# A report to Property Investor Associations on the IRD Associated Persons Proposal

26 April 2007

Hello Property Investor Associations'

The Inland Revenue have put forward a paper on reforming the definitions of associated persons. This paper is primarily aimed at Developers, Builders and traders, but may also affect our property investor members.

Submissions on the proposal close on May 11. The NZPIF is putting forward a submission and wanted to make associations aware of this and help provide suggested guidelines for submissions that individual associations may wish to make.

This report is intended to provide the NZPIF's view of the IRD proposal and attempts to develop a unified response from the NZPIF and Property Investor Associations'.

The final NZPIF submission will be circulated to Associations' as soon as possible.

**Background**

At present, Property Traders and Property Investors who make occasional trades can have one structure for trading property (including paying income tax on their trades) with another structure to hold their long term rental properties. This stops the long term rentals from being tainted by the development properties and means that the rental property can potentially be sold without attracting tax on any profit made.

Legislators originally intended that property traders, builders and developers (traders) were to pay income tax on the profits they generated from these activities. To clearly demonstrate that any buy-and-hold rental properties they purchased were genuine, legislators required traders to hold the properties for at least 10 years. If these properties were sold within 10 years then they would attract tax on any profit they made when sold. Legislators also intended to restrict traders using associated people (including structures such as trusts and companies) to prevent traders using these people or entities to avoid the legislation.

loop-holes in the legislation meant that it was relatively easy for property traders to establish structures that circumvented the associated persons rules and allowed traders to own rental property and not have to pay income tax on profits made on sale even if they sold the property within 10 years. This has created the limited potential for property traders to make property trades and avoid paying tax on the income they receive from trading.

The purpose of the IRD proposal is to close these loopholes by tightening up the definitions of associated persons.

The primary intention of the IRD proposal is to make it impossible for property traders to own rental property in different structures and avoid paying tax on any profits they make if they sell the property within 10 years. They want to ensure that traders hold onto any rental property for at least 10 years to be exempt from paying income tax on any profits they make.

While property traders can still own rental property with no tax on sale if they hold it for at least 10 years, this does not provide them with the flexibility available to other property investors who are not traders, developers or builders. There are many reasons outside the trader’s control which may create the need to sell a property within 10 years. As an example, market conditions could change and make a sale and purchase of a different investment property more advantageous. The property trader could face situations of bankruptcy, illness or divorce and be forced to sell. The property could be compulsory required by council.

While the proposals are aimed at property traders, some property investors will also be affected. These are investors who are primarily property investors but make occasional trades (which incur a tax on the income they make through trading) then use these funds not as income but to reduce borrowings on their rental properties. These investors currently protect their rental properties by holding rental and trading properties in different entities. Under the proposals this would not be possible.

There are also some positive aspects to the proposals. There is a suggestion that limited partnerships be adopted so that unintended tainting of people with no real relationship to the trader is likely to occur.  This situation may happen where a trader owns shares in a company and therefore taints other shareholders in the company. Limited partnerships would not allow this to occur.

Another benefit of the proposals is to limit the definition of family blood lines to two. Presently the definition is spread through four different legislations and involves different definitions which go up to four family blood lines. This means that a niece or nephew could be tainted by the action of their trader uncle.

While there are two good points to the IRD proposal, the prime objective is to remove the ability of traders to own rental property in separate structures and therefore avoid the associated person rules. While this does not stop traders from owning rental property, it does mean that they will have to own the rental property for at least 10 years or it will be taxed on any profit on sale.

It is likely that the motivation behind these proposals is to make it more difficult for traders to purchase property.

A potentially related matter is pressure being applied to government from various lobby groups, including business associations and the financial industry, who would like to reduce interest in property and see a capital gains tax on investment property as a good thing.

**NZPIF considerations**

The NZPIF has established a four member task force to examine the IRD proposals and the likely effect on Property Investors Association members and the industry.

While the NZPIF does not believe that the prime intention of the proposals is warranted, we note that the proposals are actually aimed at property traders, a group that we have attempted to distance ourselves from over the years. We questioned whether Property Investor Associations should represent the interests of Property Traders?

If handled incorrectly, a submission by the NZPIF and associations that strongly rejects the proposals could blur the line between investors and traders.

However we also acknowledge that given the current low rental yield environment, property investors are using trading properties as a strategy to provide rental accommodation at a reasonable price to tenants while still providing a return for themselves.

We believe that this is a delicate situation as if we strongly criticise the proposal we could be seen as acting like traders rather than investors. Rather than seeing the advantageous of having a different tax treatment between investors and traders, Legislators could use this as a reason to apply a capital gains tax over all investment property.

While we do not want to see the proposals introduced, given the number of our members who would be affected and the ramifications of being affected (having to hold rental properties for ten years) we believe that these proposals are better than a broad capital gains tax on all investment property. Consequently this will influence the tone with which we make our submission.

**Points to be made in the NZPIF submission**

- An outline of the benefits of property investors not paying tax on capital profits. (primarily this is to keep rental prices down.)
- It seems reasonable that any NZ citizen should have access to the same tax treatment, regardless of their primary source of income.
- The existing laws, while providing options to traders that were unintended, are actually fair in that they allow the same tax opportunities to all.
- Holding a rental property for ten years does not give an investor freedom to manage their property in the most prudent manner. An investor may also have no option but to sell within a ten year timeframe due to unforeseen situations out of their control.
- A reduction in rental property yields over the years has made it difficult for investors to obtain cashflow positive or even cashflow neutral investments. While good for rental prices and tenants, this low return makes it difficult for investors to achieve a taxable income. One strategy that investors may apply is to occasionally trade property, pay tax on the profit and use the funds to reduce debt on rental property. This can have the affect of making the rental property profitable and increasing the level of tax paid to the Inland Revenue. It is also

no different than making an un-taxed profit on selling a business and using this to reduce debt and increase income in another business.

- Allowing a degree of flexibility to property investors will raise the tax take as it will ensure that investors can arrange their affairs in a manner that will maximise their income.

- If property traders flout current laws, their rental property structures can be deemed invalid and they will be taxed on income they make through trading.

- For practical reasons, we think that the status quo should remain in the interests of the rental property market and affordable rental prices.

- If legislation is intent on disallowing property traders to own rental property under the same tax conditions as other citizens, then the time frame for its introduction should be extended and the legislation should not be retrospective.

**NZPIF Recommendations**

1. Retain the status quo with the exception of limited partnerships and one definition that limits associated person blood lines from four to two.

2. Investigate the legislation that confirms traders should own rental property for ten years and seek to change it, thereby allowing structures to differentiate trading properties from rental properties.

3. Should the proposals be made into legislation, delay the implementation of any changes to the 2009/2010 tax year as many investors caught by the changes have long lead times for these types of projects.

4. Should the proposals be made into legislation, this legislation should not be retrospective, as many property investors and traders have made large investments establishing and maintaining structures under the current rules.

If you have any comments or suggestions, please contact me.

Kind regards

**Martin Evans**
President, NZPIF