inconsistencies in the existing associated persons definitions. This would result in a significantly stronger definition applying for the purposes of the Act generally, while at the same time remedying the shortcomings in the existing definitions.
- 4.5 A new standardised definition of associated persons would more closely resemble the current section OD 8(3) definition than the current general definition in section OD 7. However, this can be regarded as continuing a process already in place whereby the section OD 8(3) definition has been progressively applied to more operative provisions,⁴ including standard provisions such as the depreciation rules, since its inception in 1988. Therefore, the standardised definition reform suggested in this paper brings this process to its natural conclusion.

⁴ Refer Table 2.

- 4.6 The new standardised definition of associated persons in the Income Tax Act 2004 would be similar to that applying in the GST Act. This would standardise the concept of associated persons across the Inland Revenue Acts. Moreover, having a standardised definition in place of the four current definitions would be a significant simplification measure.
- 4.7 The standard definition would contain limited modifications for the purposes of certain provisions. Those modifications are:
- The existing narrow range of relatives (that is, spouses, civil union partners and infant children) applying for purposes of the company-individual and relatives tests in the section OD 8(4) definition should continue to apply in the associated persons rules in the land transaction provisions.
 - The modification contained in section OD 8(3A) to the two companies test in section OD 8(3)(a) should be retained as a separate subsection in the standardised associated persons definition. This provision specifies that two companies are not associated when one of those companies (but not both) is not resident in New Zealand, and applies for the purposes of the international tax rules (other than sections CD 34 to CD 41 and CZ 10).
 - The existing modification contained in section EX 4(1), which qualifies the relatives test in section OD 8(3) for the purposes of section EX 3 (relating to the calculation of control interests in foreign companies), should be relocated to a separate subsection in the standardised definition of associated persons. A cross-reference should be inserted in section EX 3 to this modification for ease of comprehension.
 - The existing modification in section LE 3(5)(a) should be relocated to a separate subsection in the standardised associated persons definition provision and a cross-reference inserted in section LE 3(5) to the relocated modification for ease of comprehension. This modification specifies that, for the purposes of section LE 3(5) (part of the section LE 3 holding company rules), a section LE 3 holding company and a lower-tier company are considered to be associated persons as defined in section OD 8(3), but as if each reference in that provision to “50% or more” instead read “more than 50%”.
- 4.8 Any modification to the new standardised associated persons definition would be contained in that definition itself, with a cross-reference from the particular operative provision to the modification for ease of comprehension.

Definition of “relative”

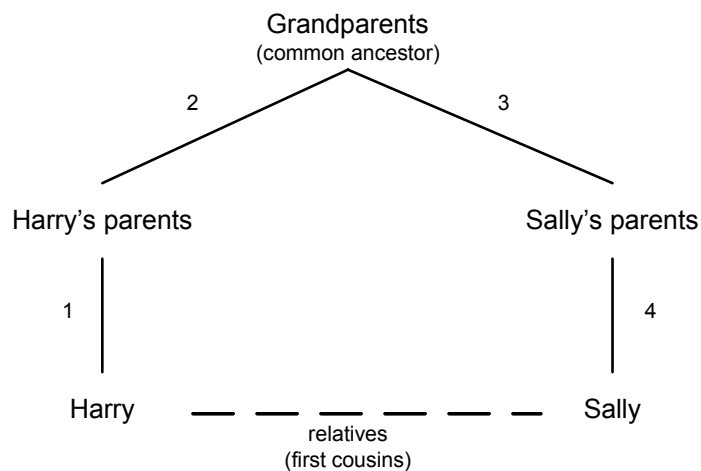
- 4.9 Two persons who are relatives are associated persons. Although the relatives test is a common test in all four current definitions of associated persons there are differences in the range of relatives which are taken into account for the purposes of these tests.

4.10 Section OB 1 contains two main definitions of a “relative”. Paragraph (c) of the definition of “relative” is used for the relatives tests in sections OD 7(1)(c) and OD 8(1)(c). In short, relatives are defined as meaning persons connected by:

- blood relationship (being within the fourth degree of relationship); or
- marriage or civil union partnership (being in a marriage or civil union with another, or with a person connected by blood relationship to the other – that is, in-laws or stepchildren); or
- adoption (being one who has been adopted as the child of the other or as the child of a person who is within the third degree of relationship to the other).

4.11 This definition of relative is very wide and, for example, would include first cousins and great nephews. To determine the degree of blood relationship (that is, consanguinity) between two persons, the Commissioner follows the procedure of counting the steps back from one of those persons to a common ancestor and then the steps forward to the other person. If there are not more than four steps the two persons are treated as being within the fourth degree of relationship and therefore are relatives under the general definition of that term. This procedure is illustrated in Example 14.

EXAMPLE 14



Harry and Sally are first cousins. They are within the fourth degree of blood relationship because there are not more than four steps between them:

- 1 – back from Harry to Harry’s parents
- 2 – back to Harry’s grandparents (the common ancestor)
- 3 – forward to Sally’s parents
- 4 – forward to cousin Sally.

4.12 A relative is also defined for the purposes of paragraph (c) of the section OB 1 definition of relative as including “a trustee of a trust under which a relative has benefited or is eligible to benefit” (through a trustee extension contained in paragraph (d) of the relative definition).

- 4.13 The definition of relative which applies for the purposes of the section OD 8(3)(d) relatives test (paragraph (a) of the definition of “relative” in section OB 1) is significantly narrower than the general definition which applies for the purposes of the associated persons definitions in sections OD 7 and OD 8(1). First, persons are connected by blood relationship if they are within the second (rather than fourth) degree of relationship. Secondly, persons are connected by adoption if one has been adopted as a child of the other or as a child of a person who is within the first (rather than third) degree of relationship to the other.
- 4.14 The relatives test in paragraph (c) of the section OD 8(4) definition of associated persons is much narrower than the other relatives tests and only applies to the spouse or infant child (or trustee of a trust under which that spouse or infant child has benefited or is eligible to benefit) of a person.
- 4.15 Officials consider that the narrower definition of relative in paragraph (a) of the section OB 1 definition is the better definition to adopt for purposes of the associated persons definition. This is because connection between relatives outside the two degrees of relationship used in the paragraph (a) definition of “relative” is not sufficiently strong to justify treating them as associated persons. The definition of relative in paragraph (c) of the section OB 1 definition is probably too wide to make it readily enforceable by the Commissioner (extending as it does to great nephews), and would also be too wide for taxpayers themselves to monitor, making self-assessment difficult.
- 4.16 The new section OB 1 definition of relative based on the existing paragraph (a) should incorporate the “trustee of a trust under which a relative has benefited or is eligible to benefit” extension currently found in paragraph (d).
- 4.17 We believe that the narrow range of relatives (spouses and infant children only) in the relatives associated persons test (section OD 8(4)(c)) currently applying for the purposes of the land transaction provisions should continue to apply for those provisions.
- 4.18 It should be noted that the definition of relative has been extended to include de facto spouses as a part of the amendments made by the Income Tax Amendment Act 2005, with application from 1 April 2007. The current non-application of the relatives associated persons test to de facto spouses is somewhat anomalous given that there would typically be a much closer relationship between de facto spouses than there would be between first cousins or great nephews.

Replacement of “related person” definition with “associated persons” definition

- 4.19 Section CD 33(15) to (17) contains a definition of “related person” which mainly relates to determining the amount of the capital gain exclusion from the dividend definition arising from the realisation of a capital asset in the course of a company’s liquidation.

- 4.20 As with the specific associated persons definitions, the definition of “related person” in section CD 33(15) to (17) was probably originally introduced as an ad hoc response to the perceived shortcomings in the general definition of associated persons. The need for a separate related parties definition for dividend exclusion purposes should no longer exist if a standardised, more robust associated persons definition is enacted. For example, the reference in section CD 33(15) to the right to acquire shares in a specified company would be covered by the application of the voting interest concept (employed in the two companies and company-individual tests) to options.
- 4.21 It would seem possible to replace the “related person” definition in section CD 33(15) to (17) with the standardised definition of associated persons suggested in this paper. The two definitions are conceptually similar and the replacement would constitute a significant simplification measure.

Repeal of section OD 1

- 4.22 Section OD 1 of the Act defines when a company is deemed to be under the control of any persons. This company control definition can be traced back to 1939 in the income tax legislation.
- 4.23 Although it was used extensively before 1994, section OD 1 now has a relatively limited role and only four sections continue to use its company control definition. Those sections are:
- Under section GD 10, a lessor is treated as having derived an amount equal to the market rental of a property that the lessor has leased to related parties for an inadequate consideration. The provision is mainly of an anti-income splitting nature. Section GD 10(4) defines a “related company” as a company that is under the control of the lessor or any relative.
 - Section NG 14 is an anti-avoidance provision designed to prevent non-resident shareholders of New Zealand-resident companies avoiding NRWT by the technique of dividend stripping. The provision mainly applies when the shares in a New Zealand company under the control of a non-resident are sold to another New Zealand company which the non-resident also controls. If any part of the purchase price for those shares is unpaid, any dividend paid by the first New Zealand company to the second New Zealand company is treated as being derived by the non-resident and therefore subject to NRWT. The provision prevents the retained earnings of a New Zealand-resident company being accessed by a non-resident without incurring NRWT and, together with section GD 10, represents the most important application of section OD 1.
 - Section DP 8 is a forestry expenditure provision which applies to a company carrying on a forestry business (a “forestry company”) on land acquired partly from the Crown, partly from Māori owners, and partly from a holding company of that company. A “holding company” is defined in section OB 1 for purposes of section DP 8 as a company which has a forestry company under its control.

- Under section FZ 1 a company is allowed a deduction for dividends paid on the specified preference shares of that company. The section does not apply to companies under the control of non-residents. Section FZ 1(3) provides that for the purposes of section FZ 1, section OD 1 has effect as if the term “50 percent” were replaced by the term “25 percent”. As section FZ 1 applies only to shares issued between 22 May 1975 and 23 October 1986, it is now of limited relevance.
- 4.24 It would be a desirable simplification measure if section OD 1 was repealed, with its function in the four operative provisions being performed by the proposed standardised associated persons definition.
- 4.25 The definition of company control in section OD 1 and the definitions of associated persons in the Act are conceptually similar in that they define related parties for purposes of operative provisions in the Act. The separate use of the section OD 1 company control definition rather than the associated persons definitions is probably a legacy of the company control definition being developed in the Act before the associated persons definitions. As mentioned above, the company control definition in the Act was developed from 1939 whereas the first associated persons definition in the Act was not enacted until 1968.
- 4.26 We therefore suggest that section OD 1 should be subsumed by the standardised definition of associated persons. It is desirable from a simplification perspective for similar concepts in the Act to be addressed in a single provision.
- 4.27 Some provisions in other Acts use section OD 1 of the Income Tax Act 2004. The provisions are:
- Section 3(4) of the Unit Trusts Act 1960 prevents one of two companies from being appointed manager of a unit trust while the other is appointed the trustee of the unit trust if the two companies are treated under section OD 1 as being controlled by the same person.
 - Section 74(4) of the Insolvency Act 1967 provides that where, in accordance with section OD 1, a company is treated as being under the control of the bankrupt and certain other persons, the official assignee may be authorised by the Court to examine the records of the company and to examine on oath any shareholder about the affairs of the company.
 - For the purposes of the Trustee Companies Management Act 1975, a company is considered to be associated with another company if, under section OD 1, the two companies are “deemed to be under the control of substantially the same persons or to consist of substantially the same shareholders”. This reference is out of date because it uses the language in section OD 1 before it was amended in 1994.

- For the purposes of the Public Service Investment Society Management Act (No. 2) 1979, a company is considered to be associated with another company if, under section OD 1, the two companies are “deemed to be under the control of substantially the same persons or to consist of substantially the same shareholders”. Again, this reference is out of date because it uses the language in section OD 1 before it was amended in 1994.

4.28 In light of the redundant terminology that many of these provisions use and the suggestion in this paper that section OD 1 be subsumed by a standardised definition of associated persons, it would be sensible for the provisions listed above to also use the standardised associated persons definition in the Income Tax Act 2004.

Clarifying application of section OD 7(1)(b) to corporate trustees

4.29 Section OD 7(1)(b) associates a company and a person other than a company when the person holds 25 percent or more of the voting interests (or market value interests) in the company. It is the policy intention that the corporate look-through rules applying to voting and market value interests in sections OD 3(3)(d) and OD 4(3)(d) do not apply to a corporate trustee (not being a bare trustee). It is therefore not necessary to trace the voting interests (or market value interests) held by a corporate trustee through to the shareholders of that corporate trustee (*Tax Information Bulletin*, Vol. 3, No. 7, April 1992, page 23). Given the non look-through treatment of voting interests held by corporate trustees, it is the practice to treat a corporate trustee as a person other than a company for the purpose of section OD 7(1)(b) (and the equivalent tests in the specific definition of associated persons). The wording of the suggested standardised associated persons definition should make this treatment clear.

Omit “income interests” test in section OD 8(3)(a)(ii)

4.30 To facilitate a standardised definition of associated persons, the two-companies test in section OD 8(3)(a)(ii), which is based on income interests, should be omitted as it would appear to be redundant given the two-companies test based on voting interests. The existence of this income interest test can probably be explained by the fact that it preceded the voting interest concept. However, this income interest-based test is no longer necessary as a result of the comprehensive voting interest-based test.

Removal of “habitually acting in concert” test

4.31 Two persons are treated as associated persons under section OD 8(3)(j) if they habitually act in concert in relation to the holding or exercise of the items listed in section EX 5(1), which defines direct control interests.

- 4.32 This test would appear to target persons who are not formally associated in the sense of shareholding thresholds (that is, the shareholding threshold-based two companies and company-individual tests) or defined status (for example, trustee-beneficiary or relatives tests), but who nevertheless have a sufficient connection (by virtue of them consciously acting together on a regular basis) to justify treating them as associated.
- 4.33 Officials consider that the Commissioner would face considerable evidentiary problems in having to show that two parties have acted in concert on a regular basis before the section OD 8(3)(j) test can be applied. In addition, the test creates uncertainty for taxpayers and the Commissioner because what constitutes “habitually acting in concert” is uncertain.
- 4.34 We therefore consider that the test should be removed from the Act for simplification and rationalisation purposes.

Simplifying the second partnership test

- 4.35 The second partnership test in sections OD 7(1)(d)(ii) and OD 8(3)(f) specifies that a partnership and any person are associated if that person is associated with a partner in the partnership under any of the other provisions in those definitions. The second partnership test in sections OD 8(1)(e) and OD 8(4)(e) does not contain that restriction and can apply when a person is associated with a partner in a partnership under any of the provisions in those definitions. Officials consider that the first approach employed in sections OD 7(1)(d)(ii) and OD 8(3)(f) is unnecessary as it is not possible for the second partnership test to operate in a reiterative manner. Accordingly, the second partnership test in the suggested standardised definition of associated persons does not need an express exclusion. This allows the drafting of the provision to be simplified.

Relocation of employee-benefit trust exceptions

- 4.36 Paragraphs (g), (h) and (i) of section OD 8(3) contain exceptions to the existing trustee-beneficiary, two trustees with a common settlor, and trustee-settlor tests. Thus, the tests do not apply when a trust is settled solely for the benefit of the employees of an employer. The suggested standardised definition of associated persons should retain the employee-benefit exceptions.
- 4.37 The existing exceptions are wordy and repetitive. Given the employee-benefit trust exceptions’ relatively minor nature in the context of the trust-related associated persons tests, the exceptions would be better located in a separate subsection in the standardised definition so that their extensive detail does not obscure the tests themselves.

Omit section OD 8(1)(h) test

- 4.38 The section OD 8(1)(h) test associating a person and a friendly society, charity, or non-profit body controlled by that person or a relative of that person should be omitted in the suggested standardised associated persons definition. The test is unnecessary given the other extensive associated persons tests applying to companies and trusts.

Omit section CD 5(1)(a)(iii)

- 4.39 Section CD 3 states that a transfer of value from a company to a person is a dividend if the cause of the transfer is a shareholding in the company, as described in section CD 5. Section CD 5(1)(a)(iii) contains a trust extension rule which treats as a dividend any distribution made by a company to a trust under which a shareholder of the company, or spouse or civil union partner of the shareholder, is a beneficiary.
- 4.40 The wording of the trust extension rule in section CD 5(1)(a)(iii) catches the situation where a shareholder of the company is also a beneficiary under a trust and the company makes a payment to a trustee of the trust.
- 4.41 Section CD 5(1)(a)(iii) can be omitted because its function will be subsumed by the suggested standardised associated persons definition⁵ – in particular, the trustee-beneficiary test.

Section CD 14(9) amendment

- 4.42 The definition of “fifteen percent interest reduction” in section CD 14(9), which is relevant to the share buy-back exclusion from the dividend definition, refers to “counted associate” which is defined inter alia as “a trustee of a trust under which a spouse, civil union partner or minor child of the shareholder is a beneficiary”. The wording should be amended to be made consistent with other references in associated persons definitions which describe discretionary beneficiaries. Therefore, the relevant part of the definition of “counted associate” in section CD 14(9) should be amended to read as follows:

“a spouse, civil union partner or minor child of the shareholder, or a trustee of a trust under which a spouse, civil union partner or minor child of the shareholder has benefited or is eligible to benefit”.

⁵ In conjunction with section CD 5(1)(a)(ii).

Section DB 33(2) amendment

4.43 Section DB 33(1) allows a taxpayer a deduction for any loss arising through misappropriation by an employee. Section DB 33(2) states that this deduction is not available where the taxpayer and the defalcating employee are associated in certain respects. These associated persons situations are where:

- “(a) the person who misappropriates the property is a relative of the person who carries on the business; or
- (b) the business is carried on by a company, and—
 - (i) the company and the person who misappropriates the property are associated persons; or
 - (ii) the company and a relative of the person who misappropriates the property are associated persons; or
- (c) the person who carries on the business is a trustee of a trust, and the person who misappropriates the property either created the trust, settled property on the trust, or is a beneficiary of the trust.”

4.44 Under the suggested standardised definition of associated persons, it would seem that the above references could be simply replaced with a reference to:

“Nothing in subsection (1) shall apply to any misappropriation of property of any kind by any person in any case where that person is associated with the person who carries on the business.”

4.45 The standardised definition would be comprehensive enough to cover all the relationships mentioned in the current section DB 33(2).