

ASSOCIATED PERSONS TEST – TIMING IN RELATION TO GROSS INCOME DERIVED FROM THE SALE OR OTHER DISPOSITION OF LAND

PUBLIC RULING - BR Pub 00/05

This is a public ruling made under section 91D of the Tax Administration Act 1994.

Taxation Laws

All legislative references are to the Income Tax Act 1994 unless otherwise stated.

This Ruling applies in respect of paragraphs (b), (c), and (d) of section CD 1(2).

The Arrangement to which this Ruling applies

The Arrangement is the sale or other disposition of land by a taxpayer who is associated with another person.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- For the purposes of determining whether any amount derived from the sale or other disposition of land is included in the gross income of any taxpayer by virtue of paragraphs (b) to (d) of section CD 1(2), the test of whether a taxpayer and another person are associated persons is applied only at the time of the acquisition of the land. The test of association is not applied at the time of the sale or other disposition of the land.

The period for which this Ruling applies

This Ruling will apply for the period from 1 July 2000 to 30 June 2003.

This Ruling is signed by me on the 14th day of June 2000.

Martin Smith

General Manager (Adjudication & Rulings)

COMMENTARY ON PUBLIC RULING BR Pub 00/05

This commentary is not a legally binding statement, but is intended to provide assistance in understanding and applying the conclusion reached in Public Ruling BR Pub 00/05 (“the Ruling”).

Background

Paragraphs (b) to (d) of section CD 1(2) include within the gross income of a taxpayer any amounts derived from the sale or other disposition of land if the taxpayer, or any other person associated with the taxpayer, carried on certain businesses at the time the land was acquired.

For the purposes of section CD 1, associated persons or persons associated with each other are defined in section OD 8(4). Section OD 8(4) was amended by the Income Tax Act 1994 Amendment Act (No 4) 1995 (“the amendments”). The definition was extended to ensure that discretionary beneficiaries fall within the trustee-beneficiary relationships included in the definition.

During the course of the related Bill, a submission was made raising the issue of whether the changes to the definition of associated persons would have any effect in relation to land acquired before the changes were made. While the amendments came into force on 17 August 1995 (the date of the Bill’s introduction), the submission queried whether the changes would have any effect in the case of an amount derived from the sale of land acquired before that date. The amendments to the definition would only apply to land acquired before 17 August 1995 if the test of association in paragraphs (b) to (d) of section CD 1(2) applies at the time the land is disposed of. If the test of association under paragraphs (b) to (d) applies at the time the land is acquired, the amended definition of associated persons would only apply in relation to land acquired after 17 August 1995.

The Ruling confirms that the test of association under paragraphs (b) to (d) of section CD 1(2) applies at the time the land is acquired. The changes to the definition of associated persons will therefore only apply to land acquired on or after 17 August 1995.

This question is important in general terms (i.e. not just because of the changes made to the definition of associated persons) because in many cases a taxpayer may be associated with a person at the time of acquisition of land, but may not be associated with the person at the time of the sale or disposition of the land (and vice versa).

A number of commentators have expressed their view as to the timing of the test of association in section CD 1(2)(b) to (d), but there seems to be uncertainty as to the correct view. This uncertainty stems from the wording and tenses used. The Commissioner’s view is, and always has been, that the test of association is applied at the time the land was acquired.

Legislation

Section CD 1(1) states:

Any amount derived from the sale or other disposition of any land, being an amount to which this section applies, is gross income.

Section CD 1(2) sets out the amounts that are included in the gross income of any person under section CD 1(1):

For the purposes of subsection (1), the gross income of any taxpayer includes the following amounts –

...

- (b) Any amount derived from the sale or other disposition of any land where the taxpayer, or any other person where the taxpayer and that other person **are associated persons**, carried on, at the time the land was acquired, the business of dealing in land, and –
 - (i) That land, which was sold or disposed of by the taxpayer, was acquired by that taxpayer for the purpose of that business of dealing in land; or
 - (ii) That land was sold or disposed of by the taxpayer within 10 years after the date on which it was acquired by the taxpayer:
- (c) Any amount derived from the sale or other disposition of any land where the taxpayer, or any other person where the taxpayer and that other person **are associated persons**, carried on, at the time the land was acquired, the business of developing or dividing land into lots, being development or division of the kind (not being work of a minor nature) referred to in paragraph (f), and –
 - (i) That land, which was sold or disposed of by the taxpayer, was acquired by that taxpayer for the purpose of that business of developing or dividing land into lots; or
 - (ii) That land was sold or disposed of by the taxpayer within 10 years after the date on which it was acquired by the taxpayer:
- (d) Any amount derived from the sale or other disposition of any land, where the taxpayer, or any other person where the taxpayer and that other person **are associated persons**, carried on, at the time the land was acquired, the business of erecting buildings, and the taxpayer or that other person carried out, whether before or after the acquisition of that land by the taxpayer, any improvements, not being improvements of a minor nature, to that land (whether by way of erecting a building or otherwise); and
 - (i) That land, which was sold or disposed of by the taxpayer, was acquired for the purpose of that business of erecting buildings; or
 - (ii) That improved land was sold or disposed of by the taxpayer within 10 years after the date on which those improvements were completed.

... [Emphasis added]

Section OD 8(4) defines “associated persons or persons who are associated” for the purposes of section CD 1.

Application of Legislation

Paragraphs (b), (c), and (d) of section CD 1(2) all use the same phrase in bringing to tax, “Any amount derived from the sale or other disposition of any land where the taxpayer, or any other person where the taxpayer and that other person are associated persons, carried on, at the time the land was acquired, the business of ...”.

The question is raised as to whether the use of the words “are associated persons” means that in order for the provisions to be satisfied the test of association is applied:

- At the time of acquisition of the land by the taxpayer: e.g. this requires a person who carried on the business of dealing in land at the time the taxpayer acquired the land to have been associated with the taxpayer at the time the land was acquired (but that person would not necessarily be associated with the taxpayer at the time of disposition); or
- At the time of disposition: e.g. this requires a person who carried on the business of dealing in land at the time the taxpayer acquired the land to be associated with the taxpayer at the time the land was disposed of (but that person would not necessarily have been associated with the taxpayer at the time of acquisition); or
- At the time of acquisition and at the time of sale or other disposal: e.g. this requires a person who carried on the business of dealing in land at the time the taxpayer acquired the land to have been associated with the taxpayer at the time the land was acquired and also to be associated with the taxpayer at the time the land is disposed of.

Plain words

On an ordinary reading of the words of the legislation, it seems clear that the phrase “at the time the land was acquired” relates to the carrying on of the relevant business, rather than to the timing of the associated persons test.

However, it is not clear as to the point in time that the words “are associated persons” are referring to. The word “are” generally indicates a present tense and, therefore, arguably indicates that the test should be applied at the most recent point in time (i.e. the time of the disposal of the land). However, another reading of the words indicates that the test should be applied at the time of acquisition.

The meaning of the words without the presence of an associated person is clear:

- An amount will be gross income if:
 - a taxpayer derives that amount from the sale or other disposition of land,
 - the taxpayer was carrying on the relevant business when the land was acquired, and
 - the land was acquired for that business or sold within 10 years of acquisition.

There are three elements to the section. First, an amount must be derived from the sale or disposition of land. Second, the taxpayer must have been carrying on the relevant business at the time the land was acquired. Third, the land must have been acquired for that business or sold within 10 years.

Arguably the second element is the most important. The fact that the taxpayer was carrying on the relevant business at the time the land was acquired is central to the issue of the taxability of any amount derived on the sale of the land. For example, if the taxpayer were not carrying on a business of dealing in land, any amount derived would not be taxable under section CD 1(2)(b). However, if the taxpayer were carrying on such a business, any amount derived would be taxable if the land was either acquired for the business or sold within 10 years.

If the land was acquired for the purpose of a relevant business, it is logical that any amount derived from the sale of the land would be taxable. This is entirely consistent with the fact that any amount derived from a business is gross income under section CD 3. However, where the land was not acquired for the purpose of such a business, any amount derived would still be taxable if the land was sold within 10 years. In this situation, it is simply the fact that the taxpayer carried on the relevant business that leads to the inclusion of the amount derived within gross income. All acquisitions of land by the taxpayer are tainted by the existence of the business, regardless of whether the land is acquired as part of that business.

Now consider the effect of the section where an associated person is involved:

- An amount will be gross income of a taxpayer if:
 - the taxpayer derives that amount from the sale or other disposition of land,
 - an associated person of the taxpayer was carrying on the business of dealing in land when the taxpayer acquired the land, and
 - the land was sold by the taxpayer within 10 years of acquisition.

Again, there are three elements to the section. First, an amount must be derived from the sale or other disposition of the land. Second, an associated person of the taxpayer must have been carrying on the business of dealing in land when the taxpayer acquired the land. Third, the land must have been sold within 10 years of acquisition.

In a situation where an associated person is involved, the central focus of the section is even more clearly the fact that a relevant business, such as dealing in land, must have been carried on at the time the land was acquired. As it is the associated person who was carrying on the required business at the time of acquisition, the taxpayer could not have acquired the land for the purposes of the business. In these circumstances the amount derived will only be taxable if the land is sold within 10 years. It is only the existence of the business at the time of acquisition that allows the section to include the amount derived on sale in the taxpayer's gross income. The taxpayer is effectively tainted by the activities of the associated person at the time the land was acquired.

The section, therefore, is concerned with what was happening at the time the land was acquired – was an associated person of the taxpayer carrying on a business of dealing in land? It would seem that in these circumstances it is logical to argue that the associated person must have been associated with the taxpayer when the land was acquired. To separate the associated persons test from the test of the relevant business is an artificial interpretation of the section. Although the section is including in gross income amounts derived on sale, the focus of the section is on the activities of either the taxpayer or the associated person **at the time the land was acquired**.

The time of sale or other disposition of the land is certainly important in the context of section CD 1. The time of the sale of the land is the time at which the application of the section is triggered. However, once the application of the section is triggered by the sale of the land, the focus of the section is clearly on the activities which took place at an earlier time. The mere fact of the sale of the land is insufficient to include any amount derived from that sale in a taxpayer's gross income. The scheme and purpose of the provisions is not simply to bring to tax amounts derived on the sale of property. There must be some other relevant purpose or intention, some other relevant action on the part of the taxpayer or associated person, or some link with business activities, before any amount will be included in gross income.

However, as it is not completely clear on the plain reading of the words that the test is applied at acquisition, relevant case law should be considered.

The question as to the relevant time for testing association does not appear to have been directly considered by any New Zealand court. However, there is implicit support for the view that the test of association is applied at the time the land was acquired in some TRA cases.

For example, in *Case H92* (1986) 8 NZTC 630, the TRA considered whether the objectors were assessable on the profit made on the sale of land, A, under any of sections 65(2)(a) and 67(4)(a), (b) and (e) of the Income Tax Act 1976. On concluding that the objectors were not dealers in land at the time the land was acquired, the issue was then whether an associated company, P, was dealing in land when the relevant land was purchased by the taxpayer. The TRA found that the company's activities did not constitute the business of dealing in land at the time of purchase. Although the TRA did not specifically consider the time at which the parties needed to be associated, the judgment appeared to assume that this was at the time of acquisition. Bathgate DJ said (at page 642):

The thrust of cross-examination of the objectors concerning P was to show that it was involved in erecting buildings **when A was purchased** by the objectors. **At that time** P and the objectors were associated persons for the purposes of sec 67(4)(b) and (c). [Emphasis added]

More recently, *Case T25* (1997) 18 NZTC 8,160 concerned whether a taxpayer was assessable on the proceeds of the sale of a commercial property. The question to be answered by the TRA was whether, on the date of acquisition by the objector of his interest in the commercial property, the objector carried on any business of developing or dividing land into lots or whether on that date any associated person of the objector (i.e. the CC Partnership or the R Syndicate) carried on such a business.

Although the timing of the test of association is not specifically referred to by Barber DJ, his Honour makes it clear that he considers the time of acquisition to be the appropriate time and he proceeds on that basis. When discussing whether the objector was a developer or subdivider as at the date of acquisition of the property, his Honour stated (at pages 8,174 – 8,175):

However, as at 17 October 1978 only two relevant projects had been undertaken. One subdivisional project (of residential land) had been completed and the other was a building project so that, at that date, the objector could not be described as carrying on the business of developing or dividing into lots ‘any land’ and **nor was any associated person of the objector at that time.**

I appreciate that the CC Partnership and the R Syndicate each commenced in 1974 and ended in late 1979; but on the crucial date, 17 October 1978, the nature of their activity did not offend s 67(4)(ba). [Emphasis added]

Barber DJ’s statement that the CC Partnership and R Syndicate ended in 1979 impliedly gives strong support for the proposition that the time for the test of association is at acquisition. In this case the property in question was disposed of in 1988. In these circumstances, if the test of association were to be applied at the time of disposal the above comments by Barber DJ would have been irrelevant.

Notwithstanding the above statements, it is clear that the issue of the timing of the test of association was not argued in *Case H92* or *Case T25*. Case law, therefore, provides limited guidance on the interpretation of the words “are associated persons” in the context of land sales.

However, case law does indicate that one should be careful in the interpretation of tenses. The use of a tense may be decisive only if it is clear what the tense used relates to. For example, in *Maradana Mosque Board of Trustees v Mahmud* [1967] 1 AC 13, the Privy Council considered a provision that empowered the Minister to make a certain order if satisfied that a school “is being administered” in contravention of the Act. Counsel for the Minister argued that it was permissible to take account of the past running of the school. The Privy Council held that only the current method of administration at the time of the order could be considered.

By way of contrast, in *Norman v Simpson* [1946] 1 All ER 74 the United Kingdom Court of Appeal needed to interpret the words “have been” and concluded that the expression could be equated to “are” or “is” in the context before the Court. In that case the use of the words “have been” did not limit the Court to considering only the point in the past at which the sub-letting commenced. In relation to section CD 1(2), it can be argued that the use of the word “are” does not necessarily limit the inquiry to the present time and that it could be interpreted as operating in the past tense.

The approach of the courts has been that if the use of a tense is not clear or is ambiguous, other sources such as the statutory context and the scheme and purpose of the legislation will be used as aids in determining the correct interpretation. This approach is also consistent with the Court of Appeal’s approach to statutory interpretation set out in *CIR v Alcan New Zealand Ltd* (1994) 16 NZTC 11,175.

Section GD 9(1)

The associated persons test is used in many provisions of the Revenue Acts. Generally, these provisions are unhelpful for present purposes as it is obvious in most cases that the associated persons test relates to only one point in time. However, section GD 9(1) is relevant here because it is closely related to the provisions currently being considered. Section GD 9(1) deals with the situation where a person transfers land to an associated person some time after acquisition.

Section GD 9(1) is in the nature of an anti-avoidance provision, and applies where land is transferred from a “transferor” to a “transferee” and the transferor and the transferee “are associated persons”. If the transferee later sells or otherwise disposes of the land, any amount derived from the transaction is gross income of the transferee if that amount would have been gross income of the transferor under section CD 1(2).

Section GD 9(1) states:

Where –

- (a) Any land has been transferred from any person (the “transferor”) to any person (the “transferee”); and
- (b) The transferor and the transferee are associated persons; and
- (c) The transferee subsequently sells or otherwise disposes of that land and the consideration from that sale or disposition exceeds the cost of the land to the transferee; and
- (d) If, had the transferor not transferred the land to the transferee but instead had sold or otherwise disposed of the land for the consideration referred to in paragraph (c), that consideration would have been gross income of the transferor under section CD 1 – that consideration shall be deemed to be gross income of the transferee under section CD 1.

Thus, section GD 9(1), like section CD 1(2), also uses the phrase “are associated persons” in a context where its meaning could be ambiguous. The section is concerned with the situation of a property being disposed of at a profit or gain, i.e. something that happens in the present and triggers the application of the section. However, the section also refers to the earlier transfer from the transferor to the transferee who “are associated persons”.

In section GD 9(1), the words “are associated persons” clearly relate back to the earlier time of the transfer from the transferor to the transferee, rather than the present time of the disposal of the land. The words “are associated persons” are followed by “and the transferee **subsequently** sells or otherwise disposes of that land”. The use of the word “subsequently” denies any connection to the event of disposal to the words “are associated persons”. The section, therefore, is an example of words in a present tense being used to relate to a past event.

Section GD 9(1) clearly supports the conclusion that “are associated persons” does not necessarily mean associated at the most recent point in time, i.e. the time of disposal, but can be interpreted as “were associated persons”. In the case of section GD 9(1), this means looking back to the time of acquisition by the relevant taxpayer, i.e. the transferee.

Legislative purpose

The use of the associated persons test in section CD 1(2) is essentially for anti-avoidance reasons and aims to stop the use of associated persons who are not carrying on any relevant business. This was referred to in the Parliamentary Debates in 1973 on the Land and Income Tax (Annual) Bill (which contained the predecessor provisions to section CD 1). Mr Munroe (MP, Invercargill) explained the difficulties in applying the then current law on the taxation of profits relating to land and the need for amendment, and stated (NZPD Vol. 386, 1973: 3653):

There is a provision in the [Land and Income Tax] Act which makes dealing in real or personal property for profit or gain assessable for tax. The Inland Revenue Department has had difficulty with this provision because of interpretations of it by the courts. The courts have tended to take the view before they will uphold an assessment, that as there is no capital gains tax in New Zealand there must be a clear pattern of previous dealings, or the circumstances must be such as to leave an inference that a profit motive was present at the time of purchase. In cases where the taxpayers have been land dealers or builders they have been able to avoid assessment of profits on property deals by claiming quite successfully that the property was held as an investment even if the sale was made shortly after acquisition. **In other cases the land dealers or builders have held properties in the names of members of their families or in associate companies for the purpose of avoiding tax on the sale of the properties.** [Emphasis added]

If the intention were to prevent dealers in land using associates (who are not dealers) to acquire the land, one would expect that the relevant association would need to be examined at the time of acquisition. The intention behind the provisions of section CD 1(2) would seem to be to make it more difficult for a person who is carrying on one of the specified businesses to hide behind associated persons. If the test of association applies only at the time of disposal, this would mean that associated person purchasers of land who are “substituted” for land dealers could avoid being taxed where the association was technically terminated immediately before the disposal of the land.

Furthermore, if the association test applies only at the time of disposal, it would apply to persons who happen (by way of “accident” or otherwise) to become associated with, for example, a land dealer just prior to their disposing of property where no taxable purpose or connection previously existed.

In addition, the anti-avoidance policy would tend to suggest that the possible interpretation of applying the association test at both acquisition and disposal is also incorrect. As such an interpretation would also require the test to be applied at disposal, the concerns expressed above would be equally applicable to that interpretation.

Conclusion

In paragraphs (b), (c), and (d) of section CD 1(2), on an ordinary reading of the words “are associated persons”, the time at which the test of association must be applied is ambiguous. However, the scheme and purpose of the provisions indicate that the correct interpretation is that the test of association is applied at the time the land is acquired by a taxpayer. The Commissioner considers this to be the better view of the law. The test is not applied at the time of sale or other disposition of the land, nor

must it be applied at both the time of acquisition and at the time of sale or other disposition.