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Briefing note

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cc: Peter Mersi, Commissioner
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From: Felicity Barker, Steve Mack

Subject: **Approach to related persons in High Wealth Individuals Project**

Background

1. The Minister of Revenue has asked us to explain the treatment of related persons in the High Wealth Individuals (HWI) research project, and how and why it differs from the treatment of associated persons in the Income Tax Act 2007 (ITA).

Discussion

General reasons for associated person rules in the ITA

2. Special rules regarding related persons (called “associated persons” in the ITA) are used for a number of purposes in the ITA. Some of these are:

Deeming transactions done by an associated person to be done by the taxpayer

3. For reasons of certainty, and in order to reduce tax avoidance opportunities, the ITA has provisions which deem a transaction done by an associated person to be done by the taxpayer or taxed in a similar way. One example of this is deeming a company distribution made to an associated person of the taxpayer/shareholder to be made to the taxpayer/shareholder when it results in a dividend.

Ignoring transactions done between associated persons

4. Transactions that could give rise to a tax benefit may be ignored when done between associated persons in order to prevent such transactions being done primarily for tax reasons. An example of this is a sale of depreciable property to an

associated person for a non-taxable capital gain may not give rise to a higher tax depreciation base to the extent of the non-taxable capital gain amount.

Combining interests owned by associated persons to determine if tax thresholds apply

5. Some tax rules provide that certain tax treatments may not apply if the taxpayer owns more than a certain amount of asset. In order to prevent such thresholds being defeated by dividing holdings among associated persons, the amounts held by associates may be aggregated in applying the threshold. An example of this is a rule for portfolio investment entities (PIEs) that no investor may own more than 20% of the fund. This requires interests of investors who are associated with each other to be aggregated to determine if the threshold is breached.

Categories of associated persons

6. The ITA has the following categories of associated persons:

- **Relatives –** persons within two degrees of blood relationship (parents, grandparents; children, grandchildren; siblings), and marriage and de facto partners;
- **Companies** – two or more companies with at least 50% common voting (or similar) ownership;
- **Company and non-corporate shareholder** – a company and a person owning at least 25% of the company;
- **Trusts** – settlors, trustees appointers and beneficiaries are associated in different ways with each other.

7. The associated person provisions are broad, and when they are used they are often limited as some relationships may not be relevant for different provisions.

Related persons for the wealth project

8. The High Wealth Individuals survey and methodology does not have a central definition of related persons. Instead, treatment of related persons is incorporated into the general approach. The principles followed were designed for the purposes of the project, rather than the factors outlined above, therefore with an eye to economic rather than tax-based relationships.

9. The most important of these are:

- Family;
- In-scope disclosed trusts; and
- In-scope entities.

Family

10. Family members are defined as the high wealth individual, their domestic partner, and dependent children. "Family" is used as the unit analysis in addition to individuals (similar to "household" used for similar analyses). "Family" is also used to aggregate interests of family member to determine if the ownership threshold for an in-scope entity is met. "Family" is narrower than the concept of relatives in the ITA associated persons provision, in that adult relatives are not included, similar to international statistical precedents for defining a household.

Trusts

11. Trusts must be disclosed when their income could be relevant to determining the effective tax rate (ETR) of an HWI or member of their household (family). A trust must be disclosed if a family member is a settlor, appointer or beneficiary of the trust, and the trust meets the materiality threshold (at least $1 million of gross assets). This is similar to the broad approach towards determining when a trust is an associated person in the ITA.

Entities

12. Entities (mostly companies) must be separately disclosed when they are material in assets and control relative to the household (family). This means, their gross assets are at least $1 million, and they are at least 10%-owned by family members (either directly or indirectly see below). In determining this, ownership interests of the family members are aggregated, together with ownership interests of disclosed trusts in the entity. This is broader than the shareholder test used in the ITA for associated persons. That requires a 25% ownership threshold, while this is 10%. That is because the ITA is concerned with transactional control of the company, while the 10% test is concerned with materiality to the ETR calculations and availability of information for the disclosure.

13. There is also an analogue to the concept of two or more companies being associated with each other, in that the HWI survey requires disclosure of *indirect ownership* of an entity (except an indirect interest in a partnership). This applies if that entity meets the asset requirement, and the 10% ownership requirement by tracing a chain of ownership through other entities up to a family member or disclosed trust.

14. Entities that do not meet these thresholds are included in the family's porfolio assets.

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