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Your ref: Taxation of Trusts PUB00261

Our ref: 11115529_1.docx

Confidential

The Commissioner
Inland Revenue
By email: publicconsultation@ird.govt.nz

12 July 2017

Dear Madam

Taxation of Trusts: PUB00261

We respond to the request for comment on PUB00261.

We appreciate the opportunity to respond after the deadline. However, we have not, despite the extension, been able to do the detailed review that it warrants. Nor have we compared it to the 1989 TIB item that it is to replace. Our approach is to approach it as a stand-alone document which is intended to reflect the current law.

General comments

PUB00261 is comprehensive and affects many taxpayers. Its comprehensive nature is likely to mean it has limited use for those most affected – trustees and beneficiaries.

Much of the complexity arises from the extended definitions of settlor and the complications of foreign and non-complying trust status, and immigration and emigration. We therefore suggest that Inland Revenue consider restructuring the IS so that it deals separately and first with complying trusts which have only New Zealand resident trustees and beneficiaries. The complications can then be dealt with so that those affected can focus on the relevant issues of interpretation.

We expect the taxation of trusts to be a future focus. We understand that US connected trusts and estates are already creating issues following reporting under FATCA. Similar issues can be expected as other countries exchange information under the Common Reporting Standard with New Zealand.

It is important that the trust rules and their interpretation is as clear and certain as possible. It is also important that the rules are fair. We have noted tax policy issues for referral to Inland Revenue Policy Advice and Strategy ("IR PAS"). These are what could be considered to be interpretational issues. We have noted policy issues which may be taxpayer friendly which could also be usefully referred to IR PAS.

Specific comments

As previously, we have added specific comments/observations/suggestions directly on a tracked change version of PUB00261. The comments are a mix of observations, questions that arise from the item and technical and policy issues.

We trust that this approach makes the comments and our suggested wording changes clear.



Inland Revenue

12 July 2017

We would as usual be happy to discuss our response with you. Please contact me on 04 816 4518.

Yours sincerely

A handwritten signature in blue ink, reading 'J + Cantin'.

John Cantin

Partner

EXPOSURE DRAFT - FOR COMMENT AND DISCUSSION ONLY

Deadline for comment: 27 June 2017. Please quote reference: PUB00261.

KPMG Comments 11 July 2017

This draft Interpretation Statement provides taxpayers with an updated summary of the tax law as it applies to trusts. When finalised, this Interpretation Statement will replace the Commissioner's original explanation of the trust rules in "Appendix: Explanation of Taxation of Trusts," *Tax Information Bulletin* Vol 1, No 5 (November 1989). This Interpretation Statement will also replace "Withholding Tax and Payments to Overseas Beneficiaries", *Public Information Bulletin* No 29 (February 1966). Broadly, this Interpretation Statement covers the same content as the 1989 explanation covered, but updates legislation, improves the order of the content, and includes new sections such as a section dealing with the minor beneficiary rules. This Interpretation Statement does not consider the foreign tax credit regime as it applies to trusts, the application of double tax agreements to trusts, or the application of s BG 1 of the Income Tax Act 2007. This is because these are entire subjects in themselves, so beyond the scope of a general guide.

INTERPRETATION STATEMENT: IS XX/XX

TAXATION OF TRUSTS – INCOME TAX

All legislative references are to the Income Tax Act 2007 (ITA 2007) unless otherwise stated.

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Part 1 Introduction

Content of this Interpretation Statement

- 1.1 This Interpretation Statement considers the taxation of trusts. It replaces "Appendix: Explanation of Taxation of Trusts", *Tax Information Bulletin* Vol 1, No 5 (November 1989) and "Withholding Tax and Payments to Overseas Beneficiaries", *Public Information Bulletin* No 29 (February 1966): 4.
- 1.2 This Interpretation Statement is intended to be a general guide as to how income derived by the trustees of a trust is taxed. It also provides an overview of the various compliance obligations imposed on settlors, trustees and beneficiaries of trusts under tax law.

Trusts generally

- 1.3 A trust is a creation of the law of equity. A trust is not a legal entity distinct from its trustee. Instead, a trust is a fiduciary relationship where a trustee holds property for the benefit of the beneficiaries of the trust or, where the trust is a charitable trust, for the specified charitable purposes. Although a trustee has legal ownership over the trust property, it holds the property subject to the beneficial interests of the beneficiaries and must act in the best interests of the beneficiaries of the trust. A trustee may be an individual (or natural person) or an entity such as a company (entity). There may also be multiple trustees, who can be removed and replaced from time to time.
- 1.4 A trust can be established by a settlor, who settles the trust property on the trust while they are alive (*inter vivos*) or by way of their will (a testamentary trust). A trust may also be settled by an entity. Alternatively, a trust may arise by operation of law (eg, a constructive trust). The property settled on the trust is known as the corpus of the trust. The trustees will usually use the corpus to derive income and capital gains.
- ~~1.5~~ The operation of a trust and the specific duties imposed on trustees are governed by the law of equity relating to trusts and by the Trustee Act 1956. For each individual trust, the operation is also governed by the trust deed. The trust deed specifies the ability of a trustee to deal with trust property and the ability to make distributions to beneficiaries for each individual trust relationship.

~~1.5.1.6~~ The trust rules in the ITA 2007 apply to determine the tax consequences that flow from the operation of the trust under trust law.

New Trusts Bill

A Trusts Bill is to be introduced to Parliament later in 2017 to update and improve on the Trustee Act 1956. The changes are consistent with common law and will improve understanding and administration of trusts. Based on the exposure draft of this Bill there are no proposed changes that are likely to impact on the income tax treatment of trusts. However, the post submission version of the Trusts Bill was not available when this Draft was completed so it is possible that there may be some implications. The development of this legislation will be monitored as this statement is advanced.

Commented [CJF1]: It would be useful to note that a trust is a particularly flexible means of holding and dealing with assets and income which raises questions that are quite different from those that arise for companies and other entities. The key problem is to ensure the right person pays tax. The trust rules are the result of addressing that problem.

EXPOSURE DRAFT - FOR COMMENT AND DISCUSSION ONLY

Trust rules

~~1.6~~1.7 The "trust rules" definition in the ITA 2007 sets out most of the rules for taxing income derived by trustees of a trust and the amounts distributed to beneficiaries of a trust. The trust rules also contain various rules relating to the compliance obligations of trustees, settlors and beneficiaries of trusts. Since the re-write of the income tax legislation, the rules that relate to trusts are contained in different parts of the ITA 2007, but most of the rules are in subpart HC.

~~1.7~~1.8 The "trust rules" are expressly defined in s YA 1 as meaning the rules contained in:

- (a) ss DV 1 to DV 7 (which relate to superannuation funds);
- (b) s DV 9 (which provides rules relating to how trusts can claim deductions);
- (c) s GB 22 (which contains a specific anti-avoidance rule relating to beneficiary income);
- (d) subpart HC (which contains the general rules relating to trusts);
- (e) subpart HZ (Terminating provisions);
- (f) ss LE 4, LE 5, LF 2, LF 3 and LO 2 (which relate to tax credits and minor beneficiary); and
- (g) ss 43B, 59 and 93B of the Tax Administration Act 1994 (TAA) (which relate to trustee filing and disclosure requirements).

~~1.8~~1.9 Aside from the trust rules as defined the following sections are fundamental to the operation of the trust regime: ss BD 1(4)(c), CV 13, CW 53, CW 54 and CX 59. They set out the treatment of amounts derived from trusts as taxable, exempt or excluded income depending on their character.

~~1.9~~1.10 The current trust regime was introduced in 1988 with application for income derived by a trustee of a trust in the income year beginning 1 April 1988 and in subsequent income years.

Rewrite of the income tax legislation

~~1.10~~1.11 Since the introduction of the trust rules, the income tax legislation has been reordered, reformatted, and progressively reviewed and rewritten over several years on a part-by-part basis. This work resulted in the introduction of the Income Tax Act 1994 (ITA 1994), the Taxation (Core Provisions) Act 1996 (the Core Provisions Act), the Income Tax Act 2004 (ITA 2004) and the ITA 2007. The purpose of the rewrite project was to reorganise and consolidate the law relating to income tax and to rewrite the tax legislation in plain language.

~~1.11~~1.12 The trust rules were rewritten in the ITA 2007 as part of the third phase of the rewrite project. While the project reorganised the provisions dealing with the taxation of trusts and changed the way the trust rules were written, no substantive changes to the law occurred. (Any intended legislative changes are noted in sch 51 of the ITA 2007.) However, additions have been made to the trust rules since the introduction of the regime in 1988, such as the introduction of the minor beneficiary rule, discussed in Part 6 of this Interpretation Statement.

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Core provisions

~~1.13~~ 1.13 The trust rules have been affected by the introduction of the Core Provisions Act that represented the first phase of the rewrite of the ITA 1994. The core provisions (in part B of the ITA 2007) set out the fundamental principles on which the rest of the income tax legislation is based, including the purposes of the Act, those to whom it applies, and the rules to be used in interpreting the Act.

Commented [CJF2]: It is not clear why this statement is made. The second sentence in 1.14 suggests not. Is "affected" only being used in the sense that the rules have been changed/moved about? Or is it a technical reference (see 1.16 below) to how trusts were taxed?

1.14 The Core Provisions Act introduced a "global/gross" approach to the calculation of tax. However even prior to that Act trustees were assessed on gross income less deductions and income was distributed gross to beneficiaries with tax credits.

Commented [CJF3]: The uncertainty of the pre-Core Provisions rules appears to be glossed over? Did Inland Revenue always have this approach?

~~1.13~~ 1.15 From the perspective of the trust regime, the charging provisions were moved into part B of the Act – *Core provisions* and the trust rules were left to focus on defining the circumstances arising from a trust which give rise to income or exclusions from income. In particular the trust rules under the Core Provisions Act provided for:

Is it worth noting at this point that this approach does not allow trust losses to be transferred to others (beneficiaries, etc)?

- (a) when settlors became agents;
- (b) elections when the settlor's residence changed;
- (c) marshalling rules for taxable distributions;
- (d) certain administrative requirements and elections; and
- (e) clarification of how the trust rules interface with the core provisions.

~~1.14~~ 1.16 The structural change made by the Core Provisions Act for the taxation of trustees was that they became taxed under the core provisions under the same source and residence rules that apply to any "person" rather than under a charging regime contained within the trust rules. Then foreign-sourced amounts derived by trustees were treated under the core provisions as either:

- (a) excluded income if the foreign-sourced amounts were derived by a resident trustee (only one trustee need be resident to qualify) where no settlor was New Zealand resident during the income year; or
- (b) as assessable income ~~where~~ wherever the trustee (or all trustees) ~~was non-~~ is/are resident and the settlor was a New Zealand resident at any time in the income year.

Commented [CJF4]: This seems to be better reflect the position for foreign sourced income?

~~1.15~~ 1.17 As a consequence of the core provisions global/gross approach, two new provisions were also introduced (now s DV 9(1) and (2)) to clarify that deductions are taken by the trustee and not the beneficiary.

Overview of the operation of trust rules

~~1.16~~ 1.18 A trust will usually have at least one settlor, trustee and beneficiary. The meaning of these terms for tax purposes is discussed in Part 2 and Part 3 of this Interpretation Statement.

~~1.17~~ 1.19 As noted above, income derived by a trustee of a trust is taxed either as "beneficiary income" or "trustee income".

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Beneficiary income is:

- income derived by the trustee of a trust that is vested absolutely in interest in a beneficiary in the income year when it was derived; or
- paid to a beneficiary during the income year or within the extended period allowed for in the Act.

Trustee income is:

- all the annual gross income derived by the trustee of a trust in an income year that is assessable under s BD 1, other than income that is beneficiary income.

Commented [CJF5]: The beneficiary income descriptions do not refer to gross income but to income. Is this intentional? Note from the earlier commentary it appears that it should be gross income as well?

~~1.18~~1.20 There are special rules for the taxation of foreign-sourced amounts derived by a trustee or a beneficiary. Foreign-sourced amounts derived by a trustee are taxed based on the residence of the settlor. Where there is no resident settlor, foreign-sourced amounts derived by a trustee are generally not taxed in New Zealand (provided any New Zealand resident trustees comply with the registration requirements discussed in Part 13 of this Interpretation Statement). Foreign-sourced amounts distributed to non-resident beneficiaries are also not subject to tax in New Zealand unless they are included in a taxable distribution made by a non-complying trust.

Commented [CJF6]: See our later comments regarding the lack of clarity regarding this conclusion.

~~1.19~~1.21 The rules for taxing foreign-sourced amounts derived by non-resident and resident trustees, in ss HC 25 and HC 26 respectively, interface with the core provisions (see s BD 1) but the resulting income amounts are provided for under part C of the Act not by part H where the trust rules are mainly set out. Part H does not make an amount income under the Act.

Commented [CJF7]: Observation: This may be mechanically correct but if there is no Part H there would be nothing to tax under Part C? (See section CV 13 for an example).

~~1.20~~1.22 These concepts, along with specific rules that apply where beneficiary income is paid to minors, are discussed in Part 4 (Income derived by trustees), Part 5 (Beneficiary income), Part 6 (Minor beneficiary rule) and Part 7 (Trustee income) of this Interpretation Statement.

~~1.21~~1.23 The tax treatment of distributions to beneficiaries of amounts that are not beneficiary income depends on the classification of the trust. For tax purposes, trusts are classified as:

Commented [CJF8]: Note that some trusts may be a combination of types?

- (a) **complying trusts** – trusts where none of the income derived by the trustee is non-resident passive income, non-residents' foreign-sourced income, or income that is exempt under s CW 54 (Foreign-sourced amounts derived by trustees), and where the trustees have always satisfied their tax obligations;
- (b) **foreign trusts** – trusts that have not had a New Zealand resident settlor at any time since 17 December 1987; and
- (c) **non-complying trusts** – trusts that are neither complying nor foreign trusts.

~~1.22~~1.24 These different types of trusts are discussed in Part 8 of this Interpretation Statement.

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~~1.231.25~~ Distributions to beneficiaries of a trust, other than distributions that are beneficiary income, will be one of:

- (a) exempt income, where the distribution is made by a complying trust;
- (b) a taxable distribution, where the distribution consists of income or related party capital gains distributed by a foreign trust or consists of income or capital gains distributed by a non-complying trust; or
- (c) a non-taxable distribution, where the distribution consists of capital gains (other than related party capital gains) of a foreign trust, or corpus of a foreign or non-complying trust.

~~1.241.26~~ The tax treatment of distributions to beneficiaries of a trust is discussed in Part 8 of this Interpretation Statement.

~~1.251.27~~ The general tax treatment discussed above applies to most trusts, including the standard family or trading trust structures often used in New Zealand. However, in some situations different tax rules apply to specific types of trusts, including:

- (a) charitable trusts;
- (b) deceased estates;
- (c) community trusts;
- (d) superannuation funds;
- (e) lines trusts;
- (f) licensing trusts
- (g) unit trusts;
- (h) Maori authorities;
- (i) foreign investment funds; and
- (j) foreign superannuation schemes.

~~1.261.28~~ The taxation of these entities is discussed briefly in Part 9 of this Interpretation Statement.

Residence

~~1.271.29~~ The trust rules are a settlor-based taxation regime. The trust rules interact with the core provisions to tax income derived by the trustees of a trust based on the residence of the settlors, rather than the residence of the trustees. All New Zealand-sourced amounts are taxed in New Zealand regardless of the residence of the settlor. However, foreign-sourced amounts are generally taxable in New Zealand only where the settlor is resident in New Zealand. This is discussed in Part 7 (Trustee income) of this Interpretation Statement. For more information see "IS 16/03: Tax Residence", Part 3: Residence and trusts (*Tax Information Bulletin* Vol 28, No 10 (October 2016): 2).

Commented [CJF9]: The usability of the IS could be enhanced by excluding these from its scope?

Commented [CJF10]: For FATCA and Common Reporting Standard purposes, there are specific approaches to establish the residency of a trust. It is different to the income tax status of the trust. This distinction should be explicitly noted, to prevent confusion.

EXPOSURE DRAFT - FOR COMMENT AND DISCUSSION ONLY

~~1.281.30~~ 1.291.30 The trust rules contain specific rules for trusts that enter and exit New Zealand due to a change in the residency of their settlor or settlors. These rules are discussed in Part 10 and Part 11 of this Interpretation Statement.

~~1.291.31~~ 1.301.31 The settlor-based taxation approach is a change from the rules that applied before 1 April 1988. Previously, foreign-sourced amounts derived by the trustees of a trust with New Zealand resident settlors were not subject to tax in New Zealand where the trustees were non-resident. The settlor-based taxation regime was chosen because it was considered too easy to avoid tax on foreign-sourced amounts under the old regime by appointing non-resident trustees. It was also considered that, in economic terms, the residence of the settlor provides a more appropriate basis for taxing foreign-sourced amounts derived by a trustee (see "Appendix: Explanation of Taxation of Trusts", *Tax Information Bulletin* Vol 1, No 5 (November 1989) at [10.15]).

Associated persons

~~1.301.32~~ 1.311.32 The associated persons rules as they apply to trusts are discussed in Part 12 of this Interpretation Statement. In particular, that part considers situations where settlors, trustees and beneficiaries will be associated for tax purposes.

Compliance obligations

~~1.311.33~~ 1.321.33 The trust rules set out various rules relating to the compliance obligations of settlors, trustees and beneficiaries of trusts. These rules include:

- (a) settlor disclosure obligations;
- (b) trustee disclosure obligations;
- (c) beneficiary disclosure obligations;
- (d) records that must be kept by trustees of foreign trusts;
- (e) sanctions for non-compliance;
- (f) filing of tax returns;
- (g) allocation of tax credits;
- (h) withholding tax obligations; and
- (i) agency obligations.

~~1.321.34~~ 1.331.34 These compliance issues are considered in Part 13 of this Interpretation Statement.

Commented [CJF11]: Excludes FATCA/CRS obligations - have these been scoped out because they are in the respective guidance notes?

Part 2 Settlor

Introduction to the term "settlor"

- 2.1 The term "settlor" is defined broadly in the ITA 2007. The core meaning of "settlor" is a person who transfers value to a trust. The definition also contains extensions, clarifications and exceptions to this core meaning.
- 2.2 The definition of "settlor" in the ITA 2007 is broad enough to include the common law meaning, but also extends beyond that meaning. At common law, a "settlor" is a person who "settles" property on a trust and this creates equitable obligations on a trustee in relation to the property.

Location of "settlor" definition

- 2.3 The definition of "settlor" is in ss YA 1 and HC 27. Section HC 27 contains a general definition, which applies for the purposes of the ITA 2007 as a whole unless otherwise stated.
- 2.4 Section YA 1 incorporates the s HC 27 definition and provides some qualifications to the s HC 27 definition for the purposes of particular sections (relating to minor beneficiaries and associated persons).

Significance of the term "settlor" in the ITA 2007

- 2.5 The definition of "settlor" is important in several respects, including:
- (a) determining when foreign-sourced amounts derived by non-resident trustees will be assessable income (s HC 25);
 - (b) determining when foreign-sourced amounts derived by resident trustees will be exempt income (s HC 26);
 - (c) determining whether a trust is a foreign trust in relation to a distribution (s HC 11), which is relevant:
 - (i) in determining whether a distribution from the trust is a taxable distribution under s HC 15(4);
 - (ii) to the ordering rules for distributions from the trust (s HC 16);
 - (iii) in determining whether a trust is a non-complying trust, since a trust that is a foreign trust will not be a non-complying trust (s HC 12);
 - (d) determining whether a settlor may be liable for the income tax liability of a trustee (s HC 29);
 - (e) understanding the minor beneficiary rules (ss HC 36 and HC 37);
 - (f) understanding the associated person provisions relating to trusts (ss YB 7 to YB 9); and
 - (g) calculating income for social assistance purposes (eg, s MB 7 (Family scheme income of settlor of trust)).
- 2.6 The definition of "settlement" in s YA 1 is linked to the term "settlor". Essentially, a settlement is an act or a failure to act by a person, or a

Commented [CJF12]: The IS refers to avoidance in a number of discussions of the expanded definition of settlor. Apart from the "defeat the effect" extension, the other elements of the definition are simply what constitutes a settlement.

It is fair to say that the definition was modelled on the Estate and Gift Duty Act definition but the reach of that provision was considered ineffective. This explains a number of the provisions which extend the definition.

Approaching the analysis in this way would remove any contrary arguments of the type "this particular arrangement is not an avoidance arrangement". It would also prevent confusion with the application of section BG 1 and other explicit avoidance provisions in the ITA.

EXPOSURE DRAFT - FOR COMMENT AND DISCUSSION ONLY

transaction or series of transactions entered into by a person, that has the effect of making the person a settlor. There cannot be a settlement without a person being, or being treated as being, a settlor.

- 2.7 Note that under trust law, each settlement is the creation of a new trust. However, for the purposes of the trust rules, if multiple settlements are made on the same terms, a trustee of the trust may treat all the settlements as one trust (s HC 3).

Comparison with definition of "settlor" in the ITA 2004

- 2.8 The current definition of "settlor" was introduced with the enactment of the ITA 2007. Although the definition was extensively rewritten, Parliament did not intend to change the meaning of settlor. There was only one identified legislative amendment in relation to the definition and even that was described as a clarification rather than a change. Schedule 51 of the ITA 2007 states:

The definition of settlor is clarified so that any transfer to a trust that increases the net assets of the trust is a settlement on the trust and any deductible payments settled on a trust are included in trustee income.

- 2.9 The view that Parliament did not intend to widen the definition of settlor is also supported by *Officials' Report to the Finance and Expenditure Committee on Submissions on the Income Tax Bill* (30 April 2007). The New Zealand Institute of Chartered Accountants (as it was then) submitted that the transfer of value concept should be removed from the definition of "settlor" in the Income Tax Bill. In response, officials stated at 46:

The drafting style adopted is again the generalised approach with specific exclusions. If specific examples of transfers of property or services are identified, they will be incorporated as an exclusion from the rule.

The definition of "settlor" in the [ITA Act] is extensive and covers all dispositions by a person to or for the benefit of a trust (in terms of the trust) of property, making available of property at less than market value, services at less than market value. It also extends to a person who uses property or services of a trust for consideration greater than market value, and includes the abstaining of entering into transactions and also is extended further in specific situations set out in section HH 1.

Neither the submission nor officials have been able to identify any particular situation that would fall outside the current definition that falls within the meaning of "transfer of value".

- 2.10 The new definition was also discussed in *Rewriting the Income Tax Act: Exposure Draft—Part H* (Policy Advice Division of the Inland Revenue Department, 4 March 2005). The Exposure Draft stated at 7:

Transfer of value and terms "distribution", "settlor" and "settlement"

The defined terms "distribution", "settlor" and "settlement" rely on the common law but also extend the common law concepts for certain classes of transaction or event. In reviewing the effect of these two terms, it seems that both a "distribution" and a "settlement" involve a transfer of value in a very similar way to the concept used in subpart CD of the [ITA 2004].

In rewriting the dividend rules in subpart CD, a transfer of value is a transaction or event that leads to a value passing from one person to another for an unequal consideration (if any) in return.

These two concepts have been re-drafted on the basis they are a transfer of value which is intended to simplify and harmonise concepts that have similar effect throughout the Act.

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- 2.11 The Exposure Draft indicates that the transfer of value concept was adopted from the dividend rules. It states that both a "distribution" and a "settlement" involve a transfer of value in a very similar way to the concept used in subpart CD of the ITA 2004 (relating to dividends).
- 2.12 The Exposure Draft also indicates that the intention in adopting the transfer of value concept was to simplify and harmonise the concepts that have similar effect throughout the Act.

Features of the definition of "settlor"

- 2.13 The definition of "settlor" in s HC 27 has the following features:
- (a) the core concept of a person who transfers value to a trust;
 - (b) a legislative response to the decision in *Re Marshall (Deceased), CIR v Public Trustee* [1965] NZLR 851 (CA) (*Re Marshall*) discussed below [2.48] – [2.50];
 - (c) rules that help in determining whether a transfer or provision has been made; and
 - (d) exceptions for:
 - (i) trusts for retirement benefits of employees;
 - (ii) employee share purchase agreements; and
 - (iii) contributions to foreign superannuation schemes.
- 2.14 A person can also be treated as a settlor under s HC 28. In particular:
- (a) a person who has a control interest in a company that settles an amount on a trust is treated as a settlor of the trust;
 - (b) where a trustee settles an amount on a sub-trust, the settlor of the head trust will also be a settlor of the sub-trust;
 - (c) a person can be treated as a settlor of a trust, if they have control over a trustee or a settlor of the trust; and
 - (d) a person can be treated as a settlor, if s HC 28(2), an anti-avoidance provision, applies.
- 2.15 Although not part of the definition of "settlor", a person may be treated as a settlor under s YB 21, if someone else settles a trust as nominee for the person.
- 2.16 Finally, as previously noted, the definition of settlor is qualified for the purposes of the minor beneficiary rules and the associated person rules.

Person who transfers value to a trust

- 2.17 As noted above, the core meaning of "settlor" is a person who transfers value to a trust. In particular, a person will be a settlor of a trust under s HC 27(2)(a) if they transfer value:
- (a) to the trust;

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- (b) for the benefit of the trust; or
- (c) on the terms of the trust.

- 2.18 For simplicity, this part of the Interpretation Statement will generally refer to transfers of value "to" a trust despite the definition also applying to transfers for the benefit of the trust or on the terms of the trust.
- 2.19 It is noted that a person will be a settlor, if they transfer value "at any time". This means a person will be a settlor of a trust if they have transferred value to the trust at any time in the past. To avoid any doubt, this includes transfers that occurred before and since the introduction of the 1988 amendments to the trust rules.

Definition of "transfer of value"

- 2.20 The definition of "settlor" uses the definition of "transfer of value" in s YA 1. The definition of "transfer of value" features:
- (a) a general meaning;
 - (b) a specific inclusion relating to the release of an obligation to pay money;
 - (c) a reference to a specific definition in s CD 5, which applies to transfers made by companies; and
 - (d) confirmation that "transfers value", which is used in the settlor definition, has a corresponding meaning.

General meaning of "transfer of value"

- 2.21 Often a transfer of value from a person to a trust will simply involve the payment of an amount, or the transfer of property, by the person to the trust with the trust providing nothing in return. In such cases, a transfer of value equal to the market value of the property will be transferred.
- 2.22 However, a transfer of value to a trust can also occur where a transaction occurs between a person and a trust and the trust does provide something in return.
- 2.23 Essentially, under the general definition of "transfer of value", there is a transfer of value from one person (person A) to another person (person B) when person A provides money or money's worth to person B and receives in return money or money's worth that has a lower market value than what was provided (para (b) of the definition in s YA 1). In net terms, money or money's worth is being transferred from person A to person B.
- 2.24 "Money's worth" means something that is convertible into money (*Wilkins (Inspector of Taxes) v Rogerson* [1961] 1 All ER 358 (CA) at 361).
- 2.25 "Market value" is an important concept in the definition of "transfer of value" and is defined in s YA 1.
- 2.26 Note that s YA 1 provides two definitions of "market value" that apply to a share or option (depending on whether the share or option is quoted on the official list of a recognised exchange). These definitions apply for the purposes of the Act as a whole unless otherwise stated. Therefore, these definitions may be

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relevant in the context of a transfer of value involving a share or option. The definition of "market value" in s YA 1 also provides meanings that apply for the purposes of specific provisions. However, the settlor definition is not one of the specific provisions.

2.27 Therefore, in many situations, the ordinary meaning of "market value" will apply. Generally, the market value of something is the price that would be agreed between a willing but not anxious seller and a willing but not anxious buyer. It is important to identify the relevant market for the property or service being provided. Also, in determining the market value, surrounding circumstances that might reasonably be expected to affect the price agreed on must be taken into account. The market value of property or services is determined objectively. The subjective value placed on property or services by the person transferring or receiving the property is not relevant (*Edge v CIR* [1958] NZLR 42 (CA); *Hatrick v CIR* [1963] NZLR 641 (CA) at 661; *R v Islam* [2009] UKHL 30 (HL)).

2.28 In the case of a transaction between a person and a trust involving the provision of money's worth in exchange for money, a transfer of value to the trust could arise in two ways:

(a) Firstly, where a person is providing money's worth to a trust, a transfer of value could arise as a result of the trust paying a *below* market value consideration.

Example 1. Transfer of value – below market consideration

Sara sells her car to a family trust to be used in a business carried on by the trust. The sale price is \$6,000, but the market price is \$10,000. Sara has transferred value of \$4,000 to the trust because she has sold her car to the trust for a discounted price.

Commented [CJF13]: This imposes transfer pricing-type rules to determine trust settlements.

(b) Secondly, where a trust is providing money's worth to a person, a transfer of value could arise as a result of the person paying an *above* market value consideration.

Example 2. Transfer of value – inflated consideration

Erica acquires management services from a trust. She pays \$10,000 for the services, but the market value is only \$1,000. Erica has transferred value of \$9,000 to the trust because she has paid an inflated price to the trust for the management services.

Commented [CJF14]: This example raises the application of BG 1 and also the deemed income rule for a trustee (where the settlement amount is deductible to the settlor). Suggest the IS note that these issues may arise but are not considered for the specific example which is to illustrate the settlement rules.

2.29 Given how easy it is for a person to transfer value to a trust by accepting a discounted price or paying an inflated price, as described above, it is necessary to treat people who engage in such behaviour as settlers.

Commented [CJF15]: We note our comment regarding the "avoidance" tone of comments in this section. It is not obvious that because it is easy to transfer value that it is necessary to treat them as such.

2.30 For simplicity, in discussing the transfer of value concept, this part of the Interpretation Statement generally assumes that a trust does not provide anything in return, and the part will generally refer to only what is provided by a person to a trust. This is despite the importance of considering both the value provided by the person to the trust and the value, if any, provided by the trust in return.

In particular, it is possible, to inadvertently be a settlor of a trust to which a person has no other connection. For example, a naive third party may sell something to a trust at less than what might be considered an objective market value. In a fast moving market, a house may be let at less than market value.

Specific inclusion relating to the release of an obligation to pay money

This appears to be a policy issue?

2.31 As well as the general definition above, a "transfer of value" also specifically includes the release of an obligation to pay money. The release may be by agreement or by operation of law.

It is also an issue for the Commissioner with respect to enforcement. Does she expect that a trust will obtain a market valuation for third party transactions to be able to show that the counter-party is not a settlor of the trust?

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Example 3. Settlement made by release of obligation

Dory sells her house to a family trust, which was settled by her parents. The purchase price is satisfied by a loan from Dory to the trust. Dory later forgives the loan owed by the trust. By forgiving the loan, Dory has transferred value to the trust equal to the loan balance. Therefore, Dory is a settlor of the trust.

- 2.32 There may be situations where the obligation to pay money will have no value (eg, because the trust and trustees are insolvent). Whether this is so will be a question of fact to be determined in each situation. If the obligation to pay money has no value, no settlement will result from the release of the obligation.

Commented [CJF16]: Is there a practical effect to this?

Transfers of value made by a company to a person

- 2.33 A special definition of "transfer of value" is also provided in s CD 5 for transfers of value made by a company to a person. This special definition applies only for the purposes of the dividend rules in subpart CD. This is implicit from the legislative history of the definition (the term "transfer of value" was originally relevant to only the dividend rules) and the placement of s CD 5 in subpart CD.
- 2.34 For the purposes of the definition of "settlor", a company will transfer value to a trust if the requirements of paras (b) or (c) of the definition of "transfer of value" in s YA 1 are satisfied, even if the company would not be treated as transferring value under the definition in s CD 5.
- 2.35 The difference between the general definition and the definition in s CD 5 is that under the general definition the provision of services for less than market value is a transfer of value. Therefore, for the purposes of the settlor definition, a company will transfer value to a trust if the company provides services to the trust for less than market value.

Commented [CJF17]: Presumably this problem is because YA 1 does not explicitly say that CD 5 is for the purposes of Part CD? Note that if the provisions were not read in this way, there would be an extended definition of "transfer of value" for Part CD as (b) and (c) would also apply for CD 4 purposes. That does not appear to be a logical or sensible result.

Note that this section would be easier to follow if 2.35 commenced this section (i.e. there is a difference between the definition of transfer of value in CD 5 and YA 1(b) and (c))

Situations included under the previous definition of "settlor"

- 2.36 The transfer of value concept in the current settlor definition is wide enough to include situations that were expressly included under the previous definition of "settlor" (in the ITA 2004 and previous Income Tax Acts). These situations are discussed below and include:
- (a) making a "disposition of property" to a trust (from [2.38]);
 - (b) making property available to a trust (ie, where there is no disposal) (from [2.40]);
 - (c) providing financial assistance to a trust (from [2.41]); and
 - (d) providing services to a trust (from [2.44]).
- 2.37 Again, for simplicity, in discussing the transfer of value from a person to a trust it is generally assumed in this part of the Interpretation Statement that something is being provided to the trust, but nothing is provided by the trust in return. This is so, even though a transfer of value could also occur if the trustee did provide something in return with a market value lower than that provided to the trust.

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Disposition of property

- 2.38 The previous definition of “settlor” included a “disposition of property” made to a trust. The term “disposition of property” was defined for the purposes of the settlor definition. The transfer of value concept in the current settlor definition is wide enough to include the situations that were covered in the definition of “disposition of property”. These situations include:
- (a) Transferring property to a trust when it is first set up. A trust is created when property is transferred to a trustee to hold subject to the terms of the trust. If a person transfers property to a trustee to hold on trust (even a nominal amount), and thereby creates a trust, the person will be a settlor of the trust.
 - (b) Transferring ownership of property to a trust.
 - (c) Providing a trust with the right to use property. This includes a lease or licence.
 - (d) Granting an interest in or over property (eg, a mortgage or charge).
 - (e) Providing a loan to a trust at a less than market interest rate (*CIR v Dick* (2001) 20 NZTC 17,396 (HC) at 17,402; *Rossiter v CIR* [1977] 1 NZLR 195 (CA)).
 - (f) Issuing shares in a company to a trust.
 - (g) Where there is a release, discharge, surrender, forfeiture, or abandonment of any debt, contract, or thing in action, or of any right, power, estate, or interest in or over any property. A debt or any other right, estate or interest is deemed to be released when it becomes irrecoverable or unenforceable by action or for any reason ceases to exist.
 - (h) Where a person grants a power over any property to a trustee (eg, a power to dispose of the person’s shares to anyone in a specified group of persons). Although the trustee does not have legal ownership of the property, the effect may be similar to a more standard trust relationship. A similar effect could be achieved by transferring property to the trustee on trust with discretions corresponding to the powers (eg, to distribute the property to beneficiaries in the specified group).
 - (i) The exercise by a person of a general power of appointment over property (ie, someone else’s property) by transferring the property to a trust. This applies only if the person has the ability to deal with the property for their own benefit. The exercise of such a power in favour of a trust would be equivalent to the person exercising it in their own favour to acquire the property and then disposing of the property to the trust.
- 2.39 The above transfers could also be made by will or by virtue of intestacy. However, where a person attempts to transfer an interest in property and the trustees disclaim that interest (ie, if the trustees reject their right to receive the property), then there will be no transfer of value.

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Making property available to a trust

- 2.40 The previous definition of “settlor” also included any person who makes property available to a trust (eg, a lease of property). The transfer of value concept in the current definition of settlor is wide enough to cover this situation.

Providing financial assistance to a trust

- 2.41 The previous definition of “settlor” stated that making property available included the provision of financial assistance. Again, the transfer of value concept is wide enough to cover this situation. Financial assistance could be provided to a trust by, for instance:
- (a) providing an interest-free loan or a loan with a below market interest rate;
 - (b) guaranteeing the repayment of an amount borrowed by a trust; and
 - (c) providing a trust with security for the purposes of borrowing.
- 2.42 If a person provides financial assistance to a trust, then there will be a transfer of value and the person will be a settlor.

Example 4. Providing financial assistance

Solid Ltd guarantees a loan made by a bank to a trust carrying out a property investment business. Solid Ltd is not paid a guarantee fee. The market value for the provision of the guarantee would have been \$10,000. In this situation, Solid Ltd will be a settlor because it has given a guarantee for no consideration.

- 2.43 A specific provision in the current definition of “settlor” (s HC 27(2)(b)) deals with the situation where a person provides financial assistance to a trust and has the right to demand payment from the trust, but the right to demand payment is not exercised or is deferred. This is discussed from [2.46].

Providing services to a trust

- 2.44 A transfer of value occurs if a person provides services to a trust for less than market value. This includes any investment advisory services, legal and accounting services, or services relating to any business carried on by the trustees of the trust.
- 2.45 Generally, the services a trustee provides to a trust in the trustee’s capacity as trustee will not result in a transfer of value, even though the trustee is not paid for the services.

Responding to the decision in *Re Marshall*

- 2.46 Under s HC 27(2)(b), a person will be a settlor if:
- (a) they provide financial assistance (eg, a loan) that involves an obligation to pay on demand (eg, a loan that bears interest if demanded); and
 - (b) the right to demand is not exercised or is deferred.
- 2.47 Section HC 27(2)(b) will apply whether or not the financial assistance involves a market rate of interest. For instance, s HC 27(2)(b) will apply to a loan that

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bears a market rate of interest if demand for payment of that interest is not exercised or is deferred.

- 2.48 Section HC 27(2)(b) is the equivalent of s 226(2)(b) of the Income Tax Act 1976. The purpose of s 226(2)(b) was to respond to the decision of the Court of Appeal in *Re Marshall*. *Re Marshall* concerned a situation where a person had lent an amount to a trust with interest payable on demand. The question was whether the failure by the person to demand the interest was a "disposition of property" in terms of para (d) of the definition of "disposition of property" in s 2 of the Estate and Gift Duties Act 1968. The court held that the right to make a demand for interest was a thing in action. The failure to make a demand did not result in a release, a discharge, a surrender, an abandonment, or a forfeiture of the thing in action. The thing in action was just not exercised.
- 2.49 The result in *Re Marshall* was that the failure to demand interest did not amount to a disposition of property, so was not a gift under the Estate and Gift Duties Act 1968. Parliament was concerned that this decision would be applied in the context of the income tax legislation and that an easy avenue would be available for avoiding settlor status while still transferring value to a trust. Therefore, Parliament introduced s 226(2)(b) of the Income Tax Act 1976.
- 2.50 It is noted that s HC 27(2)(b) does not cover the provision of financial assistance generally. The provision of financial assistance is covered under the general definition of "settlor" in s HC 27(2)(a), based on the transfer of value concept.

Commented [CJF18]: See comment regarding "avoidance". Section 226(2)(b) was part of the original trust rules so it was and is simply a statement of the law?

Determining whether a transfer or provision is made

- 2.51 The definition of "settlor" has two components in s HC 27(4) and (5) that help in determining whether a transfer or provision has been made.
- 2.52 Firstly, s HC 27(4) states that a person may make a transfer or provision directly or indirectly, by one transaction or a number of transactions, whether connected or otherwise.
- 2.53 An indirect transfer of value will generally involve an intermediary. A conclusion that a person has made an indirect transfer of value to a trust may be more likely to be reached if an associated party is involved. Also, sometimes an intermediary will be acting as a nominee. If so, s YB 21, which is discussed further below, may apply.
- 2.54 An indirect transfer of value could be made in several ways.

Example 5. Indirect transfer of value

In the following three situations, Peter indirectly transfers value to a trust:

- (a) Peter transfers property to Ed under an agreement that Ed will then transfer the property to a trust. In this example, Peter transfers property to the trust indirectly through an intermediary, Ed.
- (b) Peter gives money to Ed to acquire property on the basis that Ed will transfer the property to a trust.
- (c) Ed borrows money at a market rate to on lend to a trust at a below market rate. Peter then pays Ed the difference between the rates. In this example, Peter provides financial assistance to the trust indirectly by compensating Ed for the below market rate given to the trust.

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- 2.55 Note also that a person may be a settlor if they transfer property to an entity owned by a trust. In these circumstances, the transfer of property to the entity may have been made for the benefit of the trust. Value is effectively transferred to the trust in these circumstances because the value of the trust's ownership of the entity will increase with the transfer of the asset to the entity. However, this is not an indirect transfer of value. The reason the person may be a settlor is because of the wording of s HC 27(2)(a), which applies where a person transfers value to, for the benefit of, or on the terms of a trust.
- 2.56 Secondly, s HC 27(5) means that the fact that a person is or will become a beneficiary of a trust does not mean that they have been provided with or have received any value.

Example 6. Transfer of value—distribution to beneficiary not provision of value

Belinda, a beneficiary of a trust, transfers a collection of early generation iPhones (still in their original packaging) to a trust for a price that is \$1,000 under the market value for the collection. In the same tax year, the trust distributes \$1,000 of income to Belinda from rental profits. Despite receiving \$1,000 of beneficiary income, Belinda has still transferred value to the trust.

Exceptions

- 2.57 As noted above, the definition of "settlor" has three exceptions that apply to:
- (a) trusts for retirement benefits of employees (s HC 27(3));
 - (b) employee share purchase agreements (s HC 27(3B))[however see the grey box after [2.64]]; and
 - (c) contributions to foreign superannuation schemes (s HC 27(3C)).

Exception—trusts for retirement benefits of employees

- 2.58 Under s HC 27(3), a New Zealand resident who makes a settlement on a trust as an employer for the benefit of one or more employees is not a settlor of the trust if the trust is:
- (a) established or created mainly to provide retirement benefits to natural persons; and
 - (b) neither a foreign superannuation scheme nor a superannuation fund as defined in s YA 1.
- 2.59 A "foreign superannuation scheme" means a superannuation scheme constituted outside New Zealand. The relevant schemes are trusts in offshore jurisdictions established mainly for the purpose of providing retirement benefits to natural person members. A "superannuation fund" that is a trust means the trustees of a retirement scheme as defined in s 6(1) of the Financial Markets Conduct Act 2013 (s YA 1).
- 2.60 The exception in s HC 27(3) is relevant to contributions made by a New Zealand subsidiary company to a superannuation scheme that is established by its non-resident parent. It ensures the New Zealand subsidiary is not treated as a settlor of such a scheme if it makes contributions in relation to its employees. Without this exception, a New Zealand subsidiary could be treated as a settlor

Commented [CJF19]: The overlap or conflict with contributions to a foreign superannuation scheme is unclear in this description. Further, 2.60 suggests that it is New Zealand non superannuation fund trusts for which the employer is not a settlor?

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and, therefore, could be liable for tax on the worldwide trustee income of the scheme under s HC 29.

Exception—employee share purchase agreements

- 2.61 Under s HC 27(3B), an employer is not treated as a settlor in relation to a contribution that it makes to the trustee of an employee share purchase agreement to the extent that:
- (a) the employer's contribution is used by the trustee to acquire shares under that agreement; and
 - (b) an amount that is less than or equal to the employer's contribution would be income of an employee under s CE 1(1)(d).
- 2.62 This exception was introduced to avoid economic double taxation of employer contributions. In the absence of s HC 27(3B), the contribution could be taxed once in the hands of the trustee and again in the hands of the employee. The trustee could be taxed on the amount under s HC 7(3), as the amount is a property settlement for which the settlor is allowed a deduction. And for the employee, the amount would be employment income under s CE 1(1)(d).
- 2.63 By excluding the employer from the definition of "settlor", the contribution will not be a "settlement" and, under s HC 7(3), the trustee will not have trustee income equal to the contribution. In this way, the economic double taxation is avoided.
- 2.64 This exception is discussed further in "Recommendations of the Rewrite Advisory Panel: Meaning of 'Settlor' and 'Settlement'", *Tax Information Bulletin* Vol 22, No 1 (February 2010): 42.

Repeal of s HC 27(3B)

The Taxation (Annual Rates for 2017-18, Employment and Investment Income, and Remedial Matters) Bill introduced to Parliament in April 2017 proposes the repeal of s HC 27(3B) effective 6 months after Royal Assent. Under these proposed reforms a trustee of an employee share scheme is treated as a nominee for the employer and the employer will not get a deduction for contributions to an employee share scheme trustee. As a result s HC 27(3B) will become redundant.

Exception—contributions to foreign superannuation schemes

- 2.65 Under s HC 27(3C), a person who makes a contribution to a trust that is a foreign superannuation scheme is not a settlor of the trust.
- 2.66 As noted at [2.59], a "foreign superannuation scheme" means a superannuation scheme constituted outside New Zealand. These schemes are trusts in an offshore jurisdiction that are mainly for the purpose of providing retirement benefits to natural person members.

Commented [CJF20]: See earlier comment regarding retirement benefit trusts

Treated as a settlor under s HC 28

- 2.67 In other situations, a person may be treated as a settlor of a trust under s HC 28:

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- (a) A person can be treated as a settlor of the trust, if they have a control interest in a company that settles an amount on a trust.
- (b) A person can be treated as a settlor of a sub-trust if they are the settlor of a head trust and a trustee of the head trust settles an amount on the sub-trust.
- (c) A person can be treated as a settlor of a trust if they have control over a trustee or a settlor of the trust.
- (d) A person can be treated as a settlor of a trust if s HC 28(2), an anti-avoidance provision, applies.

2.68 These situations are discussed further below.

Person who has a control interest in a company that settles an amount on a trust

2.69 Under s HC 28(3), a person is treated as a settlor of a trust if:

- (a) a controlled foreign company (CFC) settles an amount on the trust; and
- (b) the person has a control interest of 10% or more in the CFC.

2.70 If the person has a control interest of 10% or more in the CFC at any time in the CFC's accounting period, the person is treated as having a control interest of 10% or more for the whole of the CFC's accounting period (s EX 1(3)).

2.71 CFCs and control interests are defined in subpart EX. Briefly, a CFC must be a foreign company. This means it must not be resident in New Zealand or treated as not being resident under a double tax agreement. A CFC must also be controlled by New Zealand residents. The ITA 2007 contains rules relating to the type and extent of control required for a company to be a CFC. Rules also aggregate the control interests of associated persons.

2.72 Under s HC 28(4), the same treatment that applies under s HC 28(3) applies to a company that would have been a CFC at the date of settlement if it had been a foreign company at the time.

2.73 For ease of reference, in this part of the Interpretation Statement, a company described in either s HC 28(3) or (4) is referred to as a "controlled company".

Commented [CJF21]: This paragraph could be deleted as CFC describes the company?

2.74 The objective of s HC 28(3) and (4) is to limit opportunities for avoiding the trust rules by using a controlled company to establish a trust and then winding up the controlled company. The provisions also recognise that where a controlled company is used to settle a trust, the controlled company is being used as a vehicle for the settlement. Therefore, it is appropriate to look through the controlled company to the real settlor.

2.75 This rule may be significant in determining whether the trust has a New Zealand resident settlor. Having a New Zealand resident settlor is significant for several reasons, as discussed later in this Interpretation Statement. For example, having a New Zealand resident settlor is relevant in determining whether a trustee is liable for tax on their worldwide income.

2.76 It is possible that more than one person could be treated as a settlor of a trust as a result of a settlement by a controlled company. This is because more than

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one person may have a control interest of 10% or more in the controlled company.

- 2.77 In addition, this settlor treatment can apply through multiple layers of controlled companies. A “person” that has a control interest of 10% or more in a controlled company might, itself, be a controlled company.

Example 7. Settlor—multiple layers of controlled companies

Jack has a control interest of 15% in Holdings Ltd, which is a controlled company. Holdings Ltd has a 50% control interest in Operations Ltd. Operations Ltd settles an amount on a trust. Holdings Ltd is treated as a settlor of the trust because of its control interest in Operations Ltd. Because Holdings Ltd is treated as a settlor and Jack has a control interest in Holdings Ltd of 10% or more, Jack is also treated as a settlor.

- 2.78 In addition, the controlled company provisions can work in tandem with other parts of the settlor definition. For example, a settlement may be made by a nominee of a company with the result that the company is treated as a settlor. And if a person has a control interest of 10% or more in that company, they may also be treated as a settlor.

Settlor of head-trust also settlor of sub-trust

- 2.79 Under s HC 28(5), a person is treated as a settlor of a trust (sub-trust) if:
- (a) the person is a settlor of a trust (head-trust); and
 - (b) a trustee of the head-trust:
 - (i) settles an amount on the sub-trust; or
 - (ii) makes a distribution to or on the terms of the sub-trust.
- 2.80 The purpose of s HC 28(5) is to prevent avoidance of settlor status by using trusts to settle other trusts or to make distributions to other trusts. The trustee of the head-trust will also be a settlor of the sub-trust along with the settlor of the head-trust.
- 2.81 “Distribution” is defined in s HC 14. Generally, a trustee of a trust makes a distribution when the trustee transfers value to a person because the person is a beneficiary of the trust.

Control over a trustee or a settlor

- 2.82 Under s HC 28(6), a person is treated as a settlor if:
- (a) they acquire, directly or indirectly, rights or powers in relation to a trustee or a settlor of a trust; and
 - (b) the purpose or effect of that acquisition is to enable the person to require the trustee to treat the person, or a nominee, as a beneficiary of the trust.
- 2.83 The purpose of this provision is to prevent the avoidance of settlor status by acquiring rights or powers in relation to an existing trust.

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- 2.84 The rights or powers obtained may be formal or informal. For example, it is often the case in relation to trusts established in tax havens that settlors exercise informal control over trustees.
- 2.85 The question is whether the purpose or effect of that acquisition is to “enable” a person to require the trustee to treat the person, or a nominee, as a beneficiary of the trust. It is sufficient that the person is able to so require. The person does not have to use the ability to be treated as a settlor under s HC 28(6).
- 2.86 Whether the person is able to require the trustee to treat the person, or a nominee, as a beneficiary will be a question of fact. For example, a person may be treated as a settlor under s HC 28(6) even if the legal documentation establishing the trust does not indicate that the person has the ability to require the trustee to treat the person, or a nominee, as a beneficiary.
- 2.87 In the case of trusts established outside New Zealand, individuals or entities are sometimes appointed to ensure the trustees’ decisions are in accordance with the settlor’s wishes. Such persons are often referred to as “protectors”, but other terms may be used. A person may be treated as a settlor under s HC 28(6) if they can acquire powers in relation to a trustee (eg, by being appointed as a protector, or as a person with a similar function to a protector, or by acquiring the protector or the settlor if they are an entity).
- 2.88 Note that the situation addressed by s HC 28(6) is different from the situation addressed in s YB 21 (the nominee settlor rule). A trust to which s HC 28(6) applies may have been settled on the original settlor’s own initiative. Nevertheless, the person to whom s HC 28(6) applies is effectively in the same position as if they had settled the trust directly.

Example 8. Control over a trustee

A Hong Kong resident, Jenny, transfers \$990,000 to the Dragon Trust. The trustee of the Dragon Trust, Dragon Co, is a company owned by Jenny. Apart from the trust property, Dragon Co does not have any assets. A New Zealand resident, Steve, acquires Dragon Co for \$1 million.

These circumstances suggest that Steve acquired Dragon Co to gain control of the trust funds. By acquiring Dragon Co, Steve may be able to influence it so that Dragon Co treats Steve, or his nominee, as a beneficiary of the Dragon Trust.

In this example, Steve has not transferred any value to the Dragon Trust and in the absence of s HC 28(6) would not be treated as a settlor. Nevertheless, under s HC 28(6) Steve is treated as a settlor.

Commented [CJF22]: New Zealand trusts may also do this?

Commented [CJF23]: Note it is not clear why Steve would pay \$1m to acquire control of a trust with \$990,000 of assets. Is the implication that the difference is a fee for establishing the trust? This would appear to be covered by the nominee settlor rule?

Commented [CJF24]: Note commentary above says Steve does not have to influence but the test is still that a purpose or effect is to do so. It is not clear why the circumstances suggest the outcome.

Note that 2.86 would suggest that the test is whether that has actually occurred (because in the absence of documentation that purpose or effect cannot be determined?)

Anti-avoidance provision

- 2.89 Under s HC 28(2), a person is treated as a settlor if, in relation to a trust:
- (a) they act, refrain from acting, or enter into a transaction or series of transactions; and
 - (b) this has the effect of defeating the intent and application of the trust rules.
- 2.90 This provision is an anti-avoidance rule to reinforce the definition of “settlor”.
- 2.91 Historically, the provision was intended to cover transactions of the type described in para (f) of the definition of “disposition of property” in the Estate and Gift Duties Act 1968. However, it was also intended to cover actions and

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transactions falling outside that definition as the definition of "disposition of property" in the Estate and Gift Duties Act 1968 was seen as being defective.

- 2.92 Section HC 28(2) may apply to a unilateral action (or inaction) of a person. No requirement exists for there to be a transaction (which generally implies the existence of two parties). The section may also apply where a person has entered into a transaction or a series of transactions.
- 2.93 The intention of the person who acts, refrains from acting, or enters into a transaction or transactions is not relevant. The focus is on the effect of the action, inaction, transaction or series of transactions.
- 2.94 For s HC 28(2) to apply, the action, inaction, transaction or series of transactions must have the effect of defeating the intent and application of the trust rules.
- 2.95 The intent of the trust rules is to treat any person who transfers value to a trust as a settlor.

Example 9. Avoidance arrangement 1

An example of a situation to which the anti-avoidance provision could apply is a transfer of value to a trust using a corporate intermediary. An existing shareholder of a company could effectively transfer value to a trust by causing the company to issue shares to the trust. The issue of the shares would dilute the value of the existing shareholder's shares and transfer valuable shares to the trust. Note that a shareholder could potentially achieve this through action or inaction; that is, by voting for a resolution to issue shares to the trust (action) or by not opposing other shareholders who vote for such a resolution (inaction).

Example 10. Avoidance arrangement 2

Another example of a situation to which the anti-avoidance provision could apply may be where a company settles property on a trust if the settlement resulted from an action or inaction of a person holding an interest in the company. If a company settled income on a trust rather than distributing it to its shareholders and the shareholders abstained from voting against the settlement, the shareholders may be settlors of the trust.

Nominee settlor

- 2.96 Although not located with the settlor definition, s YB 21 is relevant to the concept of settlor in the ITA 2007. Under s YB 21(1), if a person (person A) makes a settlement on a trust as a nominee for another person (person B), person B is treated as having made the settlement and person A is ignored. (However, as discussed below, person A may still have disclosure obligations in relation to the settlement.)
- 2.97 Person A settles an amount on a trust as a nominee for person B if person A does so "on behalf of" person B. However, if person A is a trustee, person A will be a nominee only if they are a bare trustee in relation to the amount (s YB 21(2)).
- 2.98 The nominee rule is extended to situations involving nominal (small) settlements. Under s YB 21(3), a person making a nominal settlement (eg, a settlement of \$10) at the request of another person is treated for the purposes of the ITA 2007 as a nominee in relation to the settlement. The Commissioner is likely to regard a settlement worth less than \$100 as a nominal settlement.

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2.99 The objective of this provision is to ensure that persons acting as nominees are not treated as settlors. Often professional advisers or relatives will assist in establishing a trust by settling a nominal sum on trust on behalf of another person. In these circumstances it is not appropriate to expose the professional adviser or relative to a potential tax liability under s HC 29 (settlor liable for income tax liability of trustee). The professional adviser or relative is not the real settlor of the trust, but is in effect only an intermediary or facilitator. The real settlor is the person on whose behalf the professional adviser or relative acted in making the settlement. Therefore, s YB 21 treats the person for whom the nominee acted as the settlor rather than the nominee.

2.100 The nominal settlement rule applies only where the settlement was made at the request of another person. Therefore, if a person settles a nominal amount on trust on that person's own initiative, they will not be a nominee. This is also implicit in the nominee concept generally.

2.101 Note that a direction or request to settle an amount on trust could be made directly or indirectly.

Example 11. Settlement by a person's lawyer—delegated

A client of a law firm may ask their lawyer to set up a trust on their behalf. If the lawyer then delegated this request to a colleague, the colleague would be regarded as having settled the trust at the direction or request of the client.

2.102 Section YB 21 makes it clear that a person cannot avoid settlor status by using nominees to establish trusts.

Disclosure obligations on nominee settlor

2.103 As noted above, if a person (person A) settles an amount on a trust as a nominee for another person (person B), person B is treated as having settled the amount and person A is ignored. However, person A may still have disclosure obligations in relation to the settlement under s 59(2) of the TAA. A disclosure obligation will arise for a nominee settlor if at the time of the settlement:

- (a) they were resident in New Zealand; and
- (b) no trustee of the trust was resident in New Zealand.

2.104 This will apply, for example, to a New Zealand firm that settles a trust in New Zealand for a foreign client with a non-resident trustee.

2.105 If the obligation applies, the nominee settlor will be required to disclose:

- (a) the fact of the settlement;
- (b) the name and address of the person who is deemed to be the settlor of the trust under s YB 21; and
- (c) such further details as the Commissioner may require and for which the Commissioner has created the form *Settlors of Trusts Disclosure IR 462* (January 2008), which requires further details such as the trust's name, IRD number, and address, a full description of the nature and date of the settlement, and the names and addresses of the trustees and beneficiaries of the trust.

Commented [CJF25]: As with companies, we understand it is possible to have "off-the-shelf" trusts. These are ones already established in anticipation of client requirements. Any settlements to establish the trust do not appear to satisfy the test as outlined in this section.

Commented [CJF26]: Is it clear that IR's processes allow an IRD number to be issued before the form is completed? It would make sense to have the IRD number application be part of the form?

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2.106 The disclosure must be made within 3 months of the date of settlement.

Minor beneficiary rule

2.107 The definition of "settlor" in s YA 1 is narrowed for the purposes of the exclusions from the minor beneficiary rules. The effect of this is to make it easier to fall within the exclusions to the minor beneficiary rule. The minor beneficiary rule is discussed further in Part 6 of this Interpretation Statement.

Associated person rules

2.108 The definition of "settlor" in s YA 1 provides that for the purposes of ss YB 7 to YB 9 (which relate to associated persons), "settlor" has the meaning given to it in s HC 27 modified by s YB 10.

2.109 Section YB 10 provides that for the purposes of ss YB 7 to YB 9 a person will not become a settlor by providing services to a trust for less than market value.

2.110 This modification prevents a professional advisor who provides services to a trust at no charge (or for less than market value) from being treated as a settlor of the trust and, therefore, as being associated with a trustee or a beneficiary under ss YB 7 to YB 9. This modification applies only for the purposes of ss YB 7 to YB 9.

Part 3 Trustees and beneficiaries

Trustees

- 3.1 A trust is not a legal person for tax purposes. The trustee as the legal owner of the trust property derives the income and is liable for the tax obligations of the trust in most situations, including as agent for the beneficiary's tax obligations.
- 3.2 The ITA 2007 recognises that a trustee is a taxable person with a tax status that is separate from the tax status of the person or entity that fills the role. "Trustee" is defined in s YA 1 to mean "the trustee only in the capacity as trustee of the trust" and includes all the persons who are trustees from time to time. As a consequence, the term is an ambulatory one. If trustees change from time to time, the tax status of the trustee of that trust does not change. The same tax number is retained for each trust despite a change in trustees.
- 3.3 However, under s HC 2 joint trustees are treated as a notional single person with each being jointly and severally liable for the tax obligations of the trustees to calculate and return income. Trustees are also jointly and severally liable for tax as agent on beneficiary income and taxable distributions. This liability will cease for the period after a trustee retires or resigns, but the Commissioner will continue to hold a trustee liable until advised in writing of a retirement or resignation.
- 3.4 Based on trust law a trustee is treated as liable up to the date of resignation. In practice, as endorsed in *Case 5/2013* [2013] NZTRA 05, (2013) 26 NZTC 2-004 this liability is to the end of the tax period prior to resignation because that is the last period in which the trustee had any control over the tax position taken.
- 3.5 The trustee definition also extends to the role of executors and administrators of deceased estates. This is essentially just for tax administration purposes, because a deceased person is not a settlor of their own estate unless their will specifically creates a trust on their death. For detail on deceased estates, see Part 9 of this Interpretation Statement.
- 3.6 A trustee's tax obligation is described in s HC 24 as being a requirement to satisfy the liability for taxable income "as if they were an individual beneficially entitled to the trustee income". As a consequence, it makes no difference to the tax treatment if a trustee is a company, another type of entity or an individual. The rate of tax on trustee income is the same and set at 33% for most trusts that are not in special categories.
- 3.7 Because s HC 24 treats a trustee as liable for tax like an individual, subpart CV (Income specific to certain entities) deals only with the income treatment of a trustee in a few special situations. There is now no specific charging provision for the New Zealand-sourced and foreign-sourced income of trustees as there once was. In contrast, amounts derived from trusts are all included as income under subpart CV.
- 3.8 New Zealand sourced income derived by a trustee is always subject to tax in New Zealand. However, there is special treatment for foreign-sourced amounts:
- (a) Foreign-sourced amounts derived by a non-resident trustee will generally be taxed in New Zealand if a settlor is resident in New Zealand (other than a transitional resident) in that income year.

Commented [CJF27]: This use of ambulatory is not the usual sense (for tax purposes). It normally denotes that a definition changes as the reference point is changed. This sentence is not actually required.

Commented [CJF28]: It is not clear if this should be by a trust? If it is "from", it does not appear to be a correct statement as for example a distribution from a complying trust of prior year profits, is not income under CV 13.

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- (b) Foreign-sourced amounts derived by a resident trustee will not be taxed in New Zealand if no settlor is resident in New Zealand (other than a transitional resident).

For detail on trustee income, see Part 7 of this Interpretation Statement.

- 3.9 With regard to passive income, such as interest, certain dividends and royalties that have a New Zealand source, taxation is based on the residence of the trustee. If the trustee is non-resident, and so derives non-resident passive income as defined in s RF 2, NRWT will be payable on the amount. In contrast, unless an exemption certificate is held, RWT is deducted from interest and dividends paid to resident trustees.
- 3.10 New Zealand does not determine the tax residency of a trust based on the tax residence of its trustees as some countries do such as the United Kingdom. However, as discussed above, the residence of the trustee is relevant in a number of situations. The residence of the trustee is determined under the rule in s YD 1 for natural persons and under s YD 2 for companies. When a trust has co-trustees, the trustees are treated as a notional single person under s HC 2. Where one of the trustees is resident, then all of the co-trustees as the notional single person under s HC 2 are resident in that capacity. If all of the co-trustees (or a single trustee) are non-resident, then the notional single person under s HC 2 will be non-resident. These results are supported by the definition of "non-resident" in s YA 1 which means a person who is not a New Zealand resident.
- 3.11 In a practical sense, if trustees have mixed residency, the filing and return obligations will typically fall on the resident trustee(s). If all the trustees are non-resident, a tax agent in New Zealand would usually attend to the obligations for a complying trust.
- 3.12 Trustees are included in the parties treated as associated persons in several relationships under subpart YB. Other provisions in the ITA 2007 can then treat such associated persons as aggregated parties or as having common interests to prevent possible manipulation of taxing transactions between or using related parties. More details on associated person rules and their impact on trusts are in Part 12 of this Interpretation Statement.

Commented [CJF29]: The NRWT is generally a final tax? If paid to an NZ resident beneficiary it becomes resident passive income but RWT is not payable/deductible by the payer?

Commented [CJF30]: See references to FATCA and CRS above

Proposed Changes to Corporate trustees

Concepts 124 Ltd v CIR [2014] NZHC 2140 and *Staithe Drive Development Ltd v CIR* [2015] NZHC 2593 changed how the voting interest test applied to corporate trustees. The decisions held that the voting interests were held by the legal individual owners of the trust companies in their personal capacity. This is regarded as contrary to the policy intent in the ITA 2007.

The Taxation (Annual Rates for 2017-18, Employment and Investment Income, and Remedial Matters) Bill 2017 realigns the ITA 2007 with the original policy intent to not require a corporate trustee to be looked through when testing association. This is achieved by introducing a new general rule for trustee capacity and some consequential changes to defined terms and operative provisions:

The definition of "company" will be amended to clarify that in most cases it does not include a company acting in the capacity of a trustee.

A new s YA 5 will clarify that a person who is acting as a trustee is acting in a capacity that is different from their other capacities.

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Section YD 1 will be amended to clarify that the test for residence applies to trustees who are natural persons. The definition of "natural person" in turn has been amended to not include a natural person acting as a trustee.

Section YD 2 will be amended to clarify that the residence test for companies applies to trustees that are companies. This is consequential upon the definition of company no longer including a company that is acting as a trustee.

Beneficiaries

- 3.13 Beneficiaries are the objects of a trust and hold a beneficial interest in the trust property. The term "beneficiary" is not defined in the ITA 2007 except for the purposes of s DX 1, which deals with only testamentary annuities, so is a narrow definition. Section YA 1 defines "beneficial interest" and this "includes an interest that is contingent, discretionary or unvested". It does not include a vested interest, because, at law, once an interest is vested the legal character has changed from a beneficial interest to a full legal interest for the recipient. Section YA 1 also defines "beneficiary income", which simply refers to the relevant provision s HC 6. This is discussed in Part 5 of this Interpretation Statement.
- 3.14 The entitlements of beneficiaries stem from the terms of the trust deed and the exercise of discretions by the trustees. As a result, the nature of a beneficiary's interest in trust property varies accordingly.
- 3.15 The trust rules impact on a person who is a beneficiary when they derive beneficiary income or receive a distribution from a trust. Beneficiary income is defined in s YA 1 by reference to its meaning in s HC 6 and then classified as income of the beneficiary under s CV 13(a). Distributions to beneficiaries may be taxable depending on the category of trust they are received from and the make-up of the distribution. The tax impact on beneficiaries is discussed in Part 5, Part 6 and Part 8 of this Interpretation Statement.
- 3.16 Beneficiaries are treated as associated persons of trustees and settlors if they have benefited or are eligible to benefit under a trust. This includes any person named as a potential beneficiary as well as discretionary beneficiaries both named and within a class. A person who could become a beneficiary by the exercise of a power of appointment is not treated as one until the power is exercised. For the detail on how a beneficiary is treated under the associated person rules, see Part 12 of this Interpretation Statement.

Part 4 Income derived by trustees

Introduction

- 4.1 The trust rules are largely concerned with the taxation of "income" derived by trustees. They ~~consider~~determine whether the income is taxed to the trustee as "trustee income" or to a beneficiary as "beneficiary income"," or not at all in certain circumstances.
- 4.2 The concepts of "beneficiary income" and "trustee income" are discussed in Part 5 and Part 7 of this Interpretation Statement respectively.
- 4.3 However, before an amount can be beneficiary income or trustee income, it must first be "income derived by a trustee". This part makes several preliminary points about the requirement for there to be "income derived by a trustee".

"Income derived by a trustee" compared with "trustee income"

- 4.4 It is important to remember that the concept of "income derived by a trustee" is not the same as the concept of "trustee income" used in the trust rules. "Trustee income" is income derived by a trustee that is not beneficiary income.

"Income" is a gross concept

- 4.5 "Income" means an amount that is income under a provision in part C (see the definition of "income" in ss YA 1 and BD 1(1)). Being defined as "income under a provision in part C" means "income" is a gross concept and does not take into account any deductions that may be claimed in the calculation of "net income".

Income includes deemed income

- 4.6 Income also includes amounts that are treated as income under a provision in part C, whether or not the amounts are treated as income under trust law (sometimes referred to as "deemed income"). For a fuller explanation of deemed income, see "IS 12/02: Income Tax – Whether Income Deemed to Arise Under Tax Law, But Not Trust Law, Can Give Rise to Beneficiary Income", *Tax Information Bulletin* Vol 24, No 7 (August 2012): 49.

Commented [CJF31]: Is deemed income NZ sourced or foreign income?

Dual derivation

- 4.7 In a sense, an amount of income derived by a trustee that is vested in or paid to a beneficiary as beneficiary income is derived twice: firstly, by the trustee, and secondly, by the beneficiary. However, the income is taxed only once (ie, to the beneficiary). "Beneficiary income" is included in the beneficiary's "income" for the purposes of calculating their net income (s CV 13(a)). The income derived by the trustee that is beneficiary income is not included in the trustee's "income" for the purposes of calculating the trustee's net income. Only income that is "trustee income" is included for this purpose.
- 4.8 In contrast, a taxable distribution of an amount that is not beneficiary income from a trustee to a beneficiary may effectively be taxed twice, once to the trustee and then again to the beneficiary.

Commented [CJF32]: As implied above, all gross income can be distributed which would produce a tax loss for the trustee if the trust had deductible expenditure. It would be useful for the statement to provide context for this result.

We assume this result is to appropriately deal with trusts (particularly resulting from wills) which may direct specific items of income to specific beneficiaries.

Part 5 Beneficiary income

Introduction

- 5.1 As noted above, income derived by a trustee is either “beneficiary income” or “trustee income”.
- 5.2 Income derived by a trustee is “beneficiary income” if the requirements in s HC 6 (Beneficiary income) are satisfied; otherwise, the income will be “trustee income”.
- 5.3 Beneficiary income is included in the income of the beneficiary and, if assessable, will be subject to tax at the beneficiary’s marginal tax rate. An exception to this is beneficiary income to which the minor beneficiary rule applies. Income subject to the minor beneficiary rule is treated as trustee income for the purposes of determining the rate of tax that applies. The trustee income tax rate is set out in Schedule 1 of the ITA 2007 and is currently 33%. The minor beneficiary rule is discussed in Part 6 of this Interpretation Statement.
- 5.4 Generally, the obligation to satisfy the income tax liability on beneficiary income is on the trustee acting as agent for the beneficiary (see from [13.63]).

Definition of “beneficiary income”

- 5.5 “Beneficiary income” is defined in s HC 6 as “income” derived in an income year by a trustee to the extent to which it:
- (a) “vests absolutely in interest” in a beneficiary of the trust in the income year; or
 - (b) is “paid” to a beneficiary in the income year or within the extended time period described in s HC 6(1B).
- 5.6 However, “beneficiary income” does not include:
- (a) income derived by a trustee of a trust that is a superannuation fund; or
 - (b) income derived by a trustee to which ss CC 3(2) and EW 50 apply (these sections relate to income that may arise under the financial arrangement rules where debt owed by a trustee of a trust is forgiven).

These ~~excluded~~ amounts are treated as trustee income.

- 5.7 The following topics and elements of the definition of “beneficiary income” are discussed further below:
- (a) the need for there to be income derived by a trustee first for there to be beneficiary income (from [5.9]);
 - (b) general comments on vesting and paying amounts (from [5.12]);
 - (c) what “vesting absolutely in interest” means (from [5.16]);
 - (d) what “paid to” a beneficiary means (from [5.24]); and
 - (e) the extended time period for payment in s HC 6(1B) (from [5.41]).

Commented [CJF33]: Suggest this is deleted as it may cause confusion with “excluded income”.

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- 5.8 This is followed (from [5.46]) by a brief discussion of s GB 22, an anti-avoidance provision that deals with situations where a trustee enters into an arrangement to defeat the intent and application of the rules relating to beneficiary income and taxable distributions.

Income derived by a trustee

- 5.9 For there to be "beneficiary income" there must first be an amount of "income" derived by a trustee. "Income" means an amount that is income under a provision in part C (see the definition of "income" in ss YA 1 and BD 1(1)). Therefore, if a trustee derives an amount from the sale of a rental property, for example, and the amount is not income under part C, then the amount cannot be beneficiary income if vested in or paid to a beneficiary.
- 5.10 If an amount of income derived by a trustee is of a particular character in the hands of the trustee (eg, interest income), the income will retain this character in the hands of the beneficiary when the amount becomes beneficiary income. The character of the income could be significant in some situations. For example, if a trustee pays interest income to a non-resident beneficiary, the payment will be characterised as a payment of interest, and the trustee may be required to withhold non-resident withholding tax from the payment.
- 5.11 Similarly, if an amount of income derived by a trustee has a source in New Zealand, the income will have the same source in the hands of the beneficiary when the amount becomes beneficiary income (s YD 4(13)). This may determine whether the beneficiary income will be assessable income for the beneficiary.

General comments on vesting and paying amounts

- 5.12 The amount that is vested in or paid to the beneficiary can take the form of money or money's worth. For example, a trustee could derive income in the form of cash sales, but vest or pay that income in or to the beneficiary by transferring assets of an equivalent value to the beneficiary. HoweverNote, the distribution of the assets might also give rise to further income tax consequences for the trustee (eg, income on the disposal of revenue account property).
- 5.13 The exact amount that is vested in or paid to a person does not need to be specified at the time of vesting or payment, as long as the amount can be calculated when the assessment of income is made for the income year. For example, the trust deed, or a resolution by the trustee during an income year, may state that two-thirds of the income derived by the trustee in the income year is allocated to a particular beneficiary. When the income derived by the trustee for the year is known it will be possible to calculate the amount and make an assessment of the trustee and beneficiary income for the income year (*Davidson v CIR* [1976] 2 NZLR 705 (SC) at 713).
- 5.14 Where an amount is future property or an expectancy, the vesting or payment of the amount will not be effective until the amount is received or receivable (*Hadlee and Sydney Bridge Nominees Ltd v CIR* (1989) 11 NZTC 6,155 (HC)).
- 5.15 The language used to vest or pay an amount varies. An amount could be "vested in" or "paid to" a beneficiary without using those words. What is

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important is that the words used have the effect of vesting or paying. For example, a trustee resolution could vest an amount in a beneficiary by resolving that income derived by the trustee is allocated to the beneficiary.

Vesting absolutely in interest

- 5.16 As noted above, income derived by a trustee in an income year will be beneficiary income to the extent to which it “vests absolutely in interest” in a beneficiary of the trust in the income year.
- 5.17 An amount may vest in a beneficiary as a result of a clause in a trust deed or as a result of the exercise of a discretion given to a trustee to allocate an amount to a beneficiary.
- 5.18 An amount will vest in a beneficiary for the purposes of the “beneficiary income” definition only if the beneficiary is given an indefeasible right to the amount (*CT v Johnson and Maeder* [1946] NZLR 446 (SC)). Vesting an amount in a beneficiary means the trustee cannot later change their mind and decide not to give the amount to the beneficiary. On vesting, the beneficiary obtains an absolute interest in the amount.
- 5.19 Vesting “in interest” means that the right given to the beneficiary can be a right to present or future possession of the amount. In other words, an amount can be vested in interest even if the beneficiary is not entitled to possession of the amount until a future date.
- 5.20 Even if there is a right to present possession, the trustee may hold the amount until the beneficiary demands it. There is no longer any requirement for the amount to be placed beyond the possession and control of the trustee. See “Appendix: Explanation of Taxation of Trusts”, *Tax Information Bulletin* Vol 1, No 5 (November 1989) at Part 5, for more detail on changes in this area when the current regime was introduced.
- 5.21 The vesting cannot be subject to a condition being met or to an event occurring.

Example 12. Vesting in interest—not conditional

A trustee might allocate an amount of income to an 8 year old beneficiary with a right to possess the amount in 10 years, when the beneficiary would be aged 18. The amount would be vested in interest as the beneficiary has immediately received an indefeasible right to the amount, despite not having a right to possess the amount. After making the allocation, the trustee could not change their mind about giving the income to the beneficiary. If the beneficiary died before reaching 18, the income would become part of the beneficiary’s estate and would not revert to the trust.

Example 13. No vesting—conditional allocation

A resolution by a trustee that trust property will belong to a beneficiary if they reach the age of 18 will not vest the property in the beneficiary unless and until that condition is satisfied. The resolution, as worded, is conditional on the beneficiary reaching the age of 18. If the beneficiary died before reaching the age of 18, the condition in the resolution would not be met and the amount would remain trust property.

Example 12 differs from this example in that the allocation of the income to the beneficiary is not conditional on the beneficiary reaching the age of 18. If the beneficiary referred to in Example 12 died before reaching 18, the income would become part of the beneficiary’s estate and would not revert to the trust.

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- 5.22 The word “absolutely” reinforces the infeasible nature of the vesting and the fact that the vesting results in the beneficiary receiving the beneficial ownership of the amount.
- 5.23 The phrase “vests absolutely in interest” is discussed in more detail in “IS 12/02: Income Tax — Whether Income Deemed to Arise Under Tax Law, But Not Trust Law, Can Give Rise to Beneficiary Income”, *Tax Information Bulletin* Vol 24, No 7 (August 2012): 49.

Paid to a beneficiary

- 5.24 The definition of “beneficiary income” was rewritten with the introduction of the ITA 2007. This is particularly relevant to the payment paragraph in the definition.
- 5.25 In the earlier income tax legislation, the definition of “beneficiary income” referred to income derived by a trustee to the extent to which the trustee “pays or applies” the income to or “for the benefit of” the beneficiary. Also, the earlier legislation did not define “pay” for the purposes of the definition of “beneficiary income”.
- 5.26 The definition of “beneficiary income” in the ITA 2007 now refers to income derived by a trustee during an income year to the extent that it is “paid to” a beneficiary. Also, the definition of “pay” in the ITA 2007 has been extended to apply for the purposes of the definition of “beneficiary income” (it now applies for the purposes of the Act generally). The definition of “pay” states that, for an amount and a person, to “pay” includes to:
- (a) distribute the amount to the person;
 - (b) credit the person for the amount; or
 - (c) deal with the amount in the person’s interest or on their behalf in some other way.
- 5.27 The definition of “pay” in the ITA 2007 includes grammatically associated terms such as “pays”, “paid” and “payment”. The definition expands the ordinary meaning to include situations where amounts are distributed, credited or dealt with in some way.
- 5.28 This rewording of the definition of “beneficiary income” was not intended to change the meaning of “beneficiary income”; rather, the change was intended to simplify the definition by relying on the definition of “pay” in s YA 1.
- 5.29 Because there was no intended change in the meaning of beneficiary income, cases dealing with the previous definition are still relevant.
- 5.30 Although the definition of “beneficiary income” suggests that the income must be paid “to” the beneficiary, the extended definition of “pay” means that the test is satisfied if the income is dealt with in the beneficiary’s interest or on their behalf in some other way. Although this is largely dependent on the facts of each case, in general terms a transaction will be in the interest of a beneficiary if it improves the material situation of the beneficiary (*Re Pilkington’s Will Trusts* [1964] AC 612 (HL); *CIR v Simpson* (1989) 11 NZTC 6,140 (CA) at 6,144).

Commented [CJF34]: This paragraph could be integrated with 5.24?

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- 5.31 An amount is dealt with in a minor beneficiary's interest and, therefore, "paid" to the beneficiary, if it is transferred to the beneficiary's parents or guardians for expenditure on behalf of the beneficiary. Receipt of the income by the parent or guardian is sufficient to discharge the trustee's obligations, and the trustee does not have to ensure the parent or guardian pays the income to the beneficiary or uses it to maintain and support them. However, distributions to minors may be subject to the minor beneficiary rule, in which case they will be taxed at the trustee tax rate.
- 5.32 An amount is dealt with on the beneficiary's behalf, and, therefore, "paid" to the beneficiary, if the trustee makes a payment of income to a person other than the beneficiary that discharges the beneficiary's obligation. In *Re Clore's Settlement Trusts* [1966] 2 All ER 272 (Ch), the court rejected a submission that a payment to a person other than the beneficiary was for the benefit of the beneficiary only if there was a direct benefit to the beneficiary. Instead, the court held (at 274) that there was a benefit to the beneficiary if the payment resulted in "the discharge ... of certain moral, or social, obligations on the part of the beneficiary, for example towards dependants". Therefore, in some situations, a payment by a trustee to a dependant of a beneficiary that discharges an obligation of the beneficiary to the dependant may be treated as a payment to the beneficiary. A payment of an amount of income does not require possession of the amount to be transferred to the beneficiary. The trustee can "pay" an amount to a beneficiary by giving the beneficiary an absolute indefeasible interest in the amount, even if the trustee retains possession of the amount. In this regard, the definition of "pay" and "vest absolutely in interest" overlap significantly.
- 5.33 In *CIR v Ward* [1970] NZLR 1, the Court of Appeal considered s 155 of the Land and Income Tax Act 1954. This provision was a forerunner of various trust taxation provisions in the ITA 2007, including s HC 6. It dealt with the taxation of trustee income that was also income derived by a beneficiary entitled in possession to the receipt of the income. The question in *Ward* was whether a resolution by a trustee that a certain amount of income be held for the credit of particular beneficiaries was a "payment or an application" of the income to or for the benefit of the beneficiaries in terms of s 155 of the Land and Income Tax Act 1954.
- 5.34 The court held that the resolution was an effective application of the income because it resulted in the income becoming the absolute property of the beneficiaries. Before the resolution, the beneficiaries had only a contingent interest in the income. Their interest was contingent because under the trust deed they were not entitled to the income unless they reached the age of 21. The effect of the trustee's resolution was that the income immediately became the absolute property of the beneficiaries and would have been part of their estates if they had died before the age of 21.
- 5.35 *Ward* demonstrates that a resolution by a trustee that results in the income becoming the absolute property of a beneficiary is sufficient for the income to be "applied" to the beneficiary. It is not necessary for the resolution to be reflected in the books of the trust in the relevant time period, nor is it necessary for possession of the amount to be immediately transferred to the beneficiary. Also, it is not necessary that the income be separated from the trust fund (eg, be paid into a separate bank account).

Commented [CJF35]: Without re-reading *Ward*, it seems that the resolution was contrary to the deed?

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- 5.36 The making of a loan to a beneficiary will not constitute paying the amount of the principal to that beneficiary as they have an obligation to repay the amount and it does not become their absolute property.
- 5.37 The court in *Ward* focused on the word "applied" rather than "paid". However, in *CIR v Albany Food Warehouse* (2009) 24 NZTC 23,532 (HC) a decision similar to that in *Ward* was reached on the word "paid". In that case, the High Court held that a resolution by the directors of a company declaring a dividend was sufficient to result in a dividend being "paid" within the extended definition of "paid" (being essentially the same as the definition of "pay" that applies for the purposes of s HC 6).
- 5.38 The decision in *Albany Food Warehouse* on the meaning of "paid" suggests that the decision in *Ward*, which focused on the word "applied", is still good authority. This is despite the removal of the word "applied" from the phrase "paid or applied" in the definition of "beneficiary income".
- 5.39 Where a beneficiary has a discretionary interest in income, and not a vested or fixed interest, it is necessary for the trustee to pass a resolution that initiates the making of a payment of income to that beneficiary. In *Montgomerie v Commissioner of Inland Revenue* [1965] NZLR 951 the Supreme Court (now the High Court) found income was not applied where there was merely an entry in the trust account crediting amounts to beneficiaries and no resolution. The Court in *Ward* confirmed that it is the resolution which is the trigger for application of income not the book entries as these merely record earlier decisions of the trustees.
- 5.40 A record of a trustee resolution can be prepared after trustees have made a decision. However, such a record cannot be used as a means of backdating such a decision. See for example *Re Samarang Developments Limited (in liquidation)*; *alt cit Walker v Campbell* (unreported HC, Christchurch, CIV 2003-409-2094, 30 September 2004, John Hansen J where the court would not give effect to attempts to back date dividend resolutions and confirmed that any dividend would not arise until the actual date of the resolution.

Commented [CJF36]: Because "paid" includes applied under the YA 1 definition?

The extended time period for payment in s HC 6(1B)

- 5.41 Income derived by a trustee during an income year will be taxed as beneficiary income if it is paid to the beneficiary within the extended time period described in s HC 6(1B).
- 5.42 The extended time period is the later of:
- (a) 6 months following the end of the income year in which the trustee derived the income (s HC 6(1B)(a)); and
 - (b) the earlier of:
 - (i) the date on which the trustee files the return of income for the income year (s HC 6(1B)(b)(i)); and
 - (ii) the date by which the trustee is required to file a return of income for the income year under s 37 of the TAA (s HC 6(1B)(b)(ii)).
- 5.43 The date by which the trustee is required to file a return may vary. Most trustees with tax agents have a return filing extension until 31 March in the

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following year. Trustees who do not have tax agents may also apply for an extension of time. For trustees without an extension, the extended time period will likely be 6 months following the end of the income year because the standard time for filing returns is shorter (just over 3 months).

- 5.44 This extended time period enables the trustee to calculate the income derived by the trustee for the relevant year before paying any income to a beneficiary. This is especially relevant for trustees who receive farming income or are trading trusts that may be unable to calculate the amount of income available for distribution to the beneficiaries until after the end of the income year.
- 5.45 Beneficiary income that is paid to a beneficiary within the extended time period is treated as being derived by the beneficiary in the same tax year as that corresponding to the trustee's income year. This may be a different income year than the income year in which the beneficiary is paid the amount.

Section GB 22—anti-avoidance

- 5.46 A specific anti-avoidance provision is included in s GB 22 to deal with situations where a trustee enters into an arrangement to defeat the intent and application of the rules relating to beneficiary income and taxable distributions. Section GB 22 applies where:
- (a) an arrangement exists that involves a trustee transferring property or providing services or other benefits to a person other than a beneficiary of the trust;
 - (b) the arrangement has the effect of defeating the intent and application of ss HC 17 to HC 23 (which deal with the tax consequences arising from a receipt of beneficiary income or taxable distributions by a beneficiary); and
 - (c) the trust is not a Maori authority.
- 5.47 If s GB 22 applies, the beneficiary of the trust is treated as receiving the property or enjoying the services or benefits provided to the other person for the purposes of ss HC 17 to HC 23 and will be taxed accordingly.
- 5.48 Section GB 22 is intended to limit opportunities for distributions to be made tax-free to a person who is not a beneficiary of the trust where a beneficiary of the trust benefits from the distribution. In many cases, these types of transactions will be treated as beneficiary income or a distribution to the beneficiary anyway. This is because of the broad definition of "pay", which includes dealing with an amount in a person's interests or on their behalf. Therefore, s GB 22 effectively operates to buttress the "beneficiary income" and "distribution" definitions in situations where a transaction may not technically be a "transfer of value" or a "payment" to the beneficiary, but where the beneficiary still benefits from the transaction.
- 5.49 Section GB 22 is also relevant to taxable distributions (discussed from [8.37]).

Commented [CJF37]: An example of the circumstances in which the Commissioner considers section GB 22 applies would be useful.

Part 6 Minor beneficiary rule

Source of content for this part

- 6.1 The minor beneficiary rule was discussed when it was enacted in "Taxing Beneficiary Income of Minors at 33% – the 'Minor Beneficiary Rule'", *Tax Information Bulletin* Vol 13, No 5 (May 2001): 28. This part of this Interpretation Statement draws from that commentary and also includes additional analysis and clarification.

Purpose

- 6.2 The purpose of the minor beneficiary rule is to limit the tax benefits that could otherwise be achieved by distributing the income of a trust to a minor beneficiary. This tax benefit could arise because of the different tax rates that may apply to trustee income, minor beneficiaries and other beneficiaries. The trustee tax rate is 33%. A minor beneficiary is likely to be on the lowest marginal tax rate of 10.5%. Other natural person beneficiaries may be on marginal tax rates of up to 33%.
- 6.3 The rule addresses the concern that a family with a trust could gain a tax advantage over a family without a trust by using the income of a trust to meet the expenses of raising their children.

Beneficiary income of a minor is treated as excluded income of the minor

- 6.4 Where the minor beneficiary rule applies, beneficiary income derived by a minor is treated as excluded income of the minor under s CX 58. This means that no income tax liability will arise in the minor's name.

Treated as trustee income

- 6.5 Instead, the trustee will be liable to pay the tax at the trustee tax rate (33%). The trustee will also be liable to include the beneficiary income in their income tax return. This is achieved in s HC 35(2)(b) by treating the beneficiary income derived by a minor beneficiary as if it were trustee income for the purposes of:
- (a) determining the tax rate that will apply (ie, the trustee tax rate of 33%);
 - (b) paying the tax; and
 - (c) providing returns of income.
- 6.6 This means the income must be included in the trustee's provisional tax calculations along with other trustee income. Also, use of money interest may apply on underpayments by a trustee. Penalties may also apply (eg, late payment penalties).
- 6.7 For the purposes of debiting and crediting a beneficiary's account with a trust, a trustee may treat income tax paid by the trustee as paid on behalf of the beneficiary. That the trustee has to return and pay the tax does not change the fact the tax is on the beneficiary income derived by the beneficiary.

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Example 14. Tax treated as paid on behalf of beneficiary

A trustee distributes \$2,000 to a minor beneficiary and pays tax of \$660 on that distribution as if it were trustee income. The beneficiary would have a credit of \$1,340 in their account with the trust. The beneficiary could not demand payment of the whole \$2,000 on the basis that the liability to pay tax was on the trustee.

- 6.8 If a trustee of a foreign trust distributes foreign-sourced amounts to a minor (defined as, a New Zealand resident) as beneficiary income and the minor beneficiary rule applies, the beneficiary income will be treated as if it were trustee income only for the purposes of determining the tax rate, paying the tax, and providing returns. These purposes do not include characterising income as non-residents' foreign-sourced amounts under s BD 1 or exempt income under s CW 54. The income is still income (albeit excluded income) of a New Zealand resident minor and is taxable in New Zealand. Therefore, a trustee of a foreign trust will be liable to pay tax on the beneficiary income.

Imputation credits and foreign dividend payment credits

- 6.9 As noted above, an amount of beneficiary income to which the minor beneficiary rule applies is treated as if it was trustee income for the purposes of paying tax on that income. This means, in the case of dividend income distributed by a trustee to a beneficiary, the dividend will be included in the trustee's assessable income. The trustee will then be able to use any imputation credits that are attached to the dividend (s LE 1).
- 6.10 The trustee is also treated as deriving the minor's beneficiary income as a beneficiary (s LE 4). This is important for the calculation under s LE 5 of the imputation credits of beneficiaries of the trust.
- 6.11 Similar rules apply in relation to foreign dividend payment credits under ss LF 1 to LF 3.

Definition of "minor"

- 6.12 The minor beneficiary rule applies where a person who is a "minor" derives an amount of beneficiary income from a trust. A "minor" is defined in s HC 35(3) as a person who is:
- (a) a natural person; and
 - (b) on the trust's balance date for the income year, is;
 - (i) a New Zealand resident; and
 - (ii) under the age of 16.
- 6.13 If the person does not possess all three of the above characteristics, the minor beneficiary rule will not apply.

Exclusions

- 6.14 There are three types of exclusion to the minor beneficiary rule:
- (a) a \$1,000 *de minimis* exclusion in s HC 35(4)(a);

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- (b) exclusions relating to income derived from particular sources (s HC 35(4)(b)(iii) to (v)); and
- (c) exclusions based on settlements on a trust (ss HC 36 and HC 37).

A \$1,000 or less de minimis exclusion

- 6.15 A *de minimis* rule is provided in s HC 35(4)(a). This section provides that the minor beneficiary rule does not apply to an amount of beneficiary income derived by a minor from a trust in an income year if the total amount of beneficiary income derived by the minor from the trust in the income year is \$1,000 or less. The minor's marginal tax rate will apply instead.
- 6.16 If the total is more than \$1,000, no amount of beneficiary income is excluded under the *de minimis* rule. In other words, the rule does not provide an exclusion for the first \$1,000 derived by the beneficiary.
- 6.17 This exclusion applies on a per trust basis. This means the exception may still apply to a distribution if the beneficiary derives beneficiary income from multiple trusts that in total exceed \$1,000 in the income year. There is no express limit on the number of trusts that can make distributions of \$1,000 or less to the same minor beneficiary and still benefit from the s HC 35(4)(a) exclusion. However, where the use of multiple trusts has the effect of producing a greater than \$1,000 exemption for a minor beneficiary, the Commissioner might consider the application of the general anti-avoidance rule in s BG 1.

Income derived from particular sources

- 6.18 The minor beneficiary rule does not apply to an amount of beneficiary income derived from a Māori authority or directly derived from a group investment fund. The minor beneficiary rule also does not apply if the minor is in receipt of a child disability allowance under the Social Security Act 1964 (s HC 35(4)(b)).
- 6.19 The exclusion from the minor beneficiary rule for beneficiary income derived from a Māori authority is now redundant as the trust rules (and, therefore, the minor beneficiary rule) do not apply to distributions from Māori authorities (s HC 1(2)(c)). From 2003, a distribution from a trust that is a Māori authority is taxed at a special Māori authority tax rate (17.5%).
- 6.20 The minor beneficiary rule will not apply to beneficiary income directly derived by a minor from a group investment fund. This is targeted at group investment funds that are structured in the form of a trust. The income must be *directly* derived by the minor from the fund. If income from the group investment fund is first derived by another trust (which is not a group investment fund) and is then distributed to the minor, the minor beneficiary rule may apply.
- 6.21 The minor beneficiary rule will not apply to beneficiary income derived by a minor who is in receipt of a child disability allowance under the Social Security Act 1964. This means any beneficiary income derived by such a minor will be taxed at the minor's marginal income tax rates. The exemption for a minor in receipt of such a child disability allowance is intended to exempt trusts set up for children with severe disabilities. The receipt of a child disability allowance is intended to provide an objective basis for determining whether a child has a severe disability.

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Exclusions based on settlements on a trust

- 6.22 Sections HC 36 and HC 37 provide exclusions from the minor beneficiary rule based on the source and nature of settlements that have been made on the trust.
- 6.23 These exclusions are discussed in more detail below. However, two points are worth noting first:
- (a) A trustee may treat multiple settlements made on the same terms as one trust.
 - (b) The meaning of "settlement" is narrowed for the purposes of these exclusions.

Trustee may treat multiple settlements made on the same terms as one trust

- 6.24 Sections HC 36(1) and HC 37(1) impose requirements that must be met in relation to "all settlements on the trust".
- 6.25 The reference to "all settlements on the trust" may at first appear inconsistent with trust law. This is because under trust law, each settlement may create a separate trust, even if each settlement is made on the same trustee and on the same terms.
- 6.26 However, under s HC 3 a trustee may treat multiple settlements made on the same terms as one trust.
- 6.27 Section HC 3 is consistent with the common practice in trust administration of treating multiple settlements on the same terms as one trust.
- 6.28 The imposition of requirements in relation to "all settlements on the trust" in ss HC 36 and HC 37 takes into account the possibility that the trustee of the trust may have treated multiple settlements made on the same terms as one trust, as allowed under s HC 3. Interpreted in this way, the reference to "all settlements on the trust" is not inconsistent with trust law.

Meaning of "settlement" is narrowed

- 6.29 The meaning of "settlement" for the purposes of the exclusions from the minor beneficiary rule in ss HC 36 and HC 37 is narrower than the general meaning under the ITA 2007. The effect of this narrower meaning is to make it easier to meet the requirements of ss HC 36(1) and HC 37(1), which must be satisfied for "all settlements on the trust".
- 6.30 The modification is actually made to the term "settlor" ("settlement" is defined in relation to the term "settlor"). "Settlor" is defined in s YA 1. Section YA 1 refers to s HC 27 for the general definition, which defines "settlor" as a person who, among other things, transfers value to, for the benefit of, or on the terms of a trust. This general definition of "settlor" is modified (in s YA 1) for the purposes of the exclusions to the minor beneficiary rule in ss HC 36 and HC 37. The definition is modified by providing that there will be no transfer of value and, therefore, no settlement, if the transfer of value in s HC 27(2) is:
- (a) The provision of financial assistance by way of a loan for less than market value, and either of the following is true:

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- (i) The loan ceased to exist before 1 April 2002; or
 - (ii) If the loan existed on or after 1 April 2002, in each tax year of the trust's existence, interest has been paid at a rate that is equal to or greater than the interest rate prescribed under the Income Tax (Fringe Benefit Tax, Interest on Loans) Regulations 1995 on 31 March of the previous tax year. (Although this interest rate is generally regarded as high, it may be lower than the market interest rate that would apply to certain high risk loans.)
- (b) The provision of financial assistance by way of guarantee and the guarantee has not been called on.
 - (c) The provision of security and the security has not been called on.
 - (d) The provision of services that are incidental to the operation of the trust (eg, bookkeeping services, accounting services, or services as a trustee).
- 6.31 These excluded settlements can be disregarded when determining whether "all the settlements on the trust" meet the requirements of ss HC 36(1) and HC 37(1). See Example 17.

Settlements made by a relative, a guardian, or their associate (s HC 36)

- 6.32 Generally, the minor beneficiary rule is intended to apply only to trusts on which a settlement has been made by a relative or guardian of the minor or by a person associated with a relative or guardian of the minor (referred to below as a "relative, guardian, or their associate"). If no such settlements have been made, then the minor beneficiary rule will not apply. This means the rule applies only in those situations where families can potentially gain a tax advantage from using a trust.
- 6.33 Therefore, an exclusion from the minor beneficiary rule is provided if no settlements have been made on the trust by a person who is a relative, guardian, or their associate (s HC 36(1)(a)).
- 6.34 For these purposes, a "relative" means a person connected with another person by being:
- (a) within the second degree of blood relationship with the other (eg, a grandfather and granddaughter or a sister and brother);
 - (b) in a marriage, civil union or de facto relationship with the other;
 - (c) in a marriage, civil union or de facto relationship with a person who is within the second degree of blood relationship with the other (ie, a person can be related to their de facto partner's grandfather under this test);
 - (d) adopted as a child of the other or as a child of a person who is within the first degree of relationship to the other (eg, a person will be associated with a child who is adopted by their daughter – essentially, a grandparent through adoption);
 - (e) in a marriage, civil union or de facto relationship with a person who is connected with another person through adoption as described in (d) (ie, a person will be related with a child who is adopted by their civil union

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partner's daughter – essentially, a grandparent through civil union and adoption); or

- (f) the trustee of a trust under which a relative has benefited or is eligible to benefit.

6.35 "Guardian" has the meaning set out in s 15 of the Care of Children Act 2004, but does not include certain "guardians" appointed under various statutes (ie, the chief executive of the Ministry of Social Development, a court or an agent of a court, or the Public Trustee). Essentially, a guardian of a child is a person who has all the duties, powers, rights and responsibilities that a parent of the child has in relation to the upbringing of the child.

6.36 Further, for the purposes of s HC 36, an associated person does not include a person associated under only ss YB 4 or YB 5. These provisions relate to relatives who are treated as associated persons.

6.37 Some types of settlement can be made by the relative, guardian, or their associate that will not disqualify the trust from the exclusion. The exclusion from the minor beneficiary rule will still apply in the following situations (s HC 36(1)(b)):

- (a) The relative, guardian, or their associate is acting as an agent of the minor and has received the property from a person other than a relative, guardian, or their associate. This exception would apply, for example, if accident compensation were paid on behalf of a disabled child to the child's parent, who settles the money on a trust.
- (b) The settlement is of an amount of damages or compensation that a court order required the relative, guardian, or their associate to pay to the minor.
- (c) The minor is a protected person (as defined in s 2 of the Domestic Violence Act 1995), in relation to a protection order, and the settlement is made before the protection order is made or during the time the protection order is in force. A settlement made after the protection order is removed will not qualify. Settlements made before the protection order is removed will continue to satisfy the requirements of the exclusion after the protection order is removed. A settlement that is made jointly by two persons (eg, both parents) will satisfy the requirements of the exclusion even if the protection order is in force against only one of the settlors.

6.38 Further, if a settlement does not meet the requirements of s HC 36(1)(a) or (b), the exclusion from the minor beneficiary rule may still apply if the mixed trust rule in s HC 36(3) applies. This is discussed at [6.43].

Settlement made on the death of a settlor (s HC 37)

6.39 Section HC 37 deals with settlements made under a will, a codicil (an amendment to a will), an intestacy or a court variation. The purpose of this is to exclude beneficiary income derived by a minor from a trust where the trust was settled on the settlor's death to provide for the minor. For this exclusion to apply, the minor must be alive within 12 months after the settlor's death. The exclusion will also apply to beneficiary income derived by a minor who has a sibling who was alive within 12 months after the settlor's death.

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- 6.40 This exclusion allows for children who were alive at the time of the settlor's death and any children whose birth may have been contemplated on the settlor's death. The exclusion was extended to beneficiary income derived by other siblings because it was considered unfair if two siblings in a family received different treatment merely because of when they were born.

Example 15. Extension to siblings

Richard Stark dies on 1 January 2000. In his will, he directs that the Winterfell farm be settled on the Grey Wolf Trust. Richard's grandson, Rob, is born in the same year, on 5 December 2000. Rob's brother, Brandon Stark, is born 5 years later. In 2017, the current trustee makes a distribution of beneficiary income to Brandon, who is now 12 years old. The only settlement that has ever been made on the trust is the transfer by Richard Stark of the Winterfell farm under the will.

The minor beneficiary rule will not apply to the beneficiary income derived by Brandon in 2017. This is because all settlements (there was only one) were made under a will and Brandon has a brother (Rob) who was alive within 12 months after the settlor's death.

- 6.41 If there is a settlement that does not meet the requirements of s HC 37(1), the exclusion from the minor beneficiary rule can still apply if the mixed trust rule in s HC 36(3) applies.

Sections HC 36 and HC 37 are read together

- 6.42 Sections HC 36 and HC 37 both require that all settlements on the trust meet their respective requirements. However, the two sections are intended to be read together.

Issue Referred to Policy

This issue has been referred to Inland Revenue's Policy and Strategy group. Pending any amendment the Commissioner will accept that the exclusions are satisfied if all of the settlements meet either the requirements in ss HC 36(1) or HC 37(1).

Example 16. Sections HC 36 and HC 37 are read together

A minor derives beneficiary income of \$1,500 from a trust in an income year. There have been two settlements on the trust:

- (a) The first settlement was made by the grandmother of the minor. This settlement was made under the terms of the grandmother's will. The child was alive when the grandmother died.
- (b) The second settlement was made by a close family friend. The family friend is not a relative or guardian of the minor and is not associated with a relative or guardian of the minor.

The first settlement would, if it were the only settlement, meet the requirements of the exclusion in s HC 37(1). Similarly, the second settlement would, if it were the only settlement, meet the requirements of s HC 36(1).

Based on the ordinary meaning of the exclusions, which both require that all settlements on the trust meet their respective requirements, neither of the exclusions would apply. This is because not all settlements on the trust satisfy each of the exclusions.

However, in this situation the Commissioner will accept that the exclusions are satisfied and that the minor beneficiary rule will not apply.

Commented [CJF38]: This is confusing. If the two must be satisfied, they must be read together? It is not clear what the problem is that requires the second sentence.

Commented [CJF39]: Is the problem that they are not read together per the examples?

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Mixed trust rule (s HC 36(3) and (4))

- 6.43 Generally, the mixed trust rule allows the exclusions from the minor beneficiary rule in ss HC 36 and HC 37 to still apply if some settlements do not meet the requirements of those sections but at least one does (and the settlements are treated by the trustee as being one trust). For this rule to apply, the settlements that do not meet the requirements must be of a relatively small value.
- 6.44 If there is more than one settlement on a trust and one or more, but not all, of the settlements fail to meet the requirements of ss HC 36(1) or HC 37(1), the exclusions from the minor beneficiary rule under those provisions may still apply. They may still apply if all of the settlements that failed to meet the requirements of s HC 36(1) or s HC 37(1) meet the requirements of s HC 36(3) and (4). Section HC 36(3) and (4) require:
- (a) The settlements were made through either:
 - (i) the disposal of property for less than market value, where the total value of settlements made in this way (in the current and in previous income years) is \$5,000 or less at the end of the trust's income year (value of each settlement is to be determined as at the date of settlement) (s HC 36(3)(a)); or
 - (ii) providing financial assistance for less than market value in the form of a loan if the total amount loaned is not greater than \$1,000 on any day in the trust's income year (s HC 36(3)(b)).
 - (b) No services are provided to the trust by a relative, guardian, or their associate. This requirement applies whether or not the trust pays for the services. For the purposes of this requirement, services do not include services that are incidental to the operation of the trust, for example, bookkeeping, accounting, or trustee services (s HC 36(4)). The purpose of this is to exclude trading trusts from the mixed trust rule. Trading trusts are intended to be subject to the minor beneficiary rule if any settlement on the trust fails to satisfy the requirements of ss HC 36(1) or HC 37(1).

Example 17. Mixed trust rule requires at least one qualifying settlement

A minor derives beneficiary income of \$1,500 from a trust in an income year. There have been two settlements on the trust:

- (a) a settlement of \$5,000 by a parent of the minor; and
- (b) the parent loans the trust \$800 interest free in the income year.

Neither settlement would meet the requirements of ss HC 36(1) or HC 37(1). The mixed trust rule requires at least one settlement that meets the requirement of those provisions. Therefore, the minor beneficiary rule will apply.

However, if there had been a third settlement that did satisfy the requirements of ss HC 36(1) or HC 37(1), then the two settlements above would not prevent the exclusion from applying. The mixed trust rule would apply. The first settlement above would meet the requirement of s HC 36(3)(a) as it is a disposal for less than market value of property (money) and the total value of settlements on the trust of this nature is not more than \$5,000. The second settlement would meet the requirements of s HC 36(3)(b) because the loan was not more than \$1,000 on any day in the income year.

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Example 18. Settlor provides services to trust

A minor derives beneficiary income of \$1,500 from a trust in an income year. There have been two settlements on the trust:

- (a) An initial settlement of \$100 by a parent of the minor (being a disposal of property for less than market value under s HC 36(3)(a)).
- (b) A second settlement was made by the grandmother of the minor. This settlement was made under the terms of the grandmother's will. The child was alive when the grandmother died.

The parent is also a full-time employee of the trust and is paid a market salary. Because the parent is paid market value, the provision of employee services by the parent is not a settlement on the trust.

The first settlement fails the requirements of s HC 36(1) because it is a settlement by a relative. The second settlement meets the requirements of s HC 37. Therefore, this is a mixed trust situation. The minor beneficiary rule will apply unless the mixed trust rule applies. The settlement by the parent will satisfy s HC 36(3)(a) because the total value of settlements made by disposal for less than market value of property is no more than \$5,000. However, the mixed trust rule will not apply because the parent provides services to the trust that are not incidental to the operation of the trust. It does not matter that the parent is paid a market value salary. Therefore, the minor beneficiary rule will apply to the beneficiary income derived by the minor.

Example 19. Some settlements can be disregarded

A minor derives beneficiary income of \$1,500 from a trust in an income year. There have been three settlements on the trust:

- (a) On 4 May 2000, a parent of the minor provided a \$2,000 interest-free loan to the trust. The trust repaid this loan on 31 March 2002.
- (b) The parent made a further \$1,000 interest-free loan to the trust, which is still outstanding.
- (c) A third settlement was made by the grandmother of the minor. This settlement was made under the terms of the grandmother's will. The child was alive when the grandmother died.

The first settlement does not come within the definition of "settlement" for the purposes of ss HC 36 and HC 37. The settlement is the provision of financial assistance by way of loan for less than market value and the loan ceased to exist before 1 April 2002 (para (b)(i) of the definition of "settlor" in s YA 1). Therefore, this settlement can be disregarded.

The second settlement does not meet the requirements of s HC 36(1) because it is a settlement by a relative. The third settlement meets the requirements of s HC 37(1). Overall, one settlement meets the requirements of ss HC 36(1) or HC 37(1) and one does not. Therefore, this is a mixed trust. Because the interest-free loan is for no more than \$1,000 the mixed trust rule will apply and the minor beneficiary rule will not apply to the beneficiary income derived by the minor.

Part 7 Trustee income

Definition of "trustee income"

- 7.1 "Trustee income" is defined in s HC 7 as an amount of income derived by the trustee of a trust, to the extent to which it is not "beneficiary income". Trustee income is generally taxed based on the residence of the settlors of the trust ~~;~~ or the source of the income?.

Income

- 7.2 Income derived by the trustees of a trust is determined according to the general rules contained in part C (s BD 1). As discussed above, "trustee income" is the portion of the total income derived by the trustees that is not "beneficiary income" (s HC 7).
- 7.3 Sections HC 7(3) and CV 13(b) extend trustee income to include the market value of any property settlement a trust receives that is excluded from corpus under ss HC 4(3) to (5).
- 7.4 New Zealand-sourced income derived by a trustee of a trust is generally assessable income (where it is not exempt or excluded income) (s BD 1). Sections YD 4 (Classes of income treated as having a New Zealand source) and YZ 1 (Source rules for interest) apply to determine whether income has a New Zealand source.
- 7.5 However, the trust rules contain specific provisions dealing with the tax treatment of foreign-sourced amounts derived by trustees. The general rule is that foreign-sourced amounts will be assessable as trustee income when the settlor is resident in New Zealand. Section HC 25 deals with situations where the trustee is not resident in New Zealand. Section HC 26 deals with situations where the trustee is resident in New Zealand.

Foreign-sourced amounts – non-resident trustees

- 7.6 Where the trustees of the trust are non-resident, foreign-sourced amounts are assessable as trustee income if, at any time in the income year (s HC 25(2)):
- (a) a settlor of the trust is a New Zealand resident who is not a transitional resident; or
 - (b) the trust is a superannuation fund ~~;~~ (see above, this is a New Zealand retirement scheme regulated under the FMCA); or
 - (c) the trust is a testamentary trust or an *inter vivos* trust, of which any trustee is resident in New Zealand and a settlor died resident in New Zealand (whether or not they died in the income year).
- 7.7 Section HC 25(2) applies so that foreign-sourced amounts are assessable if any one of the settlors of the trust (if there is more than one settlor) is resident in New Zealand at any time during an income year. An entire year of residency is not required.
- 7.8 Where there is a testamentary trust or an *inter vivos* trust, and a settlor died resident in New Zealand, foreign-sourced amounts derived by the trustees are

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assessable income in New Zealand for only income years where any trustee of the trust is resident in New Zealand (s HC 25(2)(c)). For example, if a New Zealand resident settlor of a trust that had non-resident trustees died in New Zealand in 2016, and any one of those trustees became resident in New Zealand for any part of the 2018 income year, any foreign-sourced amounts derived during the 2018 income year would be assessable income in New Zealand.

- 7.9 Foreign-sourced amounts derived by a non-resident trustee are not assessable as trustee income if the trustee is resident outside New Zealand at all times in the income year, and:
- (a) no settlement has been made on the trust since 17 December 1987 and the trustee has not made an election under s HZ 2 for the trust to pay tax on all income so that it will be treated as a complying trust (s HC 25(3)); or
 - (b) if a settlement were made on the trust after 17 December 1987, it was made by a settlor who was not resident in New Zealand at the date of the settlement and at any time between 17 December 1987 and the date of the settlement (s HC 25(4)).
- 7.10 Although s HC 25(3) and (4) means certain non-resident trustees are not required to pay tax on foreign-sourced amounts, the application of those provisions does not affect the settlor's income tax liability under s HC 29 (s HC 25(5)). Therefore, a New Zealand resident settlor will still be liable as agent of the trustee for income tax payable by the trustee.
- 7.11 Section HC 25(3) and (4) also has no effect when determining whether a trust has met the requirements to be a complying trust under s HC 10(1)(a)(ii) (s HC 25(5)). To maintain complying trust status, it is still necessary for the trustee to pay tax on the trustee's world-wide income. A trustee, settlor or beneficiary of a trust can elect, under s HC 33, to satisfy the income tax liability on the world-wide income of a trust in order to satisfy the requirements to maintain complying trust status (this is discussed further in Part 10 of this Interpretation Statement).
- 7.12 Where the trustees of the trust are non-resident and foreign-sourced amounts are assessable as trustee income under s HC 25(2), s HC 25(6) confirms that, for the purposes of calculating the taxable income of the trustee, the non-resident trustee will be treated as resident in New Zealand for the purposes of:
- (a) ss EW 9 and EW 11 (which state the situations where the financial arrangements rules will or will not apply);
 - (b) s LJ 2 (which states when a person can claim a tax credit for foreign income tax paid);
 - (c) s OE 1 (which states when a person can choose to be a branch equivalent tax account (BETA) person); and
 - (d) the international tax rules (which are defined in s YA 1 as including the rules relating to controlled foreign companies, foreign investment funds and foreign tax credits).

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7.13 New Zealand does not determine the tax residency of a trust based on the tax residence of its trustees as some countries do. Under s HC 2, joint trustees are treated as a notional single person with each being jointly and severally liable for the tax obligations of trustees to calculate and return income. As a result of this approach, if one trustee is based in New Zealand with others offshore, the resident trustee will still be responsible for return obligations.

Commented [CJF40]: It is noted above, but what if none are located in New Zealand?

Foreign-sourced amounts – resident trustees

7.14 Foreign-sourced amounts derived by trustees resident in New Zealand are exempt income under ss HC 26 and CW 54, if:

- (a) at any time in the income year no settlor of the trust is a New Zealand resident who is not a transitional resident;
- (b) the trust is not a superannuation fund, a testamentary trust or an *inter vivos* trust where the settlor died resident in New Zealand (whether or not they died in the income year);
- (c) the trust has a trust deed;
- (d) the trust is a registered foreign trust under s 59B of the TAA at the beginning of the income year, and when the foreign-sourced amounts are derived; and
- (e) the New Zealand resident trustee complies with the foreign trust disclosure requirements in ss 22, 59B, 59C and 59D of the TAA (discussed in Part 13 of this Interpretation Statement) during the income year.

7.15 For trusts that are not registered foreign trusts at the beginning of an income year, transitional rules apply. The New Zealand resident trustee will qualify for the exemption in ss HC 26 and CW 54 for all foreign-sourced amounts derived if:

- the New Zealand resident trustee applies to have the trust registered within the application period described in s 59C of the TAA (generally 30 days from the date the trust first had a resident foreign trustee); and
- the trust is not de-registered before the foreign-sourced amount is derived.

Commented [CJF41]: The circumstances that require or result in de-registration are not covered?

7.16 If the New Zealand resident trustee does not apply to have the trust registered within the application period described in s 59C of the TAA, the trust will not qualify for the exemption under ss HC 26 and CW 54 until the first full income year after the trust is formally registered.

Deductions

7.17 Section DV 9(2) applies for the purposes of calculating the trustees' deductions from trustee income (s HC 24(4)).

7.18 Section DV 9(2) states that, for the purposes of determining the deductions that the trustees are allowed in an income year, beneficiary income in the income year is treated as trustee income. This provision supplements the general permission in s DA 1, but the general limitations in s DA 2 still apply. By treating the beneficiary income as trustee income, s DV 9(2) makes it possible

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for a trustee to establish the required nexus for expenditure incurred in deriving this income.

- 7.19 Under s DV 9(1), a person who derives beneficiary income is denied a deduction for expenditure or loss that a trustee incurs in deriving the income. Instead, any deductions relating to this income are deducted from trustee income.

Losses

- 7.20 Where a trustee's annual total deductions are more than their annual gross income in an income year, the difference is their net loss for the income year (s BC 4(3)). This net loss can be carried forward to be subtracted from the trustee's net income for a future year in accordance with the provisions in part I (s BC 4(4)).

Example 20. Calculation of trustee income

The trustees of the Dublin Trust derive \$5,000 of rental income, \$500 of dividend income and \$200 of interest income in the 2017 tax year (total income \$5,700). The trustees resolve to distribute \$1,000 to each of the four beneficiaries of the trust as beneficiary income. This leaves the trustees with trustee income of \$1,700.

The trustees incur expenditure in the 2017 tax year of \$800 in rates and \$1,000 of interest (total expenditure \$1,800). All of the expenditure must be deducted from the trustee income, leaving a loss to carry forward for the Dublin Trust of \$100.

Tax liability of trustee

- 7.21 The trustee of a trust is liable to satisfy the income tax liability on trustee income as if they were an individual beneficially entitled to it (s HC 24(1)). While this may indicate that the trustee must return trustee income in their individual return, a trustee is defined in s YA 1 as being the trustee "only in the capacity of trustee of the trust" and "includes all trustees, for the time being, of the trust". Therefore, the trustee, which is deemed to include all trustees of the trust at any given time, derives the trustee income in a separate capacity, so must return the income separately. Trustee income is taxed at a flat rate of 33% (sch 1, part A, cl 3).
- 7.22 In calculating a trustee's tax liability, the trustee is not entitled to have a tax credit under subparts LC and LD (which relate to tax credits for natural persons and for certain gifts) (s HC 24(2)).
- 7.23 Under s HC 29, the settlor is liable as agent of the trustee for income tax payable by the trustee, with some exceptions. This is discussed further from [13.71].
- 7.24 Under s HC 35, beneficiary income derived by a minor is treated as if it were trustee income for the purposes of determining the tax rate (being the trustee tax rate of 33%), paying tax on the income, and providing returns of income. This is discussed further in Part 6 of this Interpretation Statement.

Part 8 Distributions from complying, foreign and non-complying trusts

Commented [CJF42]: See our general comment, the IS is particularly complex and therefore less useful for most NZ trusts because of the foreign and non-complying trust rules which may not apply to most of them. Consideration should be given to separating the discussion and analysis.

Introduction

- 8.1 The income tax treatment of amounts that are beneficiary income was discussed in Part 5 of this Interpretation Statement. This part discusses the income tax treatment of distributions to beneficiaries of amounts that are not beneficiary income.
- 8.2 In determining the tax treatment of distributions made by trustees to beneficiaries, trusts are classified into three main categories:
- (a) complying trusts;
 - (b) foreign trusts; and
 - (c) non-complying trusts.
- 8.3 A distribution from a complying trust of an amount that is not beneficiary income is exempt income of the beneficiary. However, this may not apply if the trust is a community trust (community trusts are discussed in Part 9 of this Interpretation Statement).
- 8.4 Certain distributions from foreign and non-complying trusts may be “taxable distributions” and taxed to the beneficiary. The definition of “taxable distribution” in relation to foreign and non-complying trusts is discussed in detail below. Other distributions are not taxable (eg, a distribution of the corpus of a trust).
- 8.5 This part discusses:
- (a) the definition of “distribution” (from [8.6]);
 - (b) the three categories of trust (ie, complying, foreign and non-complying trusts) (from [8.11]);
 - (c) taxable distributions (from [8.378.66]); and
 - (d) the ordering rules (from [8.71]).

Definition of “distribution”

- 8.6 A trustee makes a “distribution” when the trustee “transfers value” to a person because the person is a beneficiary of the trust (s HC 14).
- 8.7 “Transfers value” is defined in s YA 1. It is a net concept in the sense that it takes into account the market value of what is provided by, in this context, the trustee and the market value of what (if anything) is provided in return by the beneficiary. The definition is discussed in detail from [2.20] in the context of the definition of “settlor”.
- 8.8 A “distribution” can include a settlement by the trustee of a trust on another trust for the benefit of a beneficiary of the first trust, but only if:

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- (a) the amount or the property being settled would have been beneficiary income or a taxable distribution for a beneficiary had it been distributed at the time to a beneficiary resident in New Zealand; or
- (b) s EW 50 or s EZ 39 (which relate to forgiveness of debt) apply, and the property settled is an amount forgiven and treated as paid under ss EW 44(1) or (2) or EZ 39(1).

8.9 A distribution is made to a person when what is transferred vests absolutely in interest in the person or is paid to the person. A distribution may be made directly or indirectly, or by one transaction or a number of transactions, whether related, connected or otherwise. In determining whether there is a transfer of value, the fact a person is, or will become, a beneficiary of a trust does not constitute the giving or receiving of value.

8.10 An example of a distribution occurring is when a trustee permits beneficiaries to reside in a property owned by a trust without paying market value rent. For a complying trust such a distribution will be exempt income under s HC 20 but for a foreign trust or a non-complying trust the distribution may be treated as a taxable distribution with the tax status determined by ss HC 18 and HC 19 respectively.

Categories of trust

8.11 As noted above, in determining the tax treatment of distributions made by trustees to beneficiaries, trusts are classified into three main categories: complying, foreign and non-complying trusts. These categories are discussed below.

Complying trusts

Significance

8.12 Distributions from complying trusts of amounts other than amounts of beneficiary income are exempt income of beneficiaries (s HC 20). This contrasts with foreign trusts and non-complying trusts where distributions of amounts other than beneficiary income may be taxable. The reason for this different treatment is that trustee income of complying trusts has already been liable to New Zealand income tax. In contrast, income derived by trustees of foreign trusts and non-complying trusts may not have been liable to New Zealand income tax. Consequently, income accumulated by such trustees is taxed when it is distributed to a resident beneficiary.

Requirements

8.13 A trust will be treated as a complying trust for a distribution if, over the life of the trust until the time of the distribution:

- (a) the trustee income does not include any non-resident passive income, non-residents' foreign-sourced income, or exempt income under s CW 54 and s HC 26 (discussed further from [8.17]); and
- (b) the income tax obligations of the trustees have been satisfied for every tax year (discussed further from [8.22]).

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- 8.14 Most trusts established by resident settlors with trustees who are resident in New Zealand will satisfy these requirements. For example, if a resident individual settles funds or income-producing property on the terms of a trust and resident trustees are appointed, the trust will most likely be a complying trust. This is because the trustee income will have been liable to tax from the date on which the settlement was first made. Consequently, for such trusts distributions of amounts that are not beneficiary income will be exempt income and, therefore, not assessable (s HC 20).
- 8.15 Rules exist that allow a foreign trust of an immigrating settlor to become a complying trust, and a complying trust with an emigrating settlor to retain its complying trust status. For more details, see Part 10 and Part 11 of this Interpretation Statement.
- 8.16 A trust will also be a complying trust if it is a superannuation fund. For more details, see Part 9 of this Interpretation Statement.

No non-resident passive income, non-residents' foreign-sourced income or exempt income under s CW 54

8.17 For a trust to be a complying trust, it is a requirement that, over the life of the trust until the time of distribution, "trustee income" must not have included:

- (a) non-resident passive income (defined in s RF 2);
- (b) non-residents' foreign-sourced income (defined in s BD 1(4));
- (c) exempt income under ss CW 54 and HC 26, which is foreign-sourced income derived by a New Zealand resident trustee of a trust that:
 - (i) has no New Zealand resident settlors;
 - (ii) is not a superannuation fund or a trust (whether testamentary or *inter vivos*) of which a settlor died tax resident in New Zealand; and
 - (iii) is a registered foreign trust and complies with the foreign trust disclosure rules (discussed in Part 13 of this Interpretation Statement).

Commented [CJF43]: Note, without wishing to raise the use of colons and semi-colons etc, it may be useful to say that if the trustee income is any one of these then the trust is not a complying trust (although (c) appears to be an "and" test for each of the sub-paragraphs?) It is noted that 8.18 effectively says this.

8.18 In other words, the trustee's income must have always been liable to New Zealand income tax in the same manner as a New Zealand resident individual beneficially entitled to the income would have been.

Commented [CJF44]: Note that the tax rate for a trustee is different from an individual's tax rate.

8.19 This requirement applies to "trustee income". That is, income derived by the trustee that is not beneficiary income. (For a discussion of "beneficiary income" and "trustee income", see Part 5 and Part 7 of this Interpretation Statement.) If a trustee of a complying trust derives income that is non-resident passive income, then to retain complying trust status the trustee must ensure the income is distributed as beneficiary income so that the amount does not become trustee income.

8.20 The requirement applies over the life of the trust. Where relevant, this includes income years falling before the 1989 income year when the present trust regime began.

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- 8.21 The New Zealand income tax liability of trustees is determined under ss HC 7 and HC 24. For the treatment of trustee income before 1 April 1988, when the current regime was introduced, see "Appendix: Explanation of Taxation of Trusts", *Tax Information Bulletin* Vol 1, No 5 (November 1989) at [4.77].

Income tax obligations of the trustees must have been satisfied for every tax year

- 8.22 For a trust to be a complying trust, it is also a requirement that, over the life of the trust until the time of distribution, the income tax obligations of the trustees have been satisfied for every tax year.
- 8.23 This requires the satisfaction of the trustee's obligations, but not necessarily the actual payment of all income tax for which the trustee is liable. This ensures that a trust may still be a complying trust where the trustees have entered into deferred payment arrangements with the Commissioner.
- 8.24 If all of the trustee income has been liable to New Zealand income tax but the trustee's obligations have not been satisfied it is possible to convert the trust into a complying trust by satisfying the trustee's obligations retrospectively. For example, if the trustees had failed to declare income from a particular source for several years, the trust would still be a complying trust if the trustees filed amended returns declaring the omitted income and satisfied their obligations for that income (see "Qualifying Trust Status", *Tax Information Bulletin* Vol 16, No 1 (February 2004): 85).
- 8.25 A trustee would not meet all its obligations if it failed to pay tax at the appropriate rate on beneficiary income or taxable distributions in its capacity as agent. If the tax paid by the trustee fell short of the amount actually payable by the beneficiary, the beneficiary must file a return and pay the shortfall. If the beneficiary did not pay the shortfall, the trustee would be liable for this jointly and severally. If the trustee failed to pay the shortfall in such circumstances, it would not meet all its obligations.

Commented [CJF45]: If the beneficiary pays the tax, is the trust a complying trust?

Foreign trusts

Significance

- 8.26 A distribution of accumulated income (ie, income that is not beneficiary income) by a trustee of a foreign trust to a beneficiary is a taxable distribution and is included in the beneficiary's income. However, distributions of capital gains (unless made with parties associated with the trustee) and corpus are not. The terms "capital gain" and "corpus" are discussed in more detail below from [8.47] when discussing the term "taxable distribution". Current year income distributed to a beneficiary is taxed as beneficiary income.

Requirements

- 8.27 A trust is a foreign trust under s HC 11 if no settlor is resident in New Zealand at any time in the period that starts on the later of 17 December 1987 and the date on which a settlement was first made on the trust and ends when any settlor becomes resident.
- 8.28 Prior to 21 February 2017 a foreign trust only existed when a distribution was made, but the Taxation (Business Tax, Exchange of Information, and Remedial

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Matters) Act 2017 amended s HC 11 to clarify that the definition of foreign trust applies to all trusts with only foreign settlors at a point in time regardless of whether a distribution has been made.

- 8.29 A trust settled by a New Zealand resident before 17 December 1987 may be a foreign trust, but only if the settlor (and any other settlors) were not resident in New Zealand at any time from 17 December 1987.
- 8.30 A trust may be a foreign trust if a settlor was resident in New Zealand after the later of 17 December 1987 or the date of first settlement of the trust, but the settlor was not a settlor of the trust while resident in New Zealand.

Example 21. Not a settlor while resident

Maria, a non-resident, settles a trust on 1 June 2014 with a resident trustee while Joseph is resident in New Zealand. Joseph, after ceasing to be resident in New Zealand and moving offshore, settles property on the same trust on 1 October 2015. In this example, the trust will be a foreign trust because Joseph was not a settlor of the trust while Joseph was resident in New Zealand.

- 8.31 A transitional resident who is a settlor is treated as having a foreign trust under s HC 30 for the period of their transitional residence until the earlier of their exercising an election to convert that trust into a complying trust and the expiry of that option one year after they cease to be a transitional resident. This is despite the transitional resident being tax resident in New Zealand throughout that period.
- 8.32 Where a trust was first settled before 17 December 1987 and the settlor died resident in New Zealand before 17 December 1987 the trust will be treated as either a complying or a non-complying trust, depending on whether the trust satisfies the requirements to be a "complying trust".

Non-complying trusts

Significance

- 8.33 Distributions from a trustee of a non-complying trust to a beneficiary of accumulated income (amounts other than beneficiary income) and capital gains, but not corpus, are taxable distributions. The terms "capital gain" and "corpus" are discussed in more detail below from [8.47] when discussing the term "taxable distribution". These taxable distributions are taxable to the beneficiary. As with other categories of trust, current year income derived by the trustee that is beneficiary income is also included in the beneficiary's income and is taxed at the beneficiary's marginal rates (unless the minor beneficiary rule applies, in which case it is treated as if it was trustee income and taxed at the 33% trustee rate). Taxable distributions from non-complying trusts are taxed at a rate of 45% (ss HC 19, HC 34 and BF 1(b)). This penal rate, and the inclusion of capital gains in taxable distributions for non-complying trusts, reflects that New Zealand income tax may have been deferred through the use of this type of trust.

Requirements

- 8.34 Non-complying trusts are all trusts other than complying trusts and foreign trusts.

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- 8.35 Non-complying trusts are those where there has been a settlor (or settlors) resident in New Zealand since the later of 17 December 1987 or the date of first settlement of the trust and:
- (a) any of the trustee income from the income year in which the trust was first settled up to the income year in which the relevant distribution is made has included non-resident passive income or non-resident's foreign-sourced income or exempt income under s CW 54; or
 - (b) the income tax obligations of the trustees have not been satisfied for every tax year.
- 8.36 As noted above at [8.15], rules exist that allow a foreign trust to become a complying trust and a complying trust with an emigrating settlor to retain complying trust status. These rules require a trustee, beneficiary or settlor of the foreign trust to make an election. A foreign trust or a complying trust, as the case may be, will become a non-complying trust if an election is not made within the required timeframe. For more details, see Part 10 and Part 11 of this Interpretation Statement.

Taxable distributions

Introduction

- 8.37 Essentially, a "taxable distribution" is a distribution from a foreign or non-complying trust to a beneficiary that is included in the beneficiary's income. The taxable distribution concept is relevant to the taxation of amounts that are not "beneficiary income" under s HC 6.
- 8.38 The concept of a "taxable distribution" applies only in relation to foreign and non-complying trusts. It is not relevant to distributions from complying trusts. A distribution from a complying trust is taxable to a beneficiary only if it is a distribution of beneficiary income. All other distributions from a complying trust to a beneficiary are exempt (with the exception of distributions from community trusts).

Definition of "taxable distribution"

- 8.39 A "taxable distribution", for a foreign trust and a non-complying trust, is defined in s HC 15. The definition is wider for a non-complying trust.
- 8.40 In relation to a foreign trust, a distribution is a taxable distribution to the extent to which it is not a distribution of:
- (a) an amount that is beneficiary income;
 - (b) a part of the corpus of the trust;
 - (c) a profit from the realisation of a capital asset or another capital gain (other than a capital gain or other capital profit made with a related party);
 - (d) a foreign superannuation withdrawal; or
 - (e) a payment or transaction that represents a distribution of either the corpus of the trust or a capital gain.

Commented [CJF46]: IR's service delivery team have highlighted issues with unrealised gains being distributed. Unlike the "in specie" rules for company dividends, there is no clear ability to transfer assets in specie and to have unrealised gains treated as a distribution of capital gains. There does not appear to be a good reason to exclude unrealised gains from this treatment.

This is an issue that should be referred to IR Policy as a modernisation that is required.

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- 8.41 In relation to a non-complying trust, a distribution is a taxable distribution to the extent to which it is not a distribution of:
- (a) an amount that is beneficiary income;
 - (b) a part of the corpus of the trust;
 - (c) a pension; or
 - (d) a payment or transaction that represents a distribution of the corpus of the trust.
- 8.42 A taxable distribution will generally be made up of accumulated income or capital gain amounts. As can be seen from the above discussion, distributions of amounts that are beneficiary income and corpus from non-complying and foreign trusts, and distributions of capital gains in the case of foreign trusts, are not taxable distributions.
- 8.43 A trustee of a foreign or non-complying trust has limited control over whether a distribution is of income, a capital gain, corpus or otherwise. The nature of the distribution can depend on several factors, including the timing of the distribution and the ordering rules discussed from [8.71]. Therefore, the definition of "taxable distribution" in s HC 15 must be interpreted together with the ordering rules in s HC 16.
- 8.44 A distribution may also be a taxable distribution to the extent to which:
- (a) the distribution is made by a foreign or non-complying trust by disposing of property at less than market value or providing services at less than market value, and the distribution is not of an amount of beneficiary income; or
 - (b) inadequate records are kept by the trustee (see the discussion from [8.117]).
- 8.45 A distribution will not be a taxable distribution if it is a distribution of income or a capital gain from a trust (other than a unit trust, a group investment fund, or a superannuation scheme) that was derived in the 1988 or earlier tax years (ss HZ 1 and HC 1(2)(d)).
- 8.46 The discussion above on "taxable distributions" refers to "capital gains" and "corpus". These concepts are discussed next.

Capital gains

- 8.47 In determining whether a distribution from a foreign trust is a taxable distribution, it is important to understand what is included in the concept of "capital gain" for the purpose of the definition of "taxable distribution".
- 8.48 Despite referring to a specific type of capital gain (a "profit" that the trustee derives in the income year from "the realisation of a capital asset" of the trust), the definition of taxable distribution takes into account all types of capital gain. This is clear from the words "or another capital gain" in s HC 15(4)(c) and the reference to capital gain in s HC 15(4)(d).

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- 8.49 The determination of a capital gain for the purposes of the definition of "taxable distribution" is modified under s HC 15(5). Firstly, for these purposes, a capital gain does not include a gain that is required to be taken into account for the purpose of calculating a person's income. For example, s CB 6 provides that an amount that a person derives from disposing of land is income of the person if they acquired the land for a purpose of disposing of it. In the absence of s CB 6, such an amount might be regarded as a capital amount. However, it is included in the person's income under s CB 6, so cannot give rise to a capital gain for the purposes of the definition of "taxable distribution".
- 8.50 In addition, a capital gain for the purposes of the definition of taxable distribution does not include a gain that a trustee derives through a transaction (or series of transactions) between the trustee and a person associated with the trustee. For example, if a trustee sells a capital asset of the trust to a beneficiary and realises a capital gain on the sale, this capital gain will not be a "capital gain" for the purposes of the definition of "taxable distribution". This is because a trustee of a trust is associated with a beneficiary of the trust (s YB 6).
- 8.51 The transaction leading to the capital gain does not have to be a sale. The transaction may be a distribution. That is, a trustee may make a distribution to a beneficiary by transferring to the beneficiary ownership of a capital asset that has appreciated in value (ie, an *in specie* distribution). The distribution by a trustee to a beneficiary of an appreciated capital asset results in the realisation of a capital gain for three reasons:
- (a) Section FC 1(1)(c) states that subpart FC applies to the transfer of property on a distribution by a trustee of a trust to a beneficiary of the trust.
 - (b) Section FC 2 provides that the transfer of property is treated as a disposal by the trustee and an acquisition by the beneficiary at the market value of the property for the trustee. The disposal is treated as occurring on the date of the transaction.
 - (c) Because the disposition is treated as a disposal at the market value of the property for the trustee, if the value of the property has increased, the trustee will have realised a capital gain.
- 8.52 Where a trustee distributes a capital asset in this way, there will be a distribution to the beneficiary, and the capital gain amount will be included as a "taxable distribution" from a foreign trust to the beneficiary because the beneficiary is associated with the trustee. As a result s HC 15(5)(a)(ii) applies.
- 8.53 Another point to note about the determination of a "capital gain" for the purposes of the definition of "taxable distribution" is that the amount of the capital gain is reduced by any capital loss that the trustee incurs in the income year in which the capital gain was derived. Therefore, if in an income year a trustee makes a \$100 capital gain on one transaction and a \$100 capital loss on another transaction, there is no capital gain to take into account for the year.
- 8.54 Finally, the capital gains taken into account are those that have been "realised". A capital gain is realised when it has been converted into money or money's worth. A capital gain that has accrued, but that has not been converted into money or money's worth, will not be realised. As noted above, capital gains are reduced by capital losses "incurred" during the income year in which the

Commented [CJF47]: See comment at 8.40

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distribution was made. In this context, a loss that has accrued, but has not been realised, will not be "incurred".

Corpus

- 8.55 In determining whether a distribution is a taxable distribution it is also important to understand the meaning of "corpus". A distribution will not be a taxable distribution to the extent that it is a distribution of corpus.
- 8.56 "Corpus" is defined in s HC 4. Subject to the exclusions discussed below, "corpus" means an amount that is equal to the market value of a settlement of property on the trust. Generally, the market value of something is the price that would be agreed between a willing but not anxious seller and a willing but not anxious buyer. The market value is measured at the date of the settlement. Therefore, a change in the value of property settled on a trust will not change the value of the corpus of the trust.
- 8.57 The three exclusions from the general definition above are discussed next.

Property settlement by another trust

- 8.58 Firstly, corpus does not include a property settlement by a trustee of another trust to the extent to which, if the property were distributed to a beneficiary of the other trust and the beneficiary were resident in New Zealand, the distribution would be beneficiary income or a taxable distribution to that beneficiary.
- 8.59 The purpose of this exclusion is to prevent the creation of corpus by resettling amounts of income or capital gains accumulated in one trust on the terms of another trust. Without this exclusion it would be possible to avoid tax on distributions of amounts accumulated in foreign and non-complying trusts simply by settling those amounts on other trusts and then distributing them from those other trusts as tax-free corpus.
- 8.60 The exclusion applies only to the extent that the property settled would have been income (beneficiary income or a taxable distribution) to a resident beneficiary if distributed to such a beneficiary at the time of settlement. Therefore, the exclusion will not apply if the distribution from the other trust was of an amount of corpus of the other trust or, if the other trust was a foreign trust, a capital gain. In determining whether this exclusion applies, the ordering rules (discussed below) apply to determine the character of the amount distributed (ie, whether it is a distribution of income, a capital gain, or corpus).
- 8.61 There does not have to be a resident beneficiary for the exclusion to apply. The reference to a resident beneficiary is to a hypothetical person.

Property settlement for which the settlor is allowed a deduction

- 8.62 Secondly, property settled on trust is not corpus when the settlor is allowed a deduction for the settlement for New Zealand tax purposes. This might arise, for example, where a person pays an above market price for goods or services acquired from a trust. The difference between the market value of the goods and the price paid will be a transfer of value and, therefore, a settlement.

Commented [CJF48]: See comment above regarding inadvertent settlements.

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- 8.63 The purpose of this exclusion is to ensure that where a deduction is claimed for property settled on a trust a further benefit cannot be obtained in the form of a tax-free distribution of corpus.

Property settlement that would otherwise have been income to the settlor

- 8.64 Thirdly, s HC 4(5) states that a property settlement is excluded from corpus if, but for the fact of the settlement, it would be income of the settlor (or would be income if the settlor were resident in New Zealand at the time of settlement).
- 8.65 This exclusion will have limited application. If an amount is income of a person, the settlement of that amount on a trust will not prevent that amount from being their income. A person cannot avoid assessment of income that they derive by assigning that income to another person (*Hadlee and Sydney Bridge Nominees Ltd v CIR* (1989) 11 NZTC 6,155 (HC)). The same would apply to a settlement of that income.

Taxation of taxable distributions

- 8.66 Special taxing rules apply to taxable distributions from non-complying trusts:
- (a) Under ss CX 59 and HC 19 an amount that a person derives as a taxable distribution from a non-complying trust is excluded income of the person. This means that the amount will not be taxed as part of the person's "taxable income".
 - (b) However, under s BF 1(b) a person must pay income tax on a taxable distribution from a non-complying trust under part H.
 - (c) In part H, s HC 34 currently imposes tax on a taxable distribution at 45% (the rate set out in cl 4 of part A of sch 1).
 - (d) If a CFC derives a taxable distribution from a non-complying trust then under s EX 19 the income is excluded from the CFC's income and is attributed instead to those persons with an income interest in the CFC at the 45% tax rate.
- 8.67 A distribution of taxable income from a foreign trust is included in a person's income in the normal way. Under s CV 13, the income of a person includes a taxable distribution from a foreign trust to which s HC 18 applies.
- 8.68 Whether a taxable distribution is taxable to a non-resident beneficiary depends on whether the amount distributed has a source in New Zealand. Accumulated income, or a capital gain, distributed to a beneficiary as a taxable distribution has a source in New Zealand for the beneficiary to the extent to which the amount has a source in New Zealand for the trustee (s YD 4(13) and (18)).
- 8.69 If a New Zealand resident beneficiary (in their capacity as a beneficiary) derives a taxable distribution, they may be allowed a tax credit for any foreign tax paid on the amount under s LJ 6.

Section GB 22—anti-avoidance

- 8.70 Section GB 22 contains a specific anti-avoidance provision to deal with situations where a trustee enters into an arrangement to defeat the intent and application

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of the rules relating to beneficiary income and taxable distributions. This provision is discussed from [5.46].

Ordering rules

Introduction

- 8.71 Because some distributions will be taxable and some not, opportunities could arise for avoiding or deferring tax on income accumulated in trusts by distributing taxable amounts to non-resident beneficiaries or by distributing non-taxable amounts before taxable amounts. The ordering rules for distributions in s HC 16 limit opportunities for manipulating distributions from foreign and non-complying trusts in this manner. This is achieved by providing a series of ordering rules that determine the order in which amounts are treated as having been distributed from such trusts.
- 8.72 These ordering rules override the treatment of the distributions that would otherwise apply based on the trust deed or the exercise of the trustee's discretion. The rules can affect whether a distribution is treated as a distribution of income, a capital gain or corpus, and so determine whether a distribution will be a taxable distribution or not. Therefore, as noted earlier, it is necessary to interpret the definition of taxable distribution and the ordering rules together.
- 8.73 The ordering rules in s HC 16 apply when a trustee of a foreign or non-complying trust makes a distribution to a beneficiary. The four exceptions to the ordering rules are discussed from [8.105].
- 8.74 Where they apply, the ordering rules treat a distribution as being made up of the following elements in the following order:
- (a) income derived by the trustee in the current income year;
 - (b) income derived by the trustee in an earlier income year;
 - (c) a capital gain derived by the trustee in the current income year;
 - (d) a capital gain derived by the trustee in an earlier income year; and
 - (e) the corpus of the trust.
- 8.75 The rules are applied individually to each distribution made by the trustee and in the order in which the distribution is made. That is, both the order of the distributions and the order of the elements are relevant.
- 8.76 The amount of each element (eg, current year income) is finite. Once an amount of an element has been treated under s HC 16 as included in a distribution that amount is no longer available to be treated as included in another distribution. This means that the order in which the distributions are made can be significant.
- 8.77 For each distribution, the elements must be applied in the order above. The next element is relevant only to the extent that the total of the available amounts in the elements so far considered is less than the amount of the distribution.

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Distribution firstly treated as being made up of income derived by the trustee in the current income year

- 8.78 The first element that a distribution is treated as being made up of is an amount of income derived by the trustee in the income year in which the distribution is made (s HC 16(2)(a)).
- 8.79 An amount must not be treated as included in the distribution if the amount has been treated under s HC 16 as being included in an earlier distribution (ie, earlier in the year) or a distribution made at the same time.
- 8.80 An amount of "income" derived by a trustee in an income year, referred to in s HC 16(2)(a) and (b), is determined after subtracting any deduction that is taken into account in the calculation of net or taxable income for the corresponding income year.
- 8.81 "Income" otherwise has its normal meaning, being income of the trustee under a provision in part C. It means income under New Zealand income tax law, not the law under any other jurisdiction where for instance the amount may or may not be liable to tax.
- 8.82 Section HC 16(2)(a) does not make any distinction between trustee income and beneficiary income. This is because the ordering rules may cause a distribution that would otherwise be a distribution of beneficiary income to not be a distribution of beneficiary income. This is caused by the combination of the way the ordering rules work, the definition of beneficiary income, and the timing of distributions a trustee makes.

Example 22. Change to beneficiary income

During an income year the trustee of a non-complying trust derives \$100 of income and a \$100 capital gain. The trustee makes two distributions. In the first distribution, on 1 February, the trustee pays the \$100 capital gain to a non-resident beneficiary. In the second distribution, on 1 March, the trustee pays the \$100 of income to a resident beneficiary. Ordinarily, a trustee can decide whether a distribution will be of income or capital derived by the trust. In the absence of the ordering rules, the \$100 of income will be beneficiary income to the resident beneficiary because it is income and it has been paid to a beneficiary. The \$100 capital gain could not be beneficiary income because it is not "income" derived by the trustee.

However, applying the ordering rules, and remembering that the trustee pays the \$100 capital gain first and the \$100 of income second, the result is different. Applying the ordering rules, when the trustee makes the first payment, the distribution is treated as including the \$100 of income derived by the trustee (because income comes before a capital gain in the ordering rules). And because the payment is treated as income and it is paid to a beneficiary it will be beneficiary income under s HC 6. This means that when the trustee pays the second \$100 to the resident beneficiary, the only available element left is the \$100 capital gain. As a result, the ordering rules have changed when a distribution will be a distribution of beneficiary income.

Commented [CJF49]: By contrast, this seems an unexpected result. Particularly, if the distribution is not discretionary (i.e. the specific terms of trust require income and capital gains to be paid to specific beneficiaries), this result seems contrary to the "economic" position.

- 8.83 In the case of contemporaneous distributions, the trustee can generally decide how current year income will be spread between distributions. However, the total current year income treated as being included in the distributions cannot exceed the current year's income.

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Example 23. Contemporaneous distributions

A trustee of a non-complying trust wishes to distribute \$60 each to beneficiary A and beneficiary B on 24 December. The trustee has derived only \$100 of income in the current income year. However, the trustee derived \$20 of income 2 years earlier that has not yet been treated under s HC 16 as being included in a distribution. The trustee can decide to treat the distribution to beneficiary A as including \$60 of current year income and the distribution to beneficiary B as including \$40 of current year income and \$20 of previous year income. As a result, beneficiary A will have beneficiary income of \$60 and beneficiary B will have beneficiary income of \$40 and a taxable distribution of \$20. The \$20 will be a taxable distribution and not beneficiary income because, by definition, beneficiary income must be distributed in the income year it is derived by the trustee (or by the date after the end of the income year referred to in s HC 6(1B)). The beneficiary income will be taxed at the beneficiaries' marginal tax rates, and the taxable distribution will be taxed at the 45% non-complying trust distribution rate.

Commented [CJF50]: It would be useful to cite the source of this available choice?

Distribution secondly treated as being made up of income derived by the trustee in an earlier income year

- 8.84 The second element that a distribution is treated as being made up of is an amount of income, other than beneficiary income, that the trustee has derived in an earlier income year (s HC 16(2)(b)).
- 8.85 Again, an amount must not be treated as included in the distribution if the amount has been treated under s HC 16 as being included in an earlier distribution (earlier in the income year or in a previous income year) or in a distribution made at the same time.

Example 24. Accumulated income available for distribution

The trustee of a non-complying or foreign trust derived \$100 of income in the previous income year. Of that amount, \$60 was treated, under s HC 16(2)(a), as being included in a distribution in the previous income year. As a result, only \$40 of that income is available to be treated, under s HC 16(2)(b), as being included in a distribution in the current year.

Distribution thirdly treated as being made up of current year's capital gains

- 8.86 The third element that a distribution is treated as being made up of is a capital gain that the trustee derives in the income year (s HC 16(2)(c)).
- 8.87 The concept of a capital gain was considered from [8.47] in the context of s HC 16 and the definition of taxable distribution. "Capital gain" has the same meaning in the ordering rules:
- (a) A capital gain does not include any capital gain that is required to be taken into account for the purpose of calculating a person's income. These amounts will be covered by s HC 16(2)(a). An example, noted above, is a gain captured under s CB 6, which provides that an amount a person derives from disposing of land is income of the person if they acquired the land for a purpose of disposing of it. As an amount of income, the amount will be covered by s HC 16(2)(a). For the purposes of s HC 16(2)(a), the income amount will be adjusted by the deduction that the person is allowed under ss DA 1 and DB 23 for the cost of acquiring the land (s HC 16(4)(a)). In this way, the gain from the disposal of land is taken into account as income.

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- (b) A capital gain does not include a gain that the trustee derives through a transaction (or series of transactions) between the trustee and a person associated with the trustee.
- (c) A capital gain is adjusted by subtracting the amount of any capital loss that the trustee incurs in the income year.
- (d) A capital gain is an amount that has been realised. Similarly, a capital loss is an amount that has been realised and incurred.

Distribution fourthly treated as being made up of previous years' capital gains

- 8.88 The fourth element that a distribution is treated as being made up of is a capital gain that the trustee derived in an earlier income year (s HC 16(2)(d)).
- 8.89 The comments made above on s HC 16(2)(c) and the calculation of a capital gain also apply to s HC 16(2)(d).

Distribution fifthly treated as being made up of corpus

- 8.90 The fifth element that a distribution is treated as being made up of is the corpus of the trust (s HC 16(2)(e)). "Corpus" is discussed from [8.55]. Subject to some exclusions, "corpus" means an amount that is equal to the market value of a settlement of property on the trust.

Transactions that are not genuine and other ordering adjustments

- 8.91 Further ordering adjustments can be made under s HC 16(5) if a distribution:
- (a) is not a genuine transaction;
 - (b) does not place the amount distributed beyond the possession and control of the trustee; or
 - (c) is a settlement.
- 8.92 As noted above, if an amount of income or capital gain has been treated as being included in an earlier distribution or a distribution occurring at the same time, then the amount is not available to be treated as included in the distribution currently being considered. Whether an amount is available will depend on the order of distributions and, in the case of distributions made at the same time, the discretion of the trustee. Because of this, some scope to manipulate distributions still exists. For example, a foreign trust could distribute income to non-resident beneficiaries (who as non-residents may not be liable to tax on the income) and capital gains to resident beneficiaries. The s HC 16(2) ordering rules would not prevent the streaming of income and capital gains in this manner if the distribution to the non-resident was made before the distribution to the resident.
- 8.93 However, under s HC 16(5), in certain situations the streaming and availability of income and capital gain amounts can be modified. Section HC 16(5) acts as a type of anti-avoidance provision. Where the requirements of the section are met, the subsection can treat an amount of income or a capital gain as not being included in a distribution to a beneficiary (beneficiary A). This results in the amount of income or capital gain still being available to be included in the

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distribution to another beneficiary (beneficiary B) in determining the elements of a distribution to beneficiary B.

- 8.94 If s HC 16(5) applied in ~~the above~~ example, ~~23 or 24?~~, it would treat the income as not having been distributed to the non-resident beneficiary and as still being available to be included in the distribution to the resident beneficiary, for whom the amount may be a taxable distribution.
- 8.95 Section HC 16(5) will apply if:
- (a) the effect of treating the income or capital gain as being distributed to one beneficiary (beneficiary A) is that some or all of a distribution to another beneficiary (beneficiary B) would be treated as not being a taxable distribution; and
 - (b) one of the following applies in relation to the distribution to beneficiary A:
 - (i) it is not a genuine transaction entered into and carried out in good faith;
 - (ii) it does not place the amount beyond the possession and control of the trustee in their capacity as trustee; or
 - (iii) it is a settlement.

Commented [CJF51]: Note that this does not appear to apply if the effect is not to treat the distribution as beneficiary income?

Effect requirement

- 8.96 If the treatment of the distribution to beneficiary A would have no effect on whether the distribution to beneficiary B would be a taxable distribution, then s HC 16(5) will not apply and there will be no change to the ordering under s HC 16(2). The important consideration is the effect of the treatment of the distribution, rather than the subjective purpose of the trustee in making the distribution.

Distribution not a genuine transaction entered into and carried out in good faith

- 8.97 Section HC 16(5) applies where the distribution is not a genuine transaction entered into and carried out in good faith.
- 8.98 This requirement was reworded with the introduction of the ITA 2007. This expression of the requirement replaced the earlier expression, which referred to a distribution not being a "bona fide transaction". No policy change was intended with this rewording. The Courts have held that a transaction is a bona fide transaction if it is real and genuine to all intents and purposes (*CIR v Simpson* (1989) 11 NZTC 6,140 (CA)).

Not placing the amount beyond the possession and control of the trustee

- 8.99 Section HC 16(5) applies where the distribution does not place the amount distributed beyond the possession and control of the trustee.
- 8.100 This requirement would be satisfied if, for example, a distribution was made by a trustee recording a credit in a beneficiary's current account with a trust and the amount was retained and used as working capital by the trustee (this type of distribution featured in *CIR v Ward* [1970] NZLR 1 (CA)).

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Where the distribution is a settlement

- 8.101 The third situation in which s HC 16(5) may apply is where the distribution is a settlement.
- 8.102 Example 25 illustrates this requirement.

Example 25. Reordering where there is a settlement

The trustee of a foreign trust settles all of the income derived by the trustee on a sub-trust for the benefit of a non-resident beneficiary. The trustee then makes a distribution to a resident beneficiary on the basis that only capital gains and the corpus of the trust remain to be distributed.

Section HC 16(5) will apply. It will treat the amount settled on the sub-trust for the benefit of a non-resident beneficiary as still being available for inclusion in the distribution to the resident beneficiary. It does not matter that the transaction may have been genuine or that the distribution to the non-resident placed the income beyond the possession and control of the trustee.

Section HC 16(5) applies only to the extent necessary to re-order distributions

- 8.103 Section HC 16(5) applies only to the extent necessary to determine the elements of the distribution to beneficiary B (as identified and discussed at [8.928.93] to [8.95]). This means the treatment of the distribution to beneficiary A, will not necessarily be modified completely.

Example 26. Distribution only partially modified

A trustee of a non-complying trust derives a \$10,000 capital gain in an income year. The trust also has corpus of \$10,000. During the income year, the trustee distributes \$10,000 to Non-stick Ltd, a beneficiary of the trust (assume Non-stick Ltd is not taxable on this amount). This is followed by a distribution of \$8,000 to Cast Iron Ltd, another beneficiary of the trust. Cast Iron Ltd is a New Zealand resident and would be liable for tax on any distribution of income or capital gain from the non-complying trust. The \$10,000 distribution to Non-stick Ltd is made by crediting Non-stick Ltd's current account with the trust. The amount remains in the trustee's possession and control.

Applying the ordering rules under s HC 16(2), because of the order in which the distributions were made, the capital gain of \$10,000 is treated as being included in the distribution to Non-stick Ltd and \$8,000 of corpus is treated as being included in the distribution to Cast Iron Ltd.

However, these distributions will be reordered under s HC 16(5). This is because if the \$10,000 capital gain had not been treated as being included in the distribution to Non-stick Ltd, that amount would have been available to be treated as included in the distribution to Cast Iron Ltd and the amount would have been taxable income to Cast Iron Ltd. Further, the distribution to Non-stick Ltd did not place the amount distributed beyond the possession and control of the trustee.

The effect of s HC 16(5) applying is that the \$10,000 capital gain is available to be treated as included in the \$8,000 distribution to Cast Iron Ltd. This means that \$8,000 of the capital gain will be treated as included in the distribution to Cast Iron Ltd. This leaves \$2,000 of the capital gain amount, which will still be treated as being included in the distribution to Non-stick Ltd. The remainder of the distribution to Non-stick Ltd (\$8,000) will be treated as being made up of corpus. Therefore, the result is that the \$8,000 distribution to Cast Iron Ltd is treated as including \$8,000 of capital gain. This will be a taxable distribution. And the distribution to Non-stick Ltd will be treated as including \$2,000 of capital gain and \$8,000 of corpus.

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If an additional distribution of \$2,000 is later made to Cast Iron Ltd, the remaining \$2,000 of capital gain will also be treated as not being included in the distribution to Non-stick Ltd and will be available to be treated as included in the additional distribution to Cast Iron Ltd.

Exceptions to the ordering rules

8.104 Section HC 16(6) contains exceptions to the ordering rules.

Distribution by the trustee of a complying trust (s HC 16(6)(a))

8.105 The exception in s HC 16(6)(a) confirms that the ordering rules do not apply to a distribution by the trustee of a complying trust. This is consistent with s HC 16(1), which states that s HC 16 applies only when a distribution is made by a trustee of a non-complying trust or a foreign trust.

8.106 Section HC 16 does not apply to distributions from complying trusts. Generally, a trust will be a complying trust only if, over the life of the trust up to the distribution, the trustee's worldwide income has been liable to New Zealand income tax and the trustee's obligations in relation to that liability have been satisfied for every tax year (s HC 10(1)). As this income will have been taxed either to the beneficiary as beneficiary income or to the trustee as trustee income it is not necessary to apply the ordering rules to limit opportunities for manipulation of distributions.

Distribution from a non-discretionary trust (s HC 16(6)(b))

8.107 Section HC 16 does not apply to a distribution if:

- (a) the trust is a "non-discretionary trust"; and
- (b) one of the following applies:
 - (i) the trust was created by will or codicil (an amendment to a will) or by an order of court modifying a will or codicil;
 - (ii) the trust was created on an intestacy or partial intestacy; or
 - (iii) no settlement has been made on the trust after 17 December 1987.

8.108 A "non-discretionary trust" is a trust where the trustee has no discretion to determine the source, nature and amount of distributions to beneficiaries. This means, among other things, that the trustee has no discretion to classify trust property as capital or income.

8.109 In these circumstances there is less scope for distributions to be manipulated deliberately to avoid New Zealand income tax. This is because:

- (a) the trustee of the trust has no discretion to direct distributions to beneficiaries in a manner that results in the avoidance of New Zealand income tax; and
- (b) the trusts are of a type where it is unlikely that the provisions governing distributions (eg, the terms of a trust deed) would have been structured with a view towards avoiding New Zealand income tax.

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- 8.110 Non-discretionary trusts on which a settlement has been made after 17 December 1987 (apart from those created by will or codicil or on any intestacy or partial intestacy) are outside the scope of the exception. If this were not the case, it would be possible to create non-discretionary trusts or to use non-discretionary trusts established on or before 17 December 1987 to avoid the ordering rules.

Distribution made by disposing of property or providing services at less than market value

- 8.111 The ordering rules do not apply to a distribution to a beneficiary that is made by (ss HC 16(7) and HC 15(6)):
- (a) disposing of property at less than market value; or
 - (b) providing services at less than market value.
- 8.112 Section HC 15(6) also provides that the distributions described in subs (6) will be taxable distributions. Note that s HC 15(6) applies to only distributions made from a trust that is not a complying trust (ie, it applies to only non-complying and foreign trusts, not complying trusts). If a complying trust made a distribution like that described above, it would not be a taxable distribution.
- 8.113 Where distributions are made in the ways described above, there may be no amounts derived by the trustee that correspond to the distributions. Although it is appropriate to recognise these transactions as distributions, it is not appropriate to apply the ordering rules to the distributions because the distributions are not actually made from a trust's income, capital gains or corpus.

Distribution where a foreign trust becomes a complying trust

- 8.114 Section HC 16(6)(c) relates to trusts that were foreign trusts before a settlor of the trust became resident in New Zealand. It provides that the ordering rules in s HC 16 will not apply to a distribution from such a trust if the distribution is made subsequent to the settlor becoming resident and the trust is treated (under s HC 30(3)) as a complying trust in relation to the distribution. This is consistent with the fact that the ordering rules do not apply to distributions made from complying trusts.
- 8.115 This exception applies to only a distribution from a trust that is settled by a natural person.
- 8.116 Also, the exception applies only if an election has been made under s HC 30(2) (treatment of foreign trusts when settlor becomes resident). Elections made under s HC 30(2) are discussed in Part 10 of this Interpretation Statement.

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Wording in s HC 16(6)(c) referred to Policy

The wording of s HC 16(6)(c) suggests the election must be made by the settlor. The exception provides that the ordering rules do not apply to "a distribution from a trust other than a non-complying trust that is settled by a natural person who makes an election under s HC 30(2)". However, in the ITA 2004 and earlier, the election could be made by a settlor, trustee or beneficiary. Also, under s HC 30(2), a settlor, trustee or beneficiary can make an election. There is no suggestion that this change in s HC 16(6)(c) was intended. This issue has been referred to the Policy and Strategy division for amendment.

Taxable distribution where records are inadequate

- 8.117 If the records of a foreign or non-complying trust do not allow an accurate determination of the elements of a distribution under s HC 16 (ie, current and previous year income and capital gain amounts and the corpus of the trust), the distribution is a taxable distribution (s HC 15(7)).
- 8.118 Section HC 15(7) does not apply to a distribution if the ordering rules in s HC 16 do not apply to the distribution.
- 8.119 Section HC 15(7) applies where the records of a trust do not permit an accurate determination of the components of a taxable distribution when applying the ordering rules in s HC 16. The focus is on the accuracy of records relating to a particular distribution. This means for example that if a trust had inaccurate records for its income and capital gains but accurate ones for its corpus, it could still be possible to make a distribution of solely corpus as its final act on windup and not have it treated as a taxable distribution. Where however a trust had inaccurate records relating to income, but accurate records in relation to capital gains and it purported to make a distribution of a capital gain amount, there would be no certainty that the trust had distributed all of its current and accumulated income so as to properly characterise the distribution as a capital gain under the ordering rules. Consequently, s HC 15(7) would operate to treat the amount as a taxable distribution.

Commented [CJF52]: The requirement for the distribution to be a taxable distribution is not included. The result of the provision applying is that there is a taxable distribution.

Part 9 Other types of trusts

Introduction

- 9.1 The general tax treatment discussed in the above parts of this Interpretation Statement applies to most trusts, including the standard family or trading trust structures often used in New Zealand. However, in some situations, different tax rules apply to specific types of trusts including:
- (a) charitable trusts;
 - (b) deceased estates;
 - (c) community trusts;
 - (d) superannuation funds;
 - (e) lines trusts;
 - (f) licensing trusts;
 - (g) unit trusts;
 - (h) Maori authorities;
 - (i) foreign investment funds; and
 - (j) foreign superannuation schemes.
- 9.2 The tax treatments of these entities are considered in the next sections.

Charitable trusts

- 9.3 Section HC 13 defines a charitable trust as a trust:
- (a) for which all income derived or accumulated, in the current or any earlier income year, is held for charitable purposes; and
 - (b) any income derived in the current year is exempt income under s CW 41(1) or s CW 42(1).
- 9.4 For the exemptions to apply, the trust must be a registered charity under the Charities Act 2005.

Charitable purposes

- 9.5 For a trust to be a charitable trust, all income derived or accumulated by the trustee must be held for charitable purposes. This test must be satisfied for each income year.
- 9.6 "Charitable purpose" is defined in s YA 1 as including every charitable purpose, whether it relates to the relief of poverty, the advancement of education or religion, or any other matter beneficial to the community. The definition in s YA 1 also confirms that:
- (a) a trust will be charitable for the purposes of the Act if it meets the public benefit requirement apart from the fact that the beneficiaries are related by blood; and

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- (b) a marae has a charitable purpose if the physical structure is situated on land that is a Māori reservation and the funds of the marae are not used for a purpose other than the administration and maintenance of the land and physical structure of the marae or for a purpose that is not otherwise a charitable purpose.

- 9.7 The definition of “charitable purpose” in s YA 1 is the same as the definition in s 5(1) and (2) of the Charities Act 2005.
- 9.8 The general definition of “charitable purpose” in s YA 1 and the Charities Act 2005 is a statutory restatement of the established common law classification of charitable purposes stated by Lord Mcnaughten in *Commissioners for Special Purposes of Income Tax v Pemsel* [1891] AC 531 (HL). In *Re Greenpeace of New Zealand Inc* [2014] 26 NZSC 105, the Supreme Court said that charitable purposes must be recognised on a case-by-case basis by analogy with previous common law authorities.
- 9.9 Section 5(3) of the Charities Act 2005 confirms, for the avoidance of doubt, that if the purposes of an entity include a non-charitable purpose that is merely ancillary to a charitable purpose of the entity (for example, advocacy), the presence of that non-charitable purpose does not prevent the entity from qualifying for registration as a charitable entity. This provision restates an established common law principle (see, for example, *Molloy v CIR* [1981] 1 NZLR 688 (CA)).

Exemption under ss CW 41 and CW 42

- 9.10 Under ss CW 41 and CW 42, income derived for charitable purposes is exempt income. However, these provisions apply only if the entity carrying on the charitable purposes is a “tax charity”.
- 9.11 A “tax charity” is defined as an entity that is registered as a charitable entity under the Charities Act 2005 (and includes any entity that has been removed from the register for the period that it was eligible to be registered) (s CW 41(5)). An entity will qualify for registration under the Charities Act 2005 where it is established and maintained exclusively for charitable purposes and is not carried on for the private pecuniary profit of any individual (s 13 of the Charities Act 2005).
- 9.12 In addition, an entity can be a “tax charity” if it is a non-resident entity that carries out its charitable purposes outside New Zealand and the Commissioner has approved it as a tax charity in circumstances where registration under the Charities Act 2005 is unavailable (s CW 41(5)(c)).
- 9.13 Under s CW 41, an amount of income derived by a trustee of a trust for charitable purposes will be exempt income, provided the trust is a tax charity. However, this provision does not apply to income derived from a business carried on by, for, or for the benefit of the trust.
- 9.14 Section CW 42 applies to exempt income derived directly or indirectly from a business carried on by, for, or for the benefit of a trust, if:
 - (a) the trust carries out its charitable purposes in New Zealand; and
 - (b) the trustee of the trust is a tax charity; and

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- (c) no person with some control over the business is able to direct or divert, to their own benefit or advantage, an amount derived from the business, unless the person with control is the trustee of a trust that is a tax charity, and the amount is used for the purposes of the trust.

9.15 The exemption in s CW 42 applies only to the extent to which the charitable purposes of the trust are carried out in New Zealand (s CW 42(4)).

9.16 If a trustee of a charity acquires a revenue producing asset from a person of a kind discussed immediately below at [9.17] (b) then under s CW 42(3) the trustee is treated as carrying on a business if that person retains or reserves an interest in the asset, or the asset will revert to the person. The effect is that the resulting business income will not be exempt as the provisions of s CW 42(1)(c) cannot be complied with.

9.17 A person is treated as having some control over the business and as being able to direct or divert amounts from the business to their own benefit or advantage, if (s CW 42(5)):

- (a) they are in any way, whether directly or indirectly through another person or entity, able to determine or materially influence the determination of the nature or extent of a relevant benefit or advantage, or the circumstances in which a relevant benefit or advantage is to be given or received; and
- (b) that ability or influence arises because they are:
 - (i) a settlor or trustee of the trust carrying on the business, or of a trust that is a shareholder of the company that is carrying on the business;
 - (ii) a director or shareholder of the company that is carrying on the business; or
 - (iii) associated with any relevant trustee, settlor, director or shareholder.

9.18 This requirement will be satisfied if there is an ability to direct or divert an amount from the business to the person's own benefit or advantage. It is not necessary that this actually occurs.

9.19 For the purposes of s CW 42(5), a person is treated as a settlor of a trust where they have disposed of an asset to the trust that is used by the trust in carrying on its business and they retain or reserve an interest in the asset or the asset will revert to them (s CW 42(6)).

9.20 A person is not treated as having some control over the business merely because they provide professional services to the trust or company carrying on the business (s CW 42(7)). This is the case where the person's ability to determine the nature or extent of a relevant benefit or advantage arises because they:

- (a) provide services in the course of their professional public practice; or
- (b) are a statutory trustee company, Public Trust or the Māori Trustee.

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- 9.21 A relevant benefit or advantage may or may not be something that is convertible to money and includes:
- (a) deriving an amount that would be income under the Act; or
 - (b) retaining or reserving an interest in an asset disposed of to a trust or where the asset disposed of will revert to them.
- 9.22 However, a relevant benefit or advantage will not arise merely because a person earns interest on money lent at current commercial rates (s CW 42(8)).

Distributions

- 9.23 Trust rules determine the tax treatment of distributions from charitable trusts. Therefore, distributions from a charitable trust that is a complying trust, of amounts that are not beneficiary income, is exempt income under ss HC 20 and CW 53. Distributions of beneficiary income from a charitable trust retain their exempt income character, under s CW 41 or s CW 42, in the hands of the beneficiary. However, where s CW 41 or s CW 42 does not apply, the income is taxable income of the beneficiary under ss HC 17 and CV 13.

Commented [CJF53]: The IS does not make it explicit why charitable trusts are complying trusts. Is it by definition because there are no income tax liabilities so they are satisfied?

Commented [CJF54]: IF CW 41 and 42 do not apply, the trust can still be a complying trust if it meets its obligations under the Act. It does not automatically follow that if CW 41 and 42 do not apply to exempt the trust that the trust is non-complying. In fact, the Commissioner would expect them to comply with their obligations?

Settlor liability

- 9.24 A settlor is generally liable as agent of the trustee for the tax liabilities of the trustee where no trustee is resident in New Zealand. However, this rule does not apply to settlors of charitable trusts (s HC 29(4)). This rule ensures residents who make donations to charitable trusts that have non-resident trustees are not liable for any tax liabilities of the trust.

Deceased estates

- 9.25 "Trustee" is defined in the ITA 2007 as including an executor, as discussed in Part 3 of this Interpretation Statement. At common law, it is possible for a will to give rise to a trust (referred to as a testamentary trust). However, the mere fact that a person has died and an executor has been appointed to manage their estate does not give rise to a trust relationship. Trustees and executors have different capacities (*Re Hayes* [1971] 1 WLR 758 (Ch)). However, an executor is treated as a trustee under the ITA 2007 for administrative purposes.
- 9.26 Under s 43 of the TAA, a trustee is responsible for filing a return covering the period of the income year until the taxpayer's death, assuming a return is required. Income derived after death is accounted for by the estate in its return. The trustee (or trustees) for these purposes will be the personal representative, executor or administrator of the deceased person's estate.
- 9.27 Section HC 8 provides that an amount received in an income year by the trustee of an estate of a deceased person for the period after death is treated under s CV 12 as assessable income derived by the trustee during that income year. The estate trustees must file the form *Income Tax Return: Estate or trust* IR 6 (March 2016).
- 9.28 As a result, there is a need to correctly account for different sources of income when derived. The trustee is required to register the estate as a new taxpayer and apply for an Inland Revenue Department (IRD) number in the name of the estate.

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- 9.29 Section HC 8 overrides the common law principle that income earned but not derived for tax purposes by a deceased person before death is capital in the hands of the beneficiary of that person's estate. This situation could arise, for example, where the deceased person returned income on a receipts basis and the person performed services before death for which payment was not received until after death. Employees, barristers and doctors may fall into this category.
- 9.30 Section HC 8 applies only where the amount received by the trustee is not income derived by the deceased person during their lifetime as they will be taxed on that. Section HC 8 also applies only if the amount received by the trustee would have been included in the deceased person's income, if they had been alive when it was received. That is, the amount must be one that would have had the character of income in the hands of the deceased person, if it had been received by the deceased person while alive.
- 9.31 The effect of s HC 8 is that the amount the trustee receives is deemed to be income derived by the trustee. Because the amount is treated as income and not trustee income it can be vested absolutely in interest in the beneficiary or can be paid to the beneficiary, so can become beneficiary income. If there is no such vesting or payment, the income will be trustee income.
- 9.32 The trustee is liable for income tax owed by the deceased as well as for any tax liability as trustee of the estate. But the deceased's tax liability is limited to the net assets of the estate, and the Commissioner is empowered to write off any outstanding tax, if an estate has been distributed under, s 177C(2) of the TAA.
- 9.33 A final tax return must be prepared for the period up to the date of distribution when the estate is wound up. The trustee routinely secures an indemnity from beneficiaries to ensure there is cover for any tax liabilities that might arise in excess of those expected before making or completing distributions.
- 9.34 The tax treatment of property transfers after a person dies was clarified by the asset transfer rules introduced by the Taxation (Base Maintenance and Miscellaneous Provisions) Act 2005. Subject to exceptions for close relatives, transfers of property following death are treated as disposals at market value. There is a transfer from the deceased to the estate and again when the estate is distributed. When the death occurred before 1 October 2005, transitional rules apply to preserve the pre-existing regime.
- 9.35 For details about the asset transfer regime following death, see "Death and Asset Transfers", *Tax Information Bulletin* Vol 17, No 7 (September 2005): 41.

Deduction of irrecoverable book debts (s DB 32)

- 9.36 Section DB 32 applies where a debt owing to a person at the date of their death is written off, in whole or in part, by the trustee because it is not recoverable. This applies only to amounts written off as bad debts where the amount written off was earlier included in the deceased's assessable income or in the assessable income of the trustee of the deceased's estate.
- 9.37 In these circumstances, the amount written off is allowed as a deduction in this order:
- (a) first, against any income derived by the trustee as trustee income during that income year;

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- (b) second, any balance is deductible against income derived by or in trust for a beneficiary who has a vested interest in the capital of the estate to the extent that the loss is chargeable against the capital of that beneficiary; and
- (c) third, any balance is carried forward to the next income year and offset against trustee income and beneficiary income according to the rules outlined above, with any further excess being carried over to subsequent income years and offset according to the same rules.

- 9.38 Therefore, to apply s DB 32 it is necessary first to calculate the trustee income and the beneficiary income in the income year in question, ignoring the loss incurred by the debt write-off.
- 9.39 The amount written off is not deductible against beneficiary income derived by beneficiaries who have an interest in the income of the trust only.

Community trusts

- 9.40 Section YA 1 defines a "community trust" as a trust established under s 4 of the Community Trusts Act 1999 as a result of the restructuring of a trustee bank. The income derived by the trustees of a community trust is exempt under s CW 52.
- 9.41 Beneficiary income and other distributions from community trusts are taxable to beneficiaries at their marginal rates under ss HC 21(3) and CV 14. The income exemption in s HC 20 for distributions from complying trusts that are not beneficiary income does not apply to community trusts.
- 9.42 Exceptions to the general rule that community trust distributions are taxable are in ss HC 21(2) and s CZ 19. These exceptions relate to:
- (a) amounts derived by the trustees before the 2004 income year;
 - (b) distributions of corpus or capital gains; and
 - (c) the winding up of distributions, settlements or dividends made in the 2005 and 2006 income years in particular circumstances.
- 9.43 Contrary to the usual position, trustees of community trusts are not liable for tax as agents for their beneficiaries under ss HC 32(3) and HD 12(1). Consequently, the obligation lies on the beneficiaries to include such income in a return and pay tax on it.

Superannuation funds

- 9.44 A "superannuation fund" is defined in s YA 1 as a retirement scheme within the meaning of s 6(1) of the Financial Markets Conduct Act 2013.
- 9.45 Superannuation funds are complying trusts under s HC 10(1)(b). All income derived by a superannuation fund is assessable as trustee income under the trust rules. In contrast to other complying trusts, superannuation funds cannot make distributions of beneficiary income (s HC 6(2)(a)). The effect of this is that all distributions to members of a superannuation fund are exempt income for the beneficiaries (ss HC 20 and CW 53).

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- 9.46 Under s HC 24(5), the general rules for calculating trustee income are modified by ss CX 40 and DV 1 to DV 4. Section CX 40 ~~excludes from assessable income~~ amounts derived from investments in life insurance policies entered into in New Zealand to be excluded income. Sections DV 1 to DV 4 provide for specific deductions for superannuation funds relating to promotion costs and transfers of costs to master funds.
- 9.47 The income of a superannuation fund, including foreign-sourced amounts, is always assessable trustee income even where there is no New Zealand resident trustee (ss HC 25(2) and HC 26(1)).

Lines trusts

- 9.48 A "lines trust" is defined in s YA 1 to mean a trustee of a trust that:
- (a) has had shares allocated, transferred or vested in it, being shares in:
 - (i) an energy company as defined in s 2(1) of the Energy Companies Act 1992 under an approved establishment plan under that Act;
 - (ii) a company under s 76 of the Energy Companies Act 1992; or
 - (iii) a company that has had assets and liabilities of the Crown transferred to it under s 16 of the Southland Electricity Act 1993; and
 - (b) continues to hold those shares.
- 9.49 There are no specific rules in the ITA 2007 for the taxation of lines trusts. Therefore, they will generally be taxed as complying trusts, provided they qualify to do so. However, some lines trusts are registered charities, so will be taxed as charitable trusts (discussed above from [9.3]).

Trusts not taxed under the trust rules

Commented [CJF55]: Suggested heading

Licensing trusts

- 9.50 A "licensing trust" is included in paragraph (a) of the definition of "company" in s YA 1 as they are a body corporate under ss 302 and 303 of the Sale and Supply of Alcohol Act 2012. This means they have a legal existence separate from their members. A licensing trust may convert to be a community trust under ss 351 to 358 of the Sale and Supply of Alcohol Act but if they do their status as a body corporate is preserved under ss 359 and 360 of that Act and so they will continue to be treated as a company under the ITA 2017.
- 9.51 Consequently both licensing trusts and community trusts regulated by the Sale and Supply of Alcohol Act are not taxed as complying trusts.

Unit trusts

- 9.52 A "unit trust" is defined in s YA 1 as being:
- a scheme or arrangement that is made for the purpose or has the effect of providing facilities for subscribers, purchasers or contributors to participate as beneficiaries under a trust, in income and capital gains arising from the property that is subject to the trust.

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- 9.53 Section HC 1(2)(a) excludes unit trusts from the trust rules. Unit trusts are treated as companies for tax purposes. The tax treatment of distributions from and interests in unit trusts is determined largely under the dividend rules in subpart CD. Unit trusts can also elect to become portfolio investment entities (PIEs), which have their own tax regime in subpart HM.

Maori authorities

- 9.54 Section HF 2 sets out the persons who are eligible to become a "Maori authority" by making an election under s HF 11. The trusts eligible to make an election to become a "Maori authority" are the:
- (a) trustees of a trust established by an order made under Te Ture Whenua Maori Act 1993;
 - (b) trustees of a trust who own land that is subject to Te Ture Whenua Maori Act 1993;
 - (c) trustees of a trust that is recognised by Te Ohu Kai Moana Trustees Ltd as a mandated iwi organisation under s 13(1) of the Maori Fisheries Act 2004;
 - (d) trustees of a trust that is established by Te Ohu Kai Moana Trustees Ltd as a mandated iwi organisation under ss 79 and 92 of the Maori Fisheries Act;
 - (e) trustees of a trust who receive and manage assets that are transferred by the Crown as part of a settlement of a claim under the Treaty of Waitangi on behalf of Māori claimants and are contemplated by the deed of settlement; and
 - (f) Māori Trustee in their capacity as an agent for the owner of land that is subject to Te Ture Whenua Maori Act 1993.
- 9.55 Section HC 1(2)(c) excludes Maori authorities from the trust rules. In addition, under s HC 35(4), the minor beneficiary rules do not apply to a distribution from a Maori authority. The Act contains specific rules (mostly in subpart HF) relating to the tax treatment of Maori authorities and distributions from Maori authorities.

Taxation of investments in trusts

Foreign investment funds

- 9.56 A "foreign investment fund" (FIF) is defined in s EX 28 as:
- (a) a "foreign company";
 - (b) a "foreign superannuation scheme";
 - (c) an insurer under a life insurance policy that is offered or entered into outside New Zealand; or
 - (d) an entity described in sch 25, part A (no entities are currently listed).
- 9.57 A "foreign company" includes a "foreign unit trust", which is essentially a unit trust that is non-resident. A "foreign superannuation scheme" is defined in s YA 1 as a superannuation scheme constituted outside New Zealand. A "superannuation scheme" is defined in s YA 1 as including a trust established for

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the purposes of providing retirement benefits to members or beneficiaries. Therefore, trusts that are resident outside New Zealand have the potential to fall within the definition of a FIF.

- 9.58 However, distributions from FIFs are taxed under specific rules in subparts EW and CQ and not under the trust rules. Several methods are available to calculate FIF income, but the principal ones are the fair dividend rate and comparative value. For more information on FIFs, see Inland Revenue Department NZ, *A Guide to the Foreign Investment Fund Rules and the Fair Dividend Rate* IR 461 (May 2016).

Commented [CJF56]: The implication is that the FIF rules are code for taxing interests in FIFs – section reference?

Foreign superannuation schemes

- 9.59 Distributions from foreign superannuation schemes that are trusts in foreign jurisdictions set up mainly to provide retirement benefits to natural persons, are taxed either under the FIF rules or the foreign superannuation scheme rules in s CF 3, and not under the trust rules.

Part 10 Entry to the trust regime – settlor becomes resident

Overview

- 10.1 When an individual (a natural person) immigrates to New Zealand or a returning New Zealander resumes residency, there are tax implications when that person is a settlor, trustee or beneficiary of a foreign trust. This part of this Interpretation Statement explores the options available to settlors to deal with their foreign trust, and the tax implications for all three categories of persons when they become New Zealand resident.
- 10.2 Also discussed in this part is an individual's right to become a transitional resident. Transitional residence status applies for up to 48 months after becoming tax resident, plus the part remaining of the month in which the person becomes a transitional resident. During this period, they enjoy an exemption on foreign-sourced passive income. Transitional resident status affects the timing for the settlor to elect to turn a foreign trust into a complying trust, and the treatment of income from a foreign trust.

Settlor's residence determines on-going foreign trust status

- 10.3 A trust a non-resident settles before immigrating to New Zealand is a foreign trust regardless of the tax residence of the beneficiaries or the trustees. Trustee and non-resident beneficiary income of such a trust is taxed only if it has a New Zealand source.
- 10.4 Where a settlor of a foreign trust attains New Zealand residency, distributions from the trust may become subject to the trust rules. This is because once a settlor acquires residency the trust can remain a foreign trust for only up to a year after any settlor becomes resident and is not (or no longer is) a transitional resident.

Commented [CJF57]: After that point, it becomes either a complying or non-complying trust.

Transitional resident status

- 10.5 A transitional resident is a natural person who is resident after being previously non-resident for at least 10 continuous years and who has not been a transitional resident before. They are exempt from tax under ss HR 8 and CW 27 on foreign-sourced amounts (other than employment and services income) for a period of 48 months (plus the days remaining in the month) after becoming resident.
- 10.6 A person can elect to stop being a transitional resident under s HR 8(4) and an election once made is irrevocable. If an application is made under s 41 of the TAA for tax credits for families by a person eligible to be a transitional resident they and their spouse, partner or de facto (if also a transitional resident) are treated as having made an application under s HR 8(4) for the period that they apply for the credits.
- 10.7 The regime was introduced from 1 April 2006 to reduce the tax barriers to international recruitment. For more information, see "Temporary Exemption from Tax on Foreign Income for New Migrants and Certain Returning New Zealanders", *Tax Information Bulletin* Vol 18, No 5 (June 2006): 103.

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Elections into the complying trust regime

- 10.8 A non-resident settlor who is a natural person has 1 year after becoming tax resident and ceasing to be a transitional resident to elect under s HC 30 that any foreign trust they have settled becomes a complying trust. If the election is not made in this timeframe, any such trust will be classified as a non-complying trust for any distribution made of amounts derived after the term has expired. If the settlor is a company or other entity the election under s HC 30 is not available.
- 10.9 To qualify for the election under s HC 30(1), the trust must be a foreign trust for a distribution if it were made immediately before the settlor became resident. This requirement will be satisfied, if no settlor was resident at any time between:
- (a) the later of 17 December 1987 and the date the trust was first settled; and
 - (b) the date of deemed distribution on the day before the settlor becomes resident.
- 10.10 Under s HC 30(2), a settlor, trustee or beneficiary of a foreign trust can choose to satisfy the income tax liability of the trustee under s HC 33 by making an election before the expiry date using the form *Election to Pay Income Tax on Trustee Income* IR 463 (June 2008). The effect of an election is that the elector is liable to pay income tax on trustee income including foreign sourced amounts (but not on beneficiary income for which a trustee is liable as agent), and the trust is treated as a complying trust for distributions of amounts derived by the trustees after the date of the election. The trust remains a foreign trust in relation to distributions of amounts derived before the election (s HC 30(3)).
- 10.11 The election under s HC 30(2) is made by the person choosing to satisfy the trustee liability on trustee income using the procedures under s HC 33.
- 10.12 The liability of any other person to tax on the trustee income is not removed because a party has made an election under s HC 33. For example, if the newly resident settlor made the election, a resident or non-resident trustee of the trust would also remain liable. The Commissioner is not constrained from pursuing any of the liable parties jointly or severally when assessing or collecting that tax, but would not use these powers to collect any more than 100% of tax due. A trustee can make the election even though they will be the person liable in any event once the trust is a complying trust.
- 10.13 If an election is not made within the period, the trust becomes a non-complying trust under s HC 30(4)(b) for distributions of amounts derived by the trustee after the election expiry date, even if the trustee has paid tax on trustee income under s HC 24(1). Distributions of amounts derived before that date continue to be treated as derived from a foreign trust. A complying trust must have met the requirements set out in s HC 10 since inception, so these conditions can never be satisfied by a foreign trust unless it enters the regime using the election procedure in s HC 30.
- 10.14 Section HC 30(6) sets out two options for calculating income derived before the election is made or when it has expired. One option tracks the actual date of income derivation in the period and the other is a time-based apportionment method. No options are prescribed for calculating the income derived in the

Commented [CJF58]: The policy of limiting elections to a specific period should be referred to IR Policy. Invariably, the need to consider the status of trusts on becoming a resident is over-looked. This means that subsequent compliance by a settlor or another party does not cure the status of the trust. The trust must be dissolved. This may override the commercial and family reasons for establishing the trust in the first place.

We note that the IS appears to accept that NZ resident settled trusts may be able to cure the status of the trust by subsequent compliance.

Commented [CJF59]: Note the effect of the ordering rules?

Commented [CJF60]: Is this technically true for foreign sourced income?

Commented [CJF61]: This does not apply if no one else makes an election?

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period after the election is made or has expired (as the case may be), but the Commissioner will accept either of the same two methods for this or any other reasonable method of apportionment adopted.

- 10.15 If an election is not made and no further settlements are made on the trust after the settlor becomes tax resident in New Zealand, the settlor is not liable for tax on trustee income. This is the result of s HC 29(1) for trusts settled on or before 17 December 1987 and of s HC 29(5) for trusts on which a settlement has been made after 17 December 1987.

Application of s HC 30 – examples

- 10.16 Example 27 discusses new migrants with an existing trust. Examples 28–30 illustrate the application of s HC 30 in the three circumstances contemplated by that section. The three circumstances being: where an election is made to pay tax on trustee income and the trustee’s obligations are satisfied, where an election is made but the trustee’s obligations are not satisfied, and where no election is made.

Example 27. New immigrants with existing trust

Facts

Anna settled property on trust on 1 June 1986 when she was resident in Australia having been born there. The trust has two trustees: one is Anna’s Australian partner (Rick) and the other is an Australian solicitor. The trust property earns Australian-sourced income. Rick became resident in New Zealand for the first time on 1 October 2011 when he immigrated here with Anna, and his status as a transitional resident ended on 31 October 2015. He continues to be resident in New Zealand after his transitional residency stops.

Result

Rick, as a trustee of the trust, is liable to pay tax in New Zealand on the Australian-sourced trustee income from the income year commencing on 1 April 2015. This is because a settlor of the trust, Anna, is a New Zealand resident who stops being a transitional resident during this income year (s HC 25(2)). The exception in s HC 25(3) for a non-resident trustee does not apply, because Rick is not resident outside New Zealand at all times during the income year.

Even though Anna is the settlor, she is not liable as agent of the trustee for tax on trustee income because the trust was settled before 17 December 1987 and no further settlements were made after she became resident (s HC 29(1)). (If the trust had been settled after 17 December 1987, s HC 29(5) would still ensure Anna would not be liable for tax on trustee income.)

However, Anna can make an election under ss HC 30(2) and HC 33 to satisfy the income tax liability of the trustee from the date of the election. This is because Anna is a natural person who is a New Zealand resident. And, if a distribution had been made from the trust on the day before she ceased being a transitional resident, the trust would have been a foreign trust for the distribution (s HC 30(1)).

If Anna, Rick, the Australian solicitor trustee or any beneficiary of the trust make an election, the trust will be a complying trust for any distributions after the election date. The trust will continue to be a complying trust for so long as the tax obligations on the trustee’s income tax liability continue to be satisfied and the other requirements of s HC 10(1)(a)(i) are satisfied.

If an election is not made under ss HC 30(2) and HC 33, the trust will be a non-complying trust for any distributions after the expiry of the 1-year period (ie, after 31 October 2016).

Commented [CJF62]: Note next sentence makes clear the requirement to actually comply and not just elect?

Commented [CJF63]: It would be useful to state why Rick, as a NZ resident trustee does not become liable and that even if Rick pays the tax the trust is a non-complying trust

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Example 28. Election made and trustee's obligations satisfied

Facts

Len settled \$100,000 on trust on 1 April 2007 when he was resident in Hong Kong. The trustees are all resident in Hong Kong. Two members of Len's family (Kim and Jack) are beneficiaries of the trust. The trustees have discretion to pay income or capital to Kim and Jack. No further settlements were made on the trust after 1 April 2007.

Len, Kim and Jack all became resident in New Zealand on 1 May 2007 and were transitional residents for a 4-year period. None had previously been resident in New Zealand.

On 1 November 2011, Len made an election under ss HC 30(2) and HC 33 to pay tax on trustee income. All of the income the trustees derived was from outside New Zealand. The amounts the trustees derived and accumulated were:

Income year	Income	Capital gains
2008	\$1,000	Nil
2009	\$10,000	\$5,000
2010	\$11,000	\$5,000
2011	\$13,000	\$2,000
2012	\$8,000	\$3,000
2013	\$10,000	\$3,000

On 1 April 2013, the trustees made distributions to Kim of \$51,000 and to Jack of \$30,000. Len had paid tax on the trustee income derived between 1 November 2011 (the date of election) and 1 April 2013. Kim and Jack were still resident in New Zealand on 1 April 2013.

Tax consequences:

Entitlement to make election

Len is entitled to make an election under ss HC 30(2) and HC 33. This is because he is a natural person who became resident in New Zealand. And the trust would have been a foreign trust for a distribution made on 31 May 2011, the day before Len ceased being a transitional resident. The trust would have been a foreign trust, because no settlor of the trust had been resident in New Zealand from the date on which the trust was first settled on 1 May 2007 until 31 May 2011 (s HC 11).

Kim and Jack, as beneficiaries of the trust, are also entitled to make an election under ss HC 30(2) and HC 33, as are the Hong Kong trustees.

The election must be made within 1 year of the day on which the settlor became resident and ceased being a transitional resident. Len stopped being a transitional resident on 31 May 2011. The election may be made at any time on or before 31 May 2012. Therefore, Len's election on 1 November 2011 is within time.

Trustee income

Before Len stopped being a transitional resident, the trustee income was not liable to New Zealand tax because no settlor of the trust had stopped being a transitional resident and the income was all derived from outside New Zealand (ss BD 1(4) and HC 25(2)). Also, the trustees are not liable for tax on the trustee income derived in the income year when Len stopped being a transitional resident and in later income years. This is because the trustees are non-resident at all times during those income years and the settlor was not resident in New Zealand at the time of settlement (s HC 25(4)).

Commented [CJF64]: But they are not required to make an election?

Commented [CJF65]: What happens if Len dies? If Kim and Jack have not made an election, then the trust becomes non-complying?

Commented [CJF66]: And the trust has no New Zealand source income?

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The exclusion for non-resident trustees in s HC 25(4) does not affect a settlor's liability (or the requirements for a complying trust) (s HC 25(5)). However, Len is not liable as agent for the trustees for tax on trustee income. This is because Len was not resident in New Zealand when the settlement was made on the trust (s HC 29(5)).

The effect of the election is that Len is liable to pay tax on the trustee income derived from the date of election. No method is prescribed for calculating the income derived in the year of election after the date on which the election is made. However, methods modelled on s HC 30(6), namely either a time-based apportionment or a calculation based on income actually derived, will be acceptable as will any other reasonable apportionment method.

Assuming that a time-based apportionment is made, the trustee income on which Len is liable for tax for the 2012 income year is:

$$\$8,000 \times (151 \div 365) = \$3,310$$

Len is also liable to tax on trustee income derived in all subsequent income years. However, the \$10,000 derived by the trustees in the 2013 income year is distributed to Kim as beneficiary income- so there is no trustee income.

Distributions

The trust is a discretionary trust, and an election to pay tax on trustee income has been made under ss HC 30(2) and HC 33. The ordering rules in s HC 16(2) do not apply to the distributions to Kim and Jack, and the distributions are deemed to reflect the terms of the exercise of the trustees' discretion (see the exclusion from the ordering rules in s HC 16(6)).

If it is assumed that Kim is an income beneficiary only, that Jack is an income and capital beneficiary, and that the trustees exercised their discretion to pay capital to Jack, the treatment of the distributions is a \$51,000 distribution to Kim and \$30,000 distribution to Jack.

(a) \$51,000 distribution to Kim

The distribution is treated as being a distribution of the income derived in the 2008 to 2013 income years.

The \$10,000 derived in the 2013 income year is assessable as beneficiary income (s HC 17).

An amount of \$33,000 from the \$35,000 of income derived in the 2008 to 2011 income years is distributed with the remaining \$2,000 left in the 2009 income year.

The \$33,000 and the portion of income derived in the 2012 income year before the election (ie, $\$8,000 \times (214 \div 365) = \$4,690$) are assessable as a taxable distribution of \$37,690 from a foreign trust (ss HC 30(3)(a) and HC 15(4)).

The taxable distribution is taxed at Kim's normal marginal rates.

The remaining portion of income derived in the 2012 income year, \$3,310, is not assessable. This is because it is a distribution of income from a complying trust of an amount other than beneficiary income (ss HC 30(3)(b) and HC 20).

(b) \$30,000 distribution to Jack

The trustees exercise their discretion to distribute capital to Jack. The distribution is of the \$18,000 of capital gains derived by the trustees in the 2009 to 2013 income years and \$12,000 of corpus.

Capital gains of \$12,000 derived in the 2009 to 2011 income years and the portion of capital gains derived in the 2012 income year before the election are not assessable (ie, $\$3,000 \times (214 \div 365) = \$1,759$). This is because they are distributions of capital gains from a foreign trust (ss HC 30(3)(a) and HC 15(4)).

The portion of capital gains derived in the 2012 income year after the election, \$1,214, and capital gains of \$3,000 in the 2013 income year are also not assessable. This is because they are distributions from a complying trust of amounts other than beneficiary income (ss HC 30(3)(b) and HC 20).

Commented [CJF67]: This is unclear, if Len is not liable as agent for the trustees, how is Len liable? If he pays the tax on trustee income but not as agent for the trustees, how does this discharge any liability the trustees have? The later sections on compliance suggest that the settlor is taxed as an agent?

Commented [CJF68]: This would be much better shown as an additional column to the table in the facts

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The distribution of corpus is not assessable.

The result is that no part of the \$30,000 distribution is taxable to Jack.

Example 29. Election made but trustee's obligations not satisfied

Facts

The facts are the same as in Example 28, except that the trustee's income tax obligations are not satisfied in the 2013 income year.

Tax consequences:

Trustee income

The trustee income for the 2012 income year remains liable for tax as in Example 28. There is no liability to tax for the trustee income derived before the election to pay tax on trustee income was made (ie before 1 November 2011); but the settlor, Len, is liable to tax on trustee income derived after that date (ie, \$3,310). Len is also liable to tax on trustee income derived in all subsequent income years.

Distributions

Any distributions made in the income year in which the trustee's obligations are not satisfied and in any subsequent income year are treated as distributions from a non-complying trust except where they are of amounts derived before the day on which the election was made (s HC 30(3)(c)). Also, the ordering rules apply to such distributions because the trust is treated as a non-complying trust (s HC 16(1)). The ordering rules govern the order in which income, capital gains and corpus are deemed to be distributed.

The distributions made to Kim and Jack on 1 April 2013 are in an income year after the one in which the trustee's obligations are not satisfied (ie, the 2014 income year). Therefore, the trust is treated as a non-complying trust for the distributions, except where they are of amounts derived by the trustees before the election was made, and the ordering rules in s HC 16(2) apply.

The distributions are made at the same time. Rules for how contemporaneous distributions are to be ordered are in s HC 16(3). If an amount is included in an earlier or contemporaneous distribution, then it is not treated as included in the relevant distribution. The characterisation of distributions made at the same time is generally for the trustee to decide, subject to the ordering rules in s HC 16(2) and (3). In this case, it is assumed that the trustee decides to allocate \$51,000 of the income from the 2008 to 2013 income years to Kim. The remaining \$2,000 of the income from the 2009 income year is allocated to Jack because s HC 16(3)(b) treats all income as having been distributed before capital gains are distributed. The treatment of the distributions is a \$51,000 distribution to Kim and \$30,000 distribution to Jack.

(a) \$51,000 distribution to Kim

The trustee's discretion to pay out earlier years' income is overridden by s HC 16(2). Under s HC 16(2)(a) the current year's income must be paid out first and then the earlier years' income. In this case, none of the income is derived in the same year in which the distribution is made. Therefore, the treatment of the income is determined by the ordering rule in s HC 16(2)(b). That provision does not specify that preceding years' income must be regarded as having been distributed in any particular order, and it is assumed that the trustees distribute \$51,000 of the income to Kim and the remaining \$2,000 of the income to Jack.

If the income is distributed to Kim from the same income years identified in Example 28, \$37,690 of the distribution to Kim is assessable as a taxable distribution from a foreign trust at Kim's normal marginal rates. The \$37,690 comes from the same income years and amounts identified in Example 28.

The remaining portion of income derived in the 2012 income year after the election was made, \$3,310, is also assessable, but as a taxable distribution from a non-complying trust at 45% (ss HC 30(3)(c) and HC 34(1)).

Commented [CJF69]: This assumes the extended "paid or applied" rules do not apply to the trust?

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Commented [CJF70]: Underlined sentence doesn't add anything?

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Commented [CJF71]: Why? The contemporaneous rule referred to above has not been applied?

Commented [CJF72]: Doesn't the ordering rule deem this to be the case?

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The \$10,000 derived in the 2013 income year is assessable as beneficiary income.
(b) \$30,000 distribution to Jack

Commented [CJF73]: This contradicts the earlier description of all the distribution being of prior year and not current year trustee income.

The distributions to Kim and Jack are contemporaneous. Therefore, the distribution to Jack cannot be of amounts that are deemed to have been distributed to Kim, including all the income from the 2008 income year. Consequently, Jack is deemed to receive \$2,000 of the income remaining from the 2009 income year, the capital gains of \$18,000 derived in the 2009 to 2013 income years, and corpus of \$10,000.

The distribution of corpus is not assessable.

The capital gains derived in the 2009 to 2011 income years and the portion of the capital gain derived in the 2012 income year before the election are also not assessable. This is because they are distributions of capital from a foreign trust (ss HC 30(3)(a) and HC 15(4)).

However, the remaining portion of capital gains derived in the 2012 income year after the election was made, \$1,241, and the capital gain of \$3,000 derived in the 2013 income year, are assessable as a taxable distribution from a non-complying trust at 45%.

The \$2,000 of income derived from the 2009 income year is also assessable, but as a taxable distribution from a foreign trust at Jack's normal marginal rates.

Example 30. No election to pay tax on trustee income

Facts

The facts are the same as in Example 28 except that no election is made to pay tax on trustee income.

Tax consequences:

Trustee income

Because no election has been made, the trustee income is not liable to tax, and Len is not liable as agent for the trustees (for the reasons set out in Example 28): that he was not resident when the settlement was made.

Distributions

The trust is deemed to be a foreign trust for any distribution of amounts derived before the election expiry date and a non-complying trust where the distribution is of amounts derived after that date (s HC 30(4)). The ordering rules in s HC 16 apply to determine the different elements of the distribution.

The election expiry date is 1 year from the date on which Len stopped being a transitional resident. Len stopped being a transitional resident on 31 May 2011. Therefore, the election expiry date is 31 May 2012.

Commented [CJF74]: These should be part of the facts?

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The distributions to Kim and Jack are made at the same time on 1 April 2013, and it is assumed that the trustees treat \$51,000 of the income from the 2008 to 2013 income years as having been distributed to Kim and the remaining \$2,000 from the 2009 income year as having been distributed to Jack.

(a) \$51,000 distribution to Kim

The \$33,000 from the income derived in the 2008 to 2011 income years is assessable as a taxable distribution from a foreign trust at Kim's normal marginal rates (ss HC 30(4)(a) and HC 15(4)).

Commented [CJF75]: It would make more sense to describe this in the order that HC 16 treats the distribution as arising.

The \$8,000 of income derived in the 2012 income year is also assessable as a taxable distribution from a foreign trust. This is because the income in the 2008 to 2012 income years was derived before the election expiry date of 1 May 2012.

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The \$10,000 derived in the 2013 income year is assessable as beneficiary income. If it were not beneficiary income, then it would have been necessary to apportion the amount. The portion derived before the election expiry date would be a taxable distribution from a foreign trust (s HC 30(4)(a) and (6)). The portion derived after the election expiry date would also be a taxable distribution but from a non-complying trust (s HC 30(4)(b)).

(b) \$30,000 distribution to Jack

Jack is deemed to receive \$2,000 of the income remaining from the 2009 income year, the capital gains of \$18,000 derived in the 2009 to 2013 income years, and corpus of \$10,000.

The distribution of corpus is not assessable.

The capital gains derived in the 2009 to 2012 income years and the portion of the capital gain derived in the 2013 income year before the election expiry date (ie, $\$3,000 \times (30 \div 365) = \246.57) are also not assessable. This is because they are distributions of capital from a foreign trust (ss HC 30(4)(a) and HC 15(4)).

However, the remaining portion of capital gains derived in the 2013 income year after the election expiry date, \$2,753.43, is assessable as a taxable distribution from a non-complying trust at 45% (ss HC 30(4)(b) and HC 15(2)).

The \$2,000 of income derived from the 2009 income year is also assessable, but as a taxable distribution from a foreign trust at Jack's normal marginal rates.

Commented [CJF76]: See earlier comment that there is no beneficiary income.

Valuation of property, trading stock and financial arrangements on becoming a complying trust

- 10.17 Trustee income may become subject to New Zealand income tax some time after a trust was first established. This will occur, most commonly, when a non-resident settlor becomes resident in New Zealand and an election is made under ss HC 30 and HC 33 for a foreign trust to be a complying trust. When this happens, it is necessary to establish, at the date of change, the cost of trading stock and depreciable assets the trust owns, and to ensure income or expenses that would have already been accrued for financial arrangements of the trust (had the trustee income been liable to New Zealand income tax) are not accrued after the trustee income becomes liable to income tax. This is achieved by the rules in s HC 31.

Application of s HC 31

- 10.18 Section HC 31(1) has application when an amount a trustee derives on a date is assessable income when immediately before that date the income was not liable to New Zealand income tax other than as non-resident passive income. For ease of reference, this is referred to as the "change date."
- 10.19 Section HC 31(1) also applies when trustee income was previously liable to New Zealand income tax as non-resident passive income and subsequently becomes liable to New Zealand income tax as income of another type. For example, if the trustee income of a trust settled by a non-resident included interest paid by a New Zealand company, the interest would cease to be liable to income tax as non-resident passive income if the settlor and trustee became resident in New Zealand and an election was made under ss HC 30(2) and HC 33 to pay tax on trustee income.
- 10.20 Section HC 31 also applies when some trustee income was previously liable to New Zealand income tax while another portion was not, and the latter portion then becomes liable. In this situation, s HC 31 will apply only to the assets and

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financial arrangements used to produce income that was not previously liable to income tax. For example, if a trustee of a trust settled by a non-resident had trading income from within and outside New Zealand, only the profits from New Zealand would be liable to income tax. However, if the settlor became resident in New Zealand and an election was made to pay tax on trustee income, both the New Zealand and foreign business profits would be liable to income tax. Then, s HC 31 would apply in relation to the assets and financial arrangements used to earn the foreign-sourced business profits.

- 10.21 Section HC 31(1B) confirms that from 14 April 2014, s HC 31 does not apply to charitable trusts that fail to meet the requirements for deriving exempt income under ss CW 41 or CW 42. From that date, such charities are subject to the provisions of ss HR 11 and HR 12 relating to non-exempt charities ceasing their tax-exempt status and entering the tax base.

Premises, plant, machinery, equipment and trading stock

- 10.22 Section HC 31(3) sets out the method for determining the "cost" of premises, plant, machinery, equipment and trading stock on the change date. For premises, plant, machinery and equipment, the "cost" determined forms the basis for any depreciation losses that are deductible from trustee income. Cost also establishes an opening value for the trading stock provisions.
- 10.23 Either of two methods may be used to calculate the cost of the premises, plant, machinery, equipment or trading stock. The person liable for income tax on trustee income chooses the method and should indicate the method taken in the trust income tax return.
- 10.24 The first method is the historical cost of the asset, less accumulated depreciation or other value at that date (not exceeding market value) used to calculate income tax in a country (or territory) in which the trustee income has been liable to income tax. That is, the person may elect to use the depreciated basis or other value of the asset that is used for the purpose of income tax calculations in another country. If the relevant date falls within the income year in the other country, rather than at year end, it will be necessary to calculate the depreciated value by apportioning the depreciation allowed in the foreign country to the before and after periods in that income year. It will also be necessary to value the trading stock on the change date according to the methods used for income tax purposes in the foreign country, even if a valuation is not required under that country's tax laws on that date.
- 10.25 For this first method to be available, the trustee income must have been liable to income tax in another country, and the asset must have a value (whether historical cost less depreciation or any other value but not exceeding market value) for the purposes of income tax calculations in that country.
- 10.26 Under the second method, the person may use the value that would be used for the ITA 2007 at the relevant date as if the trustee income had always been assessable other than only as non-resident passive income. For premises, plant, machinery and equipment the "cost" under this option is calculated in two steps:
- (a) The first step is to establish the value of the asset that would have been used for New Zealand depreciation purposes when the asset was first available to produce income that would have been liable to New Zealand tax.

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(b) The second step is to deduct from the original depreciation basis calculated in step 1, the total amount of depreciation that would have been allowed as a deduction up to the change date, assuming a liability to New Zealand tax had always existed.

10.27 For trading stock, the person may use any of the applicable valuation methods in subpart EB to obtain a value on the date on which the trustee income became liable to New Zealand income tax.

10.28 Under the second method, it is assumed that the trustee income had at all times been liable to New Zealand income tax. This does not, however, include an assumption that assets are located in New Zealand and that, therefore, any special rates of depreciation historically available in New Zealand are applicable. If, for example, assets were used to carrying on a business in Hong Kong, the depreciation is calculated by assuming that the trustee income derived from the Hong Kong business was always liable to New Zealand income tax and that depreciation was allowed on the basis of the assets being in Hong Kong.

Financial arrangements

10.29 Section HC 31(4) and (5) sets out a method for calculating the consideration for a financial arrangement on the change date. The amount determined is then used to calculate the base price adjustment when it matures, or when it is remitted, sold or otherwise transferred. The intent is to ensure income or expenses that would have been notionally accrued in relation to the financial arrangement in the period before becoming liable to New Zealand income tax (assuming the trustee income had been liable to income tax all along) are not accrued in the period after actually becoming liable to income tax.

10.30 There are two options for establishing the consideration. The first option is the market value of the financial arrangement on the change date. The second option is the value calculated from the formula (s HC 31(5)):

consideration paid to the person + expenditure – consideration paid by a person
– income

Where (s HC 31(5)):

- **consideration paid to the person** is the consideration amount paid to the person before the change date;
- **expenditure** is the amount that would have been incurred under the financial arrangement rules before the change date;
- **consideration paid by the person** is the amount paid by the person before the change date; and
- **income** is the income that would have been derived under the financial arrangement rules before the change date.

10.31 The consideration calculated is taken into account in the formula in s EW 31 when calculating the base price adjustment for the financial arrangement.

Commented [CJF77]: What is the impact on the distribution/ordering rules for any accrued financial arrangements income to the date of change?

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Impact of transitional residence

Distributions from non-complying and foreign trusts

- 10.32 Where a transitional resident receives beneficiary income from a foreign or non-complying trust, the income retains for the beneficiary its underlying character in the hands of the trustee. Consequently, if the income is a foreign-sourced amount it will be exempt to the transitional resident.
- 10.33 A "foreign-sourced amount" is exempt income of a transitional resident under s CW 27, provided it is not employment income of the transitional resident or income from a supply of services by that transitional resident. Section HR 8(a) confirms a transitional resident is treated as if they were a non-resident for these purposes.
- 10.34 A "foreign-sourced amount" is defined in s YA 1 as meaning an amount of income that is not treated as having a source in New Zealand under s YD 4. "Income" is defined in s YA 1 as meaning "income of the person under s BD 1(1)". It therefore excludes "exempt income" and "excluded income" in s BD 1(2) and (3). Consequently, a taxable distribution from a non-complying trust, being excluded income under s HC 19(1) and s CX 59, will not qualify as a foreign-sourced amount when derived by a transitional resident and will remain taxable under s BF 1(b) irrespective of the source.
- 10.35 In *Case Y25* (2008) 25 NZTC 23,070 Judge Barber implicitly confirmed that source is irrelevant to the tax treatment of taxable distributions from a non-complying trust with a non-resident trustee by deciding that all beneficiaries both resident and non-resident were taxable at 45% on such a distribution.
- 10.36 If a transitional resident receives a taxable distribution from a foreign trust, the distribution does not retain its underlying character in the same manner as beneficiary income does, because it is a separate category of income created by ss HC 18 and CV 13(c), and the common law applicable to beneficiary income is not applicable.
- 10.37 Where a trustee of a foreign trust derives income or capital gains sourced from New Zealand, a taxable distribution to a beneficiary is treated as income having a New Zealand source to the same extent under s YD 4(13) and (18). The ordering rules in s HC 16 will determine the character of the taxable distribution. This means taxable distributions will not be exempt to transitional residents under s CW 27 as foreign-sourced amounts to the extent that they comprise accumulated income and related party capital gain amounts sourced from New Zealand.

Commented [CJF78]: This seems a strange result and analysis. Note that BD 1(3) refers to non-resident's foreign sourced amount which is defined in section BD 1(4) which in turn refers to YD 4. This suggests that section YD 4 must apply whether or not the income is ultimately excluded income or not.

Commented [CJF79]: The paragraph moves from considering beneficiary income to taxable distributions

Commented [CJF80]: How is the non-resident beneficiary taxed when the trustee is non-resident and the beneficiary is non-resident and the amounts are foreign-sourced?

Commented [CJF81]: We have not reviewed Y25. If it is support for 10.34, it does not appear to be correctly decided (see earlier comment). If it is only implied, then it does not appear to have decided the point at all.

Commented [CJF82]: This result appears to be one which should be tested as it is not clear why New Zealand should tax foreign sourced income of a non-resident. The end result is that the income has not been earned by a New Zealand resident.

Commented [CJF83]: This sentence brings back YD 4 when 10.34 says it is not relevant?

Commented [CJF84]: 10.34 suggests it can't be NZ sourced?

Distributions from complying trusts

- 10.38 Beneficiary income retains its underlying character (see [5.10]). Consequently, a transitional resident receiving beneficiary income will be taxed on New Zealand-sourced income within that distribution, but not on other foreign-sourced amounts.

Taxation of trustee income when settlor is a transitional resident

- 10.39 The treatment of foreign-sourced amounts derived by a trustee between the date on which the settlor of that foreign trust became resident and the date on

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which any election is made, is determined under ss HC 25 (foreign-sourced amounts: non-resident trustees) and HC 26 (foreign-sourced amounts: resident trustees). Section HC 25 does not make non-resident trustees liable for tax on foreign-sourced amounts while the settlor is a transitional resident, but does in the income year any settlor ceases to be a transitional resident. Section HC 26 treats foreign-sourced amounts derived by resident trustees as exempt where the settlor is a transitional resident (and the trust is a registered foreign trust that complies with certain disclosure requirements) but not in the income year the settlor ceases to be a transitional resident.

- 10.40 New Zealand-sourced income of a trustee of a foreign trust is taxable at all times irrespective of the status of the settlor.

Liability of settlor while a transitional resident

- 10.41 Where a settlor makes no settlements on a foreign trust after they become resident, they will not be liable under s HC 29(5) for the tax on trustee income of that trust unless they make an election under s HC 30 or if they were previously resident in New Zealand after 17 December 1987.
- 10.42 If a settlor makes further settlements on a foreign trust with non-resident trustees while they are a transitional resident, they would be liable for tax on the New Zealand-sourced trustee income from the time they made that settlement under s HC 29(1). From the beginning of the income year in which they cease to be a transitional resident, they will be liable for tax on the foreign-sourced amounts of the trustee through the combination of ss HC 25(2) and HC 29(1).
- 10.43 If a settlor makes settlements on a foreign trust with a resident trustee while a transitional resident, s HC 29(3) will apply to exclude the settlor from liability on trustee income.

Issues with pre-migration trusts

- 10.44 Where immigrants to New Zealand and returning New Zealanders who have been absent for more than 10 years settle a trust prior to coming to New Zealand, they may intend to have it treated as a non-complying trust under s HC 30(4) after it ceases to be a foreign trust, without the settlor having agency liability on trustee income under s HC 29(2). But agency liability will be triggered if any further settlements occur while they are resident. This can arise for example if the settlor has made a loan to the trust and fails to charge market rate interest on it. Also returning New Zealanders will continue to have an agency liability on trustee income of a non-complying trust they have settled under s HC 29(5) if they had previously been resident in New Zealand after 17 December 1987.

Commented [CJF85]: See earlier comments that a settlor is not agent?

Taxation of distributions to new or returning residents who are not transitional residents

Beneficiary income

- 10.45 The residency of a beneficiary determines how they are taxed on beneficiary income. A newly resident beneficiary who is not or who has ceased to be a

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transitional resident is taxable at marginal rates on all beneficiary income in the same manner as any resident.

Taxable distributions

- 10.46 Newly resident beneficiaries who are not or who have ceased to be transitional residents are taxed on taxable distributions at applicable rates being their marginal rate for such distributions from foreign trusts and 45% for non-complying trusts.

Commented [CJF86]: This implies that transitional residents are not so taxed but see section 10.32 to 10.37? Is this intended to apply only to complying trusts (but they would not be during the transitional residence period)?

New Zealanders returning within 5 years

- 10.47 If a person ceases to be resident and then returns to New Zealand within 5 years and resumes tax residency, they are taxed on all beneficiary income and taxable distributions that they derived over the period of absence from foreign and non-complying trusts. The intention of s HC 23 is to prevent such beneficiaries from changing residence so as to defeat the trust rules.
- 10.48 Where s HC 23 applies, the resulting income is treated under s CV 15 as being derived on the day the person becomes resident again.
- 10.49 Any beneficiary income taxable under s HC 23 may ~~be accompanied by~~ have had relevant foreign tax ~~credits~~ or non-resident withholding tax (NRWT) ~~paid~~. However, s LJ 6(2) permits foreign tax credits on taxable distributions only if they are substantially the same as NRWT. This means no credit is available for underlying tax paid on that type of income, the credit is only for tax in the nature of a withholding tax imposed on non-residents.

Trustees immigrating to New Zealand

- 10.50 If a trustee migrates to New Zealand and becomes resident that alone will not result in the trust being taxable, because prime liability is determined by the residency of the settlor and beneficiaries and the source of the income. If the settlor is non-resident, no beneficiaries are resident and no income has a New Zealand source, the trustee would have no liability for New Zealand tax in their capacity as trustee.
- 10.51 A resident trustee must, however, disclose details of trusts they are a trustee of with non-resident settlors (foreign trusts) under s 59B of the TAA. These obligations are discussed in Part 13 of this Interpretation Statement.

Part 11 Exit from the trust regime

Impact of settlor leaving New Zealand

- 11.1 New Zealand does not have a residence test for trusts. Therefore, there is no specific regime for the emigration of trusts (unlike for companies).
- 11.2 The taxation of trustee income is generally dependent on the residence of the settlor. Therefore, if the tax residence of a New Zealand settlor changes, there may be tax implications in relation to the treatment of trustee income. Specifically, foreign-sourced amounts derived by a non-resident trustee are liable to tax under s HC 25 where a settlor is resident and not a transitional resident. Foreign-sourced amounts derived by a resident trustee are taxable, if the settlor is resident and not a transitional resident, because the tax exemption for foreign-sourced trustee income in s HC 26 does not apply in such circumstances. New Zealand-sourced income of a trustee is always taxable, but where the trust is a foreign or non-complying trust the tax rate on trustee income depends on the type of income and the potential relevance of a double tax treaty (eg, in setting rates of NRWT on interest, dividends and royalties) rather than just the flat 33% rate applicable to all trustee income of a complying trust.
- 11.3 If all the settlors of a complying trust leave New Zealand, s HC 26(1) will result in the foreign-sourced amounts of a resident trustee being exempt income in the income year following the departure of the last of the settlors, provided that the foreign trust is registered under s 59B of the TAA (see Part 13 of this Interpretation Statement). The same applies under s HC 25 where the trustee is non-resident. If the trustee does not pay tax on worldwide trustee income, the trust will cease to be a complying trust at the time it next makes a distribution.
- 11.4 If complying trust status is lost, under s HC 10(1)(a) the trust will become a non-complying trust and subject to the ordering rules in s HC 16 (discussed in Part 8 of this Interpretation Statement) with taxable distributions derived by any New Zealand resident beneficiaries attracting tax at 45%.
- 11.5 Sections HC 33(1B) and HC 10(1)(ab) permit the trustee of a complying trust that ceases to meet the requirements under s HC 10(1)(a) to retain that status even after the last settlor leaves New Zealand. From 1 April 2008, a trustee in this position can be treated as having made an election to satisfy the income tax liability of the trustee under s HC 33 just by indicating that it is a complying trust in the annual return and continuing to pay tax on the worldwide trustee income before making any distribution.
- 11.6 Consequently, when a settlor leaves New Zealand they can effectively choose to migrate their trust and thereafter have it treated as a non-complying trust for beneficiaries remaining resident in New Zealand or carry on as a complying trust and pay full tax in New Zealand on the worldwide trustee income.

Impact of trustee leaving New Zealand

- 11.7 Many other countries base the tax residence of trusts on the residence of the trustee. Consequently, even if one trustee of a complying trust adopts

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residency in another country it may result in the new country of residence seeking to tax the trustee income of that trust.

- 11.8 In New Zealand, the residency of the trustee is not the main factor in determining the liability of the trustee to pay tax on trustee income. Where a trustee ceases to be New Zealand resident, that trustee will remain liable for tax on worldwide trustee income of a trust settled by a person who remains resident in New Zealand, including in the income year such a settlor ceases to be a transitional resident. Tax liability on foreign-sourced amounts is imposed under s HC 25 on foreign trustees where the settlor is resident and not a transitional resident. New Zealand-sourced income derived by a non-resident trustee in such a situation will be taxable based on the source rules in s YD 4.

Beneficiaries ceasing to be resident in New Zealand

- 11.9 A beneficiary of a complying trust who ceases to be New Zealand tax resident is treated for tax purposes in the same manner as any non-resident beneficiary. Tax is paid by the trustee as their agent or withheld at applicable NRWT rates from beneficiary income and New Zealand-sourced taxable distributions.
- 11.10 A taxable distribution from a foreign trust to a non-resident beneficiary is taxable to the same extent as the income has a New Zealand source under s YD 4(13) and (18). The ordering rules in s HC 16 are applied to determine the character of the amounts distributed as accumulated income and related party capital gains.
- 11.11 A taxable distribution from a non-complying trust to a non-resident beneficiary is taxed at 45% irrespective of source. It is excluded income under s CX 59 and therefore not an amount of income that is non-resident's foreign sourced income in terms of s BD 1(5) and the source rules do not apply. This treatment was impliedly accepted by Judge Barber in *Case Y25*.
- 11.12 Beneficiary income derived by a non-resident is taxed if it has a New Zealand source. Foreign-sourced amounts are not assessable income of a non-resident under s BD 1(5).

Commented [CJF87]: Not sure what "taxable distribution" is intended to mean given the paragraph assumes a complying trust?

Commented [CJF88]: Note: it is assumed that the income retains its character.

Commented [CJF89]: This paragraph is not the same as 10.34 which implies there is no non-resident foreign income?

Part 12 Associated persons

Overview

- 12.1 Subpart YB sets out the rules for determining when persons will be associated for tax purposes. Several provisions in subpart YB deal with trusts. The associated persons rules relating to trusts were strengthened from 1 April 2010 with some exceptions where the rules apply to land transactions.
- 12.2 The associated persons rules are designed to prevent changes to the tax treatment of a transaction by conducting it with or flowing it through an associated party. They also ensure transactions between related parties are undertaken at arm's length. A major area of concern has been the use of trusts by property developers to move property transactions from a taxable business to a non-taxable capital investment by a related party trust. As a result, the rules were strengthened in relation to trusts. See Inland Revenue Department NZ, *A Guide to Associated Persons Definitions for Income Tax Purposes* IR 620 (November 2010) at 6.
- 12.3 The broad rules for associated persons in the trust context can be summarised as:

Associated persons rule	Income tax – land	Income tax – other
Trustees and beneficiaries	No	Yes
Trustee and relative of beneficiary	No	Yes
Trustee and settlor	Yes	Yes
Settlor and beneficiary	No	Yes
Two trustees and same settlor	Yes	Yes
Trustees and person with power to appoint and remove trustees	Yes	Yes

- 12.4 Several modifications apply to the trust-based land? tests to ensure the rules do not over-reach in their object of protecting the tax base. These modifications include:
- not having the beneficiary association tests, or person and the trustee for a relative test, applying to land sales transactions;
 - excluding charities as beneficiaries for the tests and excluding charitable trusts from the trustee and settlor test; and
 - not including the provision of services to a trust for less than market value in the settlor definition for associated person tests.

Trust-specific associated person tests

- 12.5 Under s YB 6(1), a trustee is associated to the beneficiaries of a trust. This rule does not apply for the purposes of the "land provisions" under s YB 6(2). "Land provisions" is defined in s YA 1 to cover numerous land-related transactions:

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land provisions means the following provisions:

- (a) sections CB 7 to CB 11 (which relate to certain land transactions), except CB 8 (Disposal: land used for landfill, if notice of election):
- (b) section CB 15 (Transactions between associated persons):
- (bba) section CC 1B (Consideration relating to grant, renewal, extension, or transfer of leasehold estate or licence):
- (bbab) section EE 67 (Other definitions):
- (bb) section EI 4B (Consideration for agreement to grant, renew, extend, or transfer leasehold estate or licence):
- (c) sections FB 3 to FB 5 (which relate to the transfer of land on a settlement of relationship property)

- 12.6 Beneficiaries are defined under s YB 6(1) to include those that have benefited under a trust as well as those eligible to benefit. This latter class includes any person named by the trustee as a potential beneficiary as well as discretionary beneficiaries that are named or within a designated class.
- 12.7 Importantly, where trustees or other persons have a general power to appoint beneficiaries, any person yet to be appointed is not included as a beneficiary. For elaboration of the policy on when a person under a trust is eligible to benefit, see "Income Tax: Associated Persons", *Tax Information Bulletin* Vol 7, No 9 (February 1996): 25.
- 12.8 Exceptions for certain employer trusts exist under s YB 15, the bonus bonds unit trust and energy consumer trusts (lines trusts) under s YB 16(1), as well as charities under s YB 16(2). Community trusts that hold shares in the successor companies to the former trustee banks are excluded, because, technically, these "purpose" trusts do not have beneficiaries at law.
- 12.9 Two persons are associated under s YB 5(1) if one is a trustee and the other is associated under the "two relatives test" with a person who has benefited or is eligible to benefit under the trust. The "two relatives test" is in s YB 4 and determines that two relatives are associated if they are within two degrees of relationship; they are married, in a civil union or in a de facto relationship; or if one person is within two degrees of blood relationship to the other person's spouse, civil union partner or de facto partner. Again the provision does not apply to land provisions under s YB 5(2), and there is also the same exception under s YB 16(1) described above. A trustee will be associated to the person's relatives within the second degree (ie, their spouse, civil union partner, de facto partner, parents, grandparents, children, grandchildren, siblings and in-laws).
- 12.10 Trusts with a common settlor are associated under s YB 7. Under this provision two persons who are married, in a civil union or in a de facto relationship are treated as the same person to prevent circumvention by the use of mirror trusts. Further, for the purposes of s YB 7, a settlor does not include someone who provides services to the trusts for less than market value, eg a family member who provides accounting services to a family trust for no consideration (s YB 10). Also s YB 7 does not apply where a trust is only for the benefit of employees (s YB 15).

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- 12.11 A trustee and a settlor are associated under s YB 8. The same exceptions listed in [12.10] apply with the addition of an exception for charitable trusts under s YB 8(2).
- 12.12 A settlor and any beneficiary of the trust are associated under s YB 9. Again, the same exceptions described in [12.10] apply.
- 12.13 The associated persons rules do not apply to associate a deceased person with their estate. While a trustee is defined as including an executor and an administrator, an estate is not the same as a trust, as discussed in Part 9 of this Interpretation Statement (in relation to deceased estates). In addition, under ss FC 1 and FC 2, a transfer of a deceased person's assets to their executor is treated as a transfer for market value. This means a deceased person is not a "settlor" of their estate because there is no transfer for less than market value.
- 12.14 A trustee and a person with power to appoint or remove a trustee are associated under s YB 11. An exception exists for certain employer trusts under s YB 15.
- 12.15 For more detail on the associated persons regime and for an explanation of the reasoning behind various exclusions such as charities and energy consumer trusts (lines trusts) with examples, see Inland Revenue Department NZ, *A Guide to Associated Persons Definitions for Income Tax Purposes* IR 620 (November 2010).

Part 13 Compliance

Introduction

- 13.1 There are tax obligations placed on settlors, trustees and beneficiaries of trusts. Many such obligations are common to all taxpayers (eg, the obligation to pay tax on the due date), and are not dealt with in this Interpretation Statement. Rather, this part of the Interpretation Statement explains the compliance obligations that are unique to trusts.

Settlor disclosure obligations

- 13.2 Section 59 of the TAA requires a ~~person~~resident who makes a settlement on a trust ~~while resident~~ after 17 December 1987 to disclose that settlement to the Commissioner if there is:
- (a) no resident trustee, at the time of settlement; or
 - (b) a resident trustee and later there are no resident trustees, then when there are no resident trustees.
- 13.3 Where a nominee settlor (as set out in s YB 21) is resident, they must make the disclosure regarding the person deemed to be the settlor under s YB 21, if there is no resident trustee at settlement.
- 13.4 Disclosure must be made on the prescribed form *Settlors of Trusts Disclosure* IR 462 (January 2008) within 3 months of the date when the settlement is made on non-resident trustees or all trustees become non-resident, as the case may be.
- 13.5 Under s 93B of the TAA, the Commissioner is permitted to make default assessments of trustee income in a fair and reasonable manner where:
- (a) a person has failed to disclose trust details required under s 59 or
 - (b) information requested under s 17 of the TAA (information to be furnished on request).
- This can also occur under s 93B if the person is unable to obtain sufficient information to calculate trustee income.
- 13.6 The disclosure requirement does not apply to superannuation funds or to any person in respect of a superannuation fund. Consequently, members of such schemes do not have to disclose their contributions. It also does not apply before 1 April 2009 to any offshore superannuation scheme classified by the Government Actuary under regs 29 or 30 of the Superannuation Schemes Regulations 1983.

Disclosure details for resident settlors of non-complying trusts

- 13.7 Each time a settlement is made resident settlors (or their nominee settlors if applicable) of non-complying trusts must disclose under s 59(1) and (2) of the TAA using the prescribed form *Settlors of Trusts Disclosure* IR 462 (January 2008):
- (a) the name of the trust;

Commented [CJF90]: Include in a separate section as next section covers what must be disclosed?

Commented [CJF91]: This reads as a different requirement from the previous paragraphs. It appears to be a description of what must be disclosed? It does not appear to be limited to non-complying trusts?

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- (b) details of the settlement (covering both the original and any later settlement amounts and dates);
- (c) the market value of property transferred to the trust;
- (d) details of consideration received by a settlor for property settled on the trust;
- (e) the names and addresses of trustees and beneficiaries;
- (f) copies of the trust deed and any amending deeds;
- (g) the name and address of persons for whom a nominee is acting;
- (h) the full legal description and address of any real property settled on a trust;
- (i) the number, type and name of the company and country of incorporation of any shares settled;
- (j) details of the parties, interest rate and term of financial arrangements settled;
- (k) the consideration paid and the nature of the services provided that are settlements; and
- (l) any other information the Commissioner requires.

13.8 Disclosure on the prescribed form is required within 3 months of the date of settlement or of the date on which there is no trustee of the trust resident in New Zealand.

Disclosure obligations for resident trustee of foreign trust

- 13.9 Resident foreign trustees are required to register foreign trusts with Inland Revenue (s 59B(2) of the TAA). A "resident foreign trustee" is defined in s 3(1) of the TAA as a New Zealand tax resident who alone or jointly acts as a trustee of a foreign trust that is not a charity registered under the Charities Act 2005.
- 13.10 A resident foreign trustee must apply to register the foreign trust within 30 days of the date of formation, or the date any trustee first becomes a resident foreign trustee (s 59C(1)(b) of the TAA). Sections 59C(3) and (4) of the TAA provide for a "grace period" for registration if all of the trustees of a foreign trust are natural persons not in the business of providing trustee services, and none of them have been resident foreign trustees before. In that case, the time limit for application extends to four years and 30 days from the first date on which the foreign trust had a resident foreign trustee. This concession recognises that some people may become resident foreign trustees due to changes of circumstances, and allows them time to understand their obligations.
- 13.11 The resident foreign trustee must provide the following information about a foreign trust at the time of registration (s 59B(3) of the TAA):
- the name of the trust;
 - information about all settlements made on the trust, including the provision of services to the trust for less than market value, other than minor services that are incidental to the activities of the trust (where all

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the trustees of the foreign trust are natural persons who are not in the business of providing trustee services, it will only be necessary to provide information about settlements for the four years prior to the earliest date that the trust was required to be registered);

- the name, email address, physical address, jurisdiction of tax residence, and taxpayer identification number of all settlors, beneficiaries, trustees and persons with control over the trust (eg, protectors and people with powers of appointment); and
- a copy of the trust deed or functional equivalent, including any documents that amend or supplement the trust deed.

13.12 The resident foreign trustee must also provide a signed declaration that each person referred to on the registration form has either been informed of, and has agreed to provide the information necessary for compliance with these rules, and the requirements of the Anti-Money Laundering and Countering Financing of Terrorism Act 2009, is deceased or, despite the efforts of the resident foreign trustee, cannot be located (s 59B(4) of the TAA).

13.13 Resident foreign trustees must also comply with on-going disclosure requirements. These disclosure requirements include:

- A requirement to file annual returns, including the trust's financial statements, and details of any settlements and distributions made over the year. The due date for filing the return is six months after the trust's balance date or by 30 September if the trust does not have a non-standard? balance date (s 59D of the TAA).
- A requirement to provide any updates to the information provided at registration within 30 days after becoming aware of the alteration (ss 59B(5) and 59C(2) of the TAA).
- General record keeping requirements (s 22 of the TAA) (discussed further from [13.20]).

Commented [CJF92]: If there is no balance date, presumably the return is to 31 March?

13.14 An initial registration fee of \$270 and annual filing fees of \$50 are payable. However, no fees are payable where all resident foreign trustees of the foreign trust are natural persons that are not in the business of providing trustee services (s 59E of the TAA).

13.15 Where there is more than one resident foreign trustee, all of the resident foreign trustees will be responsible for the performance of the trustee obligations (s 59B(7) of the TAA). However, the trustee that applies for registration of the trust will be the "contact trustee", and will be responsible for all communication with Inland Revenue (s 59B(3) of the TAA). If the contact trustee wishes to relinquish that role, or expects to cease being a resident foreign trustee for the trust, they must inform Inland Revenue of the date this will occur, the contact details for any replacement contact trustee, and their updated contact details (s 59B(6) of the TAA).

13.16 Failing to comply with the registration and on-going disclosure requirements will mean that the foreign trust will cease to be eligible for an exemption from tax on its foreign sourced income under ss CW 54 and HC 26.

13.17 Information obtained by Inland Revenue about foreign trusts can be shared with the Department of Internal Affairs, the New Zealand Police and the Overseas

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Investment Office. In addition, the information can be shared internationally with New Zealand's tax treaty partners.

- 13.18 For further information on the foreign trust disclosure rules, refer to the Policy and Strategy special report *Foreign trust disclosure rules* (March 2017). This report also discusses the transitional rules that are applicable for foreign trusts that existed on 21 February 2017 when the new rules were enacted.

Disclosure obligations for beneficiaries

- 13.19 Beneficiaries who receive beneficiary income and taxable distributions from foreign or non-complying trusts must fill in form *Schedule of beneficiary's estate or trust income* IR 307 (September 2014). A new form must be completed for each trust that income is received from. The form is attached to the beneficiary's tax return and filed with it.

Records to be kept by resident foreign trustee

- 13.20 A resident foreign trustee is obliged to keep (and produce on request) records that disclose the history and operation of the trust under s 22(7)(d) of the TAA. This information need not include the 2-year concession period referred to above in s 59B(3), but must otherwise cover:
- (a) a copy of the trust deed and any other constitutional documents;
 - (b) settlement and distribution details made on or by the trust;
 - (c) a record of the assets and liabilities of the trust; and
 - (d) records of the accounting information system if the trust carries on a business, which extends to the charts and codes of accounts, relevant accounting system instruction manuals, and relevant system and programme documentation used in every income year to administer the trust.
- 13.21 If there is more than one resident foreign trustee, they may appoint one to be the official agent for recordkeeping duties under s 22(2C) of the TAA. This option is also available for making disclosure under s 59B(7).
- 13.22 Permission can be obtained from the Commissioner to keep records in languages other than English and to keep records off-shore under s 22(2BA) of the TAA. For information about when and how the Commissioner may authorise keeping records offshore and in languages other than English, see "SPS 13/01: Retention of business records in electronic format, application to store records offshore and application to keep records in Māori", *Tax Information Bulletin* Vol 25, No 3 (April 2013): 8.

Sanctions for non-compliance

- 13.23 If a settlor or trustee knowingly does not provide information about a trust or knowingly does not keep proper records, a penalty can be imposed on them under s 143A of the TAA. The penalty is a fine of up to \$50,000 for knowingly providing false information or knowingly not disclosing or imprisonment for up to 5 years or both. A person who aids, abets or incites either of these offences is liable to the same fine or term of imprisonment.

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- 13.24 The penalty under s 143A of the TAA will not apply if a resident foreign trustee convicted of knowingly not providing information subsequently provides that information.
- 13.25 The Commissioner's policy is that penalties for failure to make disclosure will not apply if a resident foreign trustee is unaware of the disclosure obligations. The lack of awareness is a question of fact determined on a case-by-case basis. For more information concerning the obligations, duties and implications in this area, see "New Disclosure and Record-Keeping Rules for Foreign Trusts", *Tax Information Bulletin* Vol 18, No 5 (June 2006): 107 at 110.

Default assessments

- 13.26 Section 93B of the TAA empowers the Commissioner to make default assessments in three situations relevant in this context under that Act; that is, where a person:
- (a) has failed to disclose the details of a trust under s 59 of the TAA;
 - (b) has failed to provide information in relation to a trust requested by the Commissioner under s 17 of the TAA; and
 - (c) is unable to obtain sufficient information to calculate the trustee income of the trust.
- 13.27 In any of these circumstances, the Commissioner may determine (in a fair and reasonable manner) the amount of trustee income for the income year.

Requests for information about trusts from other countries

- 13.28 Inland Revenue provides information about a foreign trust to the Australian Tax Office under the Exchange of Information article in the double tax treaty between New Zealand and Australia, if the resident foreign trustee discloses that a settlor of the foreign trust is an Australian resident.
- 13.29 Inland Revenue also provides information about foreign trusts to other countries New Zealand has agreements with on a case-by-case basis when a treaty partner makes a valid request if relevant parties (such as settlors and beneficiaries) reside in that country. Inland Revenue is permitted to require information to be provided under s 17 of the TAA by a person if considered necessary to satisfy New Zealand's treaty obligations subject to tax confidentiality laws in ss 20 and 20B of the TAA and litigation privilege if relevant.
- 13.30 There is generally no obligation to send information to treaty partners if there is considered to be a risk in how that information will be used or disclosed. There are also restrictions on disclosure where the information is contrary to public policy, or would disclose any trade, business, industrial, commercial or professional secret or trade process.
- 13.31 Changes However, changes have been made to the ITA 2007 and the TAA to incorporate the G20/OECD standard for Automatic Exchange of Financial Account Information in Tax Matters (AEOI). The AEOI focuses on imposing due diligence and reporting obligations on certain financial institutions. These obligations are in the Common Reporting Standard (CRS) which is supplemented

Commented [CJF93]: The Commissioner should consider an Operational Statement on this when issuing the final IS.

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by OECD Commentary. The approach is to incorporate CRS directly into law by reference and to require application of the CRS consistently with the OECD Commentary. Because of similarities, the CRS provisions have been merged with the FATCA framework in part 11B of the TAA.

- 13.32 The CRS includes certain unit trusts and ~~professionally~~ managed investment trusts in the term "financial institution". Settlers, mandatory beneficiaries, discretionary beneficiaries (if they receive distributions), any other natural persons that have effective control over the trust, and any persons that provide a loan to the trust, will be deemed to hold a "financial account" with such a financial institution trust.
- 13.33 From 1 July 2017 financial institutions must commence due diligence reviews and thereafter an annual reporting regime commences.

Commented [CJF96]: Suggest deleting as "professionally" may be a limitation not reflected in the CRS.

Legislative update

More guidance on AEOI/CRS obligations for trusts that are financial institutions can be obtained from *Tax Information Bulletin* Vol 29, No 4 on the Taxation (Business Tax, Exchange of Information and Remedial Matters) Act 2017 [expected in May]. Inland Revenue will also publish a comprehensive guide after it has considered submissions on the draft released in December 2016. The guide will deal with the AEOI standard and the implementation legislation at a detailed technical level.

Commented [CJF97]: For completeness, note that both have since been updated and assume that this will be updated for the final version.

Filing of tax returns

- 13.34 Under s 59(3) of the TAA, trustees are required to make a return of all income derived by the trustees for each separate trust they are responsible for. This extends to both trustee income and beneficiary income. Superannuation funds are included in this obligation.
- 13.35 One return for each trust must be filed, if it derives income. Co-trustees file jointly and do not include any of their personal income. The trustee is liable for tax on all income as if beneficially entitled under s HC 24.
- 13.36 Each year a trust must file the tax return *Income Tax Return: Estate or Trust* IR 6 (March 2016) and include:
- (a) all income derived by the trust;
 - (b) the tax credits relating to that income;
 - (c) the allocation of income between trustee income and beneficiary income; and
 - (d) any taxable distributions made.
- The completed form *Estate or Trust Beneficiary Details* IR 6B (March 2016) should be attached to the IR 6.
- 13.37 From 16 November 2015 s 43B of the TAA permits a complying trust to make a declaration, using the form *Non-Active Trust Declaration* IR 633 (November 2015), that it is a non-active trust, so is not required to file a tax return, and will inform the Commissioner if that status changes. Previously, such trusts were required to file nil tax returns. However, the Commissioner has the power to

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override a non-active trust declaration and request that a trust files a tax return. This measure provides relief to trusts with little or no income and, in particular, those trusts owning houses on land occupied by beneficiaries who do not pay rent who are required to have IRD numbers if such land is either transferred or received.

- 13.38 Under s 43B(1)(a) of the TAA, a trustee of a complying trust is not required to file an income tax return if throughout the year:
- (a) the trust is a non-active trust, meaning:
 - (i) the trust has not derived or been deemed to derive any income;
 - (ii) the trust has no deductions;
 - (iii) the trust has had no transactions involving assets of the trust that gave rise to income for the trust; and
 - (iv) the trust has not had any fringe benefits for current or former employees; and
 - (b) the trust meets the criteria to be a complying trust under s HC 10.
- 13.39 In determining the non-active status of the trust the following minimal income and expense items can be ignored to ease the compliance burden:
- (a) reasonable fees paid to "professional trustees" (as defined in s 20 of the TAA) to administer the trust;
 - (b) bank charges and other minimal administration fees not exceeding \$200 per year;
 - (c) bank account interest not exceeding \$200 per year; and
 - (d) rates, insurance and other expenditure incidental to a dwelling owned by the trust and incurred by beneficiaries.

(d)

Commented [CJF98]: The filing obligations of a settlor electing complying status have not been covered?
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Allocation of tax credits

- 13.40 Any tax credits associated with income derived by a trustee are generally allocated in the same proportion as the income is allocated between beneficiary income, trustee income and taxable distributions.
- 13.41 The practice has developed whereby trustees allocate RWT credits to beneficiaries as they see fit. This allows trustees to allocate less RWT when distributing interest or dividend income to beneficiaries on lower tax rates and more RWT to beneficiaries on higher tax rates. This practice is in-line with the guidance provided in *Trusts' and Estates' Income Tax Rules* IR 288 (April 2016) and is accepted by Inland Revenue.

Clarifying allocation of RWT Credits

Legislative amendments are being considered to clarify that trustees may allocate RWT credits as they see fit.

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13.42 Imputation credits must be allocated in proportion to the total distributions received from the trust under s LE 5. A trustee cannot allocate such credits to beneficiaries as they choose and must use this formula under s LE 5(2):

$$\text{(person's distributions} \div \text{trust distributions)} \times (\text{total beneficiary credits} - \text{person's supplementary credits})$$

In this formula:

- **person's distributions** is the total distributions for the tax year made to the person in their capacity as beneficiary;
- **trust distributions** is the total distributions for the tax year made to all beneficiaries (in their capacity as such) including any supplementary dividends;
- **total beneficiary credits** is the total imputation credits attached to dividends and total supplementary dividends for the tax year paid to all beneficiaries; and
- **person's supplementary dividend** is the total supplementary dividends for the tax year paid to the person as beneficiary of the trust.

13.43 When applying the formula, all distributions, including those of corpus and non-taxable capital gains, are taken into account, not just beneficiary income. The formula applies whether or not the trustees have any discretion to differentiate between beneficiaries.

Example 31. Allocation of imputation credits to beneficiaries

A trust has three adult beneficiaries, Daniel, Rebecca and Mick, and income of \$40,000, consisting of \$30,000 of interest and dividends of \$10,000 with \$600 of attached imputation credits. The \$40,000 of income is distributed between the income beneficiaries Daniel and Rebecca equally, and Mick as a capital beneficiary is distributed corpus of \$20,000.

The formula requires the imputation credits to be allocated like this:

Beneficiary	Distribution	%	Imputation credits
Daniel	\$20,000	33.33	33.33% x \$600 = \$200
Rebecca	\$20,000	33.33	33.33% x \$600 = \$200
Mick	\$20,000	33.33	nil

Accordingly, \$200 of imputation credits are lost, because Mick's corpus distribution is ineligible to receive them, yet it still dilutes the imputation credit entitlements of the other income beneficiaries.

13.44 Beneficiaries can claim a credit for tax paid on beneficiary income and taxable distributions and their share of tax credits in their personal tax returns.

13.45 When dividend income is distributed to a minor beneficiary, imputation and RWT credits remain with the trustee to be assessed along with the minor beneficiary income at the trustee rate (s LE 4). However, the amount of these credits that may be attached to the distribution is calculated by ignoring the minor beneficiary rule under ss LE 5 and LF 3. Consequently, the minor beneficiaries are treated, effectively, as deriving the distribution for the purposes of the tax credit rules.

Commented [CJF99]: Note that these rules are different from the expected trust rules which allow income to retain their character. If a dividend is distributed, imputation credits would normally be expected to flow. The policy reason for this should be explained.

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Resident withholding tax substitution payments

- 13.46 A trustee can substitute cash distributions for RWT credits under s RE 2(7). This means beneficiaries do not have to seek a refund for RWT deducted over and above their marginal tax rate as they get RWT credits at their correct rate and the cash equivalent of the excess RWT paid by the trustee. A trustee who does this is then entitled to a credit to the extent that cash has been substituted for RWT credits under s LB 3(5). The beneficiary is treated by s RE 2(8) as having received resident passive income that is beneficiary income when getting such a RWT substitution payment. There is no obligation on the trustee to withhold RWT from the substitution payment despite its deemed status as resident passive income. The beneficiary has no right to the RWT credit as a result.

Example 32. Trustee pays resident withholding tax substitution payment

The trustees of the Egmont trust receive \$1,000 of gross interest from government stock with RWT deducted at 33%. They have \$670 net cash and \$330 of RWT credits. They wish to distribute the income to Emma, a beneficiary with a marginal tax rate of 17.5%. They resolve to do this by distributing all the \$670 of net interest plus a RWT substitution payment of \$155 and \$175 of the RWT credit.

Emma has beneficiary income of \$1,000. Her marginal tax rate is 17.5%, so she will have tax to pay of \$175. This tax can be satisfied using the RWT credit of \$175, so she has no further tax to pay. In economic terms, Emma is in the same position as having obtained a refund of the excess RWT paid. The trustees set off the substitution payment of \$155 against the remaining RWT credits of the same amount, so are in a revenue-neutral situation.

Withholding tax obligations on trustees

- 13.47 Unless a recipient holds an exemption certificate or some other exemption applies, a trustee has an obligation to deduct RWT from distributions to beneficiaries to the extent that they consist of resident passive income and RWT has not already been deducted (ss RE 2, RE 5(3), and RE 7 to RE 9). "Resident passive income" is defined in s RE 2(1) to include interest, dividends and replacement payments under share-lending arrangements. The obligation on a trustee to deduct arises only if the original payer has not already made the deduction prior to the trustee receiving it. This can occur, for example, if the trustees hold an RWT exemption certificate because of the amount of income they earn or because they are in a tax loss.
- 13.48 If trustees are issued an RWT exemption certificate, the certificate is in the name of the trust. Therefore, the certificate continues when trustees change. However, a trustee will remain jointly and severally liable for any RWT the trust is required to pay (eg, RWT payable on distributions to beneficiaries) until written notification of retirement is provided to the Commissioner under s RE 30.
- 13.49 Non-resident passive income is defined in s RF 2 as meaning:
- income having a source in New Zealand that a non-resident derives and that consists of—
- (a) a dividend other than an investment society dividend:
 - (b) a royalty:
 - (c) an investment society dividend when the non-resident is not engaged in business in New Zealand through a fixed establishment in New Zealand:

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- (d) interest when the non-resident is not engaged in business in New Zealand through a fixed establishment.

- 13.50 A resident trustee of a complying trust who derives passive income such as interest and dividends will frequently have RWT withheld from them by the payer. Any passive income including royalties a resident trustee distributes to a non-resident beneficiary is treated as non-resident passive income. The trustee has an obligation, at the time of payment, to withhold NRWT at the appropriate rate from the distribution under ss RF 3 and RF 4. The NRWT withheld must then be paid to Inland Revenue by the 20th of the following month or at 6-month intervals if the annual amount is less than \$500. For more details on the obligations for NRWT payers, see Inland Revenue Department NZ, *NRWT: Payer's Guide* IR 291 (October 2015).
- 13.51 The time of payment is not when the trustee receives the income, but when it is paid to a non-resident beneficiary. This includes crediting to an account or being dealt with in their interest or on their behalf as well as when vested absolutely in their interest.
- 13.52 If RWT has already been deducted from the income, then, under s RF 5, the RWT paid is used to offset the NRWT payable. If more RWT has been withheld than the NRWT payable, the non-resident beneficiary can file a tax return to seek a refund of the excess. If the RWT is less than the NRWT payable, then the trustee must withhold the difference as NRWT from the payment.
- 13.53 The NRWT is payable on the amount actually paid to the beneficiary because this is gross income of the beneficiary. The trustee may not have passed on all the income derived because the trustee has funded some or all of its expenses from that income. In this situation, the part of the income retained to meet expenses will be trustee income. If, however, any charges are made directly to the non-resident beneficiary in relation to the distribution, such as handling fees or commissions, then the amount subject to NRWT is the amount paid before these charges are deducted.
- 13.54 If a non-resident beneficiary has a fixed entitlement to any non-resident passive income the trustee can arrange for the payer at source to deduct NRWT at the appropriate rate, or have approved issuer levy (AIL) paid on payments of interest if applicable, rather than have the trustee attend to this.
- 13.55 If a trustee distributes other New Zealand sourced income (eg rents) to non-residents as either beneficiary income or taxable distributions, the trustee must pay tax as agent for the beneficiary at their relevant marginal tax rate under s HC 32. Consequently, the trustee will routinely deduct that tax from the distribution to fund its obligation.

Commented [CJF100]: The ability to apply AIL and/or NRWT is noted at 13.54 but not foreign investor tax credits. This problem should also be referred to IR Policy for further consideration.

Commented [CJF101]: By who? A third party directly or by the trustee?

Commented [CJF102]: Practically, how does this work?

Agency obligations for trustees and settlors

Trustee and settlor agency liability

- 13.56 Where a beneficiary derives beneficiary income or a taxable distribution during any income year the trustee is liable to satisfy the income tax liability of the beneficiary on that income as their agent under s HC 32. This means the agency provisions in subpart HD (Agents) apply. This agency liability does not apply to distributions from community trusts under ss HC 32(2) and HD 12(1) since the beneficiaries of community trusts account for their own tax.

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- 13.57 Section HD 3(2) requires every person who is an agent to make returns of the income for which the person is an agent. A trustee deriving income must file an annual tax return IR 6 (March 2016), attaching the form *Estate or Trust Beneficiary Details* IR 6B (March 2016) to record the income distributed and tax paid for each beneficiary.
- 13.58 An agent is assessed on such income as if the agent were the principal. This means the trustee is personally liable for tax on beneficiary income and taxable distributions as if that income were the trustee's income.
- 13.59 Section HD 4(a) ensures the liability of the agent (trustee) does not release the principal (beneficiary) from liability for their tax obligations. Further, under s HD 2, any assessment of the agent for tax does not preclude an assessment of the principal for the same tax and vice versa. Consequently, the trustee and beneficiary are jointly and severally liable for tax on beneficiary income and on taxable distributions. In practical terms, these provisions are used as a collection mechanism, but are never used to collect more than 100% of the tax due. The beneficiary remains liable to furnish returns and to assessment for tax on beneficiary income and taxable distributions.
- 13.60 Section HC 29(2) sets out a settlor's liability for tax as agent of a trustee for a trust they have made a settlement on while resident. It does not apply where there is a resident trustee for the full income year and from the time of the initial settlement on a trust to the end of that first income year. Consequently, it routinely applies to non-complying trusts. The intention of the provision is to enable tax to be captured from resident settlors on trustee income of non-complying trusts when trustees are non-resident.
- 13.61 Where there is more than one settlor, they are jointly and severally liable for tax on that income. The settlor's liability does not, however, extend to the trustees' liability for income tax as agent for beneficiaries under s HC 32.
- 13.62 Settlor liability applies to trusts (other than charitable trusts and superannuation funds) where a settlement was made to or for the benefit of a trust after 17 December 1987. It does not apply under s HC 29(4)(c) where the trustee income is derived from a settlor remitting an amount under a financial arrangement.

Trustee liability as agent of beneficiary (s HC 32)

Residency of a trustee is not relevant

- 13.63 The residence of a trustee is not relevant for the purposes of s HC 32. A trustee is liable for tax as agent on beneficiary income and taxable distributions whether the trustee is resident or not.
- 13.64 When a beneficiary is non-resident, the trustee's agency liability is limited to income sourced from New Zealand that the beneficiary derives. When a trustee fails to meet a resident beneficiary's tax obligations, the liability falls under s HD 4 on the beneficiary.

Commented [CJF103]: This appears inconsistent with earlier comments on agency?

Commented [CJF104]: Practical impact of this on non-resident?

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Beneficiary may undertake the duties with consent

13.65 Under s HD 4(b), if the Commissioner agrees, the beneficiary and trustee may decide that a beneficiary is to undertake the duties of making assessments, providing returns, and satisfying the beneficiary's tax liability rather than the trustee. Where this occurs, the trustee is not relieved from having to file a return for the trust's other income. If the beneficiary fails to perform its direct assessment duties, the trustee remains personally liable for the beneficiary's tax liability under s HD 4(a).

Calculating the tax payable by the trustee as agent

13.66 Section HD 7 prescribes that the rate of tax for which an agent is assessable and liable is determined by reference to the taxable income of the principal. However, tax is payable on the amount of agency income only as a proportion of the taxable income of that principal. This means a trustee must first calculate the tax payable on the total taxable income of the beneficiary and then determine the portion referable to just the beneficiary's income and taxable distributions.

13.67 For example, if during the income year ending 31 March 2016 an individual beneficiary derives beneficiary income of \$5,000 and total taxable income, (including the beneficiary income) of \$50,000, the tax payable by the trustee on the beneficiary income would be calculated as follows:

Tax payable on taxable income at current marginal rates	
\$48,000 × (10.5% to \$14,000 then 17.5%) =	\$7,420
\$2,000 × 30%	= \$600
<hr/>	
Total	= \$8,020
Tax payable on beneficiary income	
\$8,020 × (\$5,000 ÷ \$50,000)	= \$802

Commented [CJF105]: How does the trustee know of the other income?

13.68 Where a beneficiary derives a taxable distribution from a non-complying trust the taxable distribution is assessable at the rate of 45% (s HC 34 and in sch 1, part A, cl 4). Consequently, the amount of tax is calculated at the flat rate of 45% on such a distribution rather than using the method described above.

13.69 In practical terms, where the trustee has paid tax on beneficiary income or on a taxable distribution in full, the beneficiary will not be required to pay tax on that income. If the trustee pays tax on the beneficiary income or taxable distribution but the amount paid is less than the correct amount, the beneficiary will be required to pay the difference; if they do not, the trustee remains liable.

Commented [CJF106]: Impact on provisional tax of the beneficiary is not covered?

Right of recovery against beneficiary

13.70 Under s HD 5(2), when an agent pays tax, the agent may recover the amount from the principal, or the agent may deduct the amount from any money held that belongs to the principal. Therefore, a trustee has an effective right of indemnity against a beneficiary for any tax paid as their agent. Section HD 5(3) permits an agent to retain an amount out of money belonging or payable to the principal that is reasonably sufficient to pay the tax when it is due or in a later income year. As a result, where the trustee has not yet paid tax on beneficiary

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income or on a taxable distribution, the trustee may deduct an appropriate amount from either the income or distribution to cover the tax.

Settlor agency liability on trustee income (s HC 29)

- 13.71 Where a settlement has been made on a trust after 17 December 1987 and during any income year the trustee derives trustee income, any settlor of the trust who is resident in New Zealand at any time during that income year is liable to income tax on the trustee income for the entire income year as agent of the trustee.
- 13.72 Under s HC 29(2) the settlor liability for trustee income does not extend to beneficiary income for which the trustee is liable as agent under s HC 32. The settlor has a statutory right of indemnity against the trustee for any tax paid by the settlor on trustee income in s HD 5(2) and (3).
- 13.73 The same agency consequences applicable to trustees liable as agent for beneficiaries apply to settlors in this context. Section HD 3(2) requires every agent to make returns of the agency income that the principal is required to make and must satisfy their principal's tax liability. Under s HD 2, the principal and agent are jointly and severally liable for the tax obligations and the liability of one remains despite the assessment of the other. Therefore, the Commissioner may assess the settlor for income tax on trustee income whether or not the Commissioner also assesses the trustee for income tax on such income. There is no requirement for the Commissioner to assess the trustee on the trustee income and to attempt to collect the tax from the trustee before an assessment can be made on the settlor. Where an assessment is made on the settlor, this does not preclude an assessment being made on the trustee. However, these tax collection aids are never used to collect more than 100% of the tax payable. If an assessment is made on the settlor under s HD 4 this does not release the trustee from the liability to make returns and to be assessed and charged with tax. However, the Commissioner can agree that the principal is to undertake the duties on application by the parties.
- 13.74 Settlor are, therefore, jointly and severally liable for tax on the entire trustee income, and it is for the settlors to apportion liability among themselves. Section HC 29(6) provides an exception to this general rule. An apportionment of the liability can be made where the settlor can satisfy the Commissioner (with full disclosure) that another settlor or others settlors should be liable, having regard to their respective settlements.

Exceptions to settlor liability (s HC 29(3)–(6))

Trustee resident (s HC 29(3))

- 13.75 Section HC 29(3) provides that a settlor of a trust is not liable if the trust has a resident trustee for the full income year. Where the first settlement on a trust with a resident trustee is made during an income year then the settlor is not liable from that time until the year ends.
- 13.76 A resident corporate settlor of a foreign trust unable to elect into the complying trust regime under s HC 30 on migration to New Zealand, because the settlor is not a natural person, would be liable for the tax on trustee income under s HC 29 unless an exception applied. The most likely exception is the presence

Commented [CJF107]: These remaining sections should be in section 10 with the entry discussion

Commented [CJF108]: Is the statutory right enforceable against non-residents?

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of a New Zealand resident trustee for the entire income year during which the corporate settlor is resident under s HC 29(3).

- 13.77 Liability is not imposed on the settlor because a resident trustee can pay the tax. Where no trustee is resident during the income year or where a trustee is resident for only part of the income year, it may be less likely that the tax can be collected from the trustee.

Commented [CJF109]: Note that using this rule would not make it a complying trust?

Superannuation funds and charities (s HC 29(4))

- 13.78 Settlers of superannuation funds and charitable trusts are not liable for tax on trustee income under s HC 29(4). The trustees of superannuation funds are liable for tax on world-wide income and there is no beneficiary income for members of superannuation funds because all income is taxed to the trustee. Settlers of charitable trusts are not liable for any tax payable by charitable trustees (eg, fringe benefit tax paid on benefits provided to employees of a business run by a charity). The settlers of charitable trusts who make charitable gifts and donations might be discouraged from making such gifts and donations if they were liable for trustee income, even though that income would usually be exempt to charitable trusts under ss CW 41 and CW 42.

Commented [CJF110]: This sentence is an odd formulation of the policy reason for not making such settlers liable – there is no practical reason to do so if the income is exempt?

Non-resident settlors (s HC 29(5))

- 13.79 A settlor of a trust is not liable to income tax on trustee income if the settlor is a natural person who was not resident in New Zealand at the time of any settlement by that settlor and who was not resident at the time of any settlement since 17 December 1987. This rule does not apply if the settlor elects to pay tax on trustee income under s HC 33.
- 13.80 Section HC 29(5) ties in with s HC 30, which permits a settlor of a foreign trust who becomes resident in New Zealand and is not or is no longer a transitional resident to elect to convert the trust to a complying trust. Read together, the effect of these provisions is that settlers of foreign trusts who become resident in New Zealand and are not (or cease to be) transitional residents are not liable for income tax on trustee income unless they elect to pay tax on such income within the period of a year after ceasing to be a transitional resident. Immigrants who settled trusts before becoming resident in New Zealand (and ex-patriate New Zealanders returning after more than 10 years abroad) may have made the settlement without knowledge of the New Zealand trust tax regime. Therefore, they are not automatically liable for income tax on trustee income on becoming resident and before ceasing transitional residence. In this regard, new immigrant settlers of such trusts are treated in a similar manner to resident settlers who settled trusts before 17 December 1987. For more information on the election procedure for newly resident settlers, see Part 10 of this Interpretation Statement.
- 13.81 For s HC 29(5) to apply the settlor must be a natural person. This is consistent with the s HC 30 election option, which also applies only to natural persons. The settlor must not have been resident in New Zealand at the time of any settlement by that settlor or by any other person after 17 December 1987.
- 13.82 Section HC 29(5) does not apply where the settlor elects to pay tax on trustee income under s HC 33. Several categories of election are covered by the s HC 33 procedure, including elections under s HC 30 when a foreign trust can

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be converted to a complying trust within a year of transitional residence ceasing. If an election under s HC 33 to pay tax on trustee income is made by a trustee or beneficiary, and not by the settlor, the settlor will continue to be exempted from liability for tax on trustee income if s HC 29(5) is satisfied.

Limitation of liability (s HC 29(6))

Requirements and application

- 13.83 Section HC 29(6) may be used to limit the liability of settlors where there is more than one settlor of the trust. It provides that a settlor is not liable to income tax on trustee income to the extent to which the settlor can satisfy the Commissioner, through full disclosure of the settlements made, that another settlor should be liable having regard to the respective settlements made.
- 13.84 Section HC 29(6) may apply where the settlors are all resident in New Zealand, and the settlors prefer an apportionment of liability under that provision to the joint and several liability imposed by s HC 29(2). It may also apply where there is a mix of resident and non-resident settlors, and the resident settlors seek to limit their liability to a proportionate share of the trustee income.
- 13.85 In determining whether the liability of a settlor should be limited, the Commissioner must have regard to the respective settlements made by the settlor and by other settlors. It is incumbent on the applicant to propose a method of apportionment that is fair and reasonable. An apportionment may be relatively simple, if different settlements result from dispositions of property to the trust. The two following methods are examples of apportionments that would be acceptable to the Commissioner:
- (a) The first method is by determining, at the time of the settlement, the proportion that the market value of the property settled by the settlor on the trust bears to the market value of the trust's net assets. This proportion then remains unchanged until a further settlement is made on the trust. When a further settlement is made, the property settled earlier is revalued and the liability of the settlors is worked out by comparing the current values of all property settled on the trust.
- (b) The second method is by tracing the income attributable to the property settled on the trust by the settlor

Example 33. Apportioning liability between settlors

To illustrate the first method, assume that in year 1 Megan and Grant each transfer property with a market value of \$10,000 to a trust. In year 4, Grant transfers more property with a market value of \$5,000 to the trust. In year 4, the properties transferred by Megan and Grant in year 1 have each increased 50% to a market value of \$15,000, so trust assets are \$30,000 before Grant's second settlement. The liability of Megan and Grant for tax on trustee income in years 1 to 3 is calculated in each of those income years as:

trustee income \times ($\$10,000 \div \$20,000$)

In year 4, the proportions of trustee income for which Megan and Grant are liable are recalculated by revaluing the property originally contributed by them and by taking into account the additional settlement made by Grant. The proportion of trustee income for which Megan would be liable to income tax would be:

$(\$15,000 \div \$35,000) \times 100\% = 43\%$

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Grant would be liable to income tax on the remaining 57% of the trustee income.

- 13.86 Where different types of property are settled producing different returns, a tracing approach may be more appropriate. This approach could be used, for example, if one settlor transferred shares to a trust while another transferred land. The liability of the settlors could then be determined by allocating the income derived from the shares to that settlor and by allocating the income derived from the land to the other settlor.
- 13.87 The examples discussed above assume quite simple facts. In more complex cases, for example, where property settled by one settlor has been later disposed of by the trustee, or where settlements have arisen from the contribution of property or the provision of services, it may not be possible to make a sensible comparison of the settlements for the purpose of s HC 29(6). If this is the case, the provision will not apply. Whether it can be applied or not will depend on the facts of each case.

Limitation of liability and complying trust definition (s HC 29(7))

- 13.88 Section HC 29(7) provides that s HC 29(6) does not apply to determine whether the tax obligations for a trustee's income tax liability are met for the purposes of s HC 10(1)(a)(ii) when meeting the requirements of a complying trust.
- 13.89 As a consequence, if tax is not paid on all the income of a trustee under s HC 24 because the resident settlor's liability to tax is limited by s HC 29(6), the trust will not be a complying trust in relation to any distribution made from it.

Commented [CJF111]: But if tax is paid by the trustee?

Trustee income from remittance of debt (s HC 29(4)(c))

- 13.90 Under s HC 29(4)(c), a settlor is not liable to income tax on trustee income to the extent that the trustee income is derived under ss EW 31 or EZ 38 from amounts remitted by the settlor using the base price adjustment mechanism under the financial arrangement rules.
- 13.91 The remittance of a financial arrangement will generally give rise to income to the issuer of the financial arrangement. Where the remittance of a financial arrangement by the settlor results in trustee income, s HC 29(4)(c) exempts the settlor from liability to tax for that. However, the trustee will remain liable to tax for the trustee income arising from the remittance, and, if the trustee's obligations for that liability are not satisfied, the trust will not be a complying trust for distribution purposes.

Draft items produced by the Office of the Chief Tax Counsel represent the preliminary, though considered, views of the Commissioner of Inland Revenue.

In draft form these items may not be relied on by taxation officers, taxpayers, and practitioners. Only finalised items represent authoritative statements by Inland Revenue of its stance on the particular issues covered.

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We would appreciate your initial feedback on this item, which you can provide through [three quick questions](#).

Send detailed submissions public.consultation@ird.govt.nz.

Field Code Changed

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