Inland Revenue
Te Tari Taake

INTERPRETATION STATEMENT | PUTANGA WHAKAMĀORI

Taxation of trusts

Issued | Tukuna: 1 February 2024

IS 24/01

This interpretation statement explains the taxation of trusts under the trust rules in the Income Tax Act 2007 (ITA 2007). It is a general guide as to how income derived by the trustees of a trust is taxed. This statement also explains the various compliance obligations imposed on settlors, trustees and beneficiaries under tax law.

All legislative references are to the ITA 2007 unless otherwise stated.

REPLACES | WHAKAKAPIA

- **IS 18/01: Taxation of trusts – income tax**, *Tax Information Bulletin* Vol 30, No 7 (August 2018): 17

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Part 1: Introduction | Whakataki

Trusts generally

1.1 A trust is a creation of the law of equity and 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 beneficiaries or, where the trust is a charitable trust, for the specified charitable purposes. Although the trustee has legal ownership of the trust property, they hold it subject to the beneficial interests of the beneficiaries and must act in accordance with the terms of the trust and the Trusts Act 2019. A trustee may be a natural person or an entity such as a company. There may be multiple trustees and they may retire, be removed or be replaced from time to time.

1.2 A trust is established by a settlor. A settlor can be a natural person while they are alive (*inter vivos*) or by way of their will (a testamentary trust). A settlor can also be 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. The trustees will often use the corpus to derive income and capital gains.

1.3 Trusts are often created by a trust deed (or functional equivalent document) and this generally specifies the ability of a trustee to deal with the trust's property and make distributions to beneficiaries. The operation of a trust and the specific duties imposed on trustees are also governed by the law of equity relating to trusts and the Trusts Act 2019. The trust rules in the ITA 2007 apply to determine the tax consequences that flow from the operation of the trust under trust law.

1.4 References in this statement to "a trust" or "the trust" are references to the trustee(s) of a particular trust, as appropriate.

Definition of trust rules

1.5 The term "trust rules" is defined in s YA 1. The definition lists the sections in the ITA 2007 and Tax Administration Act 1994 (TAA) that contain many of the rules affecting trusts. These include rules for taxing foreign-sourced income derived by trustees and amounts distributed to beneficiaries. The trust rules also contain rules relating to the compliance obligations of settlors, trustees and beneficiaries. Most of the trust rules are in subpart HC.

1.6 Trust rules in s YA 1 means:

- s BD 1(4)(c) (which relates to non-residents' foreign-sourced income);
- ss CV 13, CW 53, CW 54 and CX 59 (which relate to distributions by trusts and amounts derived by trustees);

- ss DV 1 to DV 7 (which relate to superannuation funds);
- s DV 9 (which relates to deductions by trustees and beneficiaries);
- s GB 22 (which contains a specific anti-avoidance rule relating to beneficiary income);
- subpart HC (which contains the general rules relating to trusts);
- subpart HZ (which contains terminating provisions);
- ss LE 4, LE 5 and LO 2 (which relate to tax credits);
- the definitions of "look-through company" and "look-through counted owner";
- s YD 3BA (which deals with the country of residence of joint trustees); and
- ss 43B, 59, 59BA, 59BAB, 59B, 59C, 59D, 59DB, 93B and 139AC of the TAA (which relate to filing and disclosure requirements of trustees and settlors).

1.7 Section CX 58 is also relevant to the taxation of trusts and treats amounts derived by certain minors as excluded income.

Overview of the trust rules

1.8 A trust that is properly constituted will have at least one settlor, trustee and beneficiary. The meaning of these terms for tax purposes is discussed in Part 2 (Settlors) and Part 3 (Trustees and beneficiaries).

1.9 Income derived by a trustee is taxed as either beneficiary income or trustee income.

1.10 Beneficiary income is essentially income derived in an income year by a trustee to the extent that it (s HC 6):

- vests absolutely in interest in a beneficiary in the income year; or
- is paid to a beneficiary during the income year or within the extended period allowed for in s HC 6(1B).

1.11 Trustee income is essentially income derived by a trustee in an income year to the extent it is not beneficiary income (s HC 7). It includes minors' beneficiary income (see Part 6 (Minor beneficiary rule)).

1.12 Special rules exist for the taxation of foreign-sourced amounts derived by a trustee. In general, these amounts are taxed based on the settlor's residence. Where the trustee is resident but there is no New Zealand-resident settlor who is not a transitional resident, foreign-sourced amounts derived by a trustee are generally not taxed in New Zealand (provided that if the trust is a foreign exemption trust, the trustee complies with the obligations discussed in Part 13 (Compliance)). Where the trustee is non-resident but there is a New Zealand-resident settlor who is not a

transitional resident, foreign-sourced amounts are generally subject to tax in New Zealand.

1.13 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). The amounts identified in subpart HC are income under part C.

1.14 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).

1.15 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:

- **complying trusts** – essentially trusts where tax has always been paid in New Zealand on the worldwide income derived by the trustee, whether by obligation or election, and the tax obligations relating to the trustee's income tax liability have been satisfied;
- **foreign trusts** – essentially trusts that have not had a New Zealand resident settlor at any time since 17 December 1987; and
- **non-complying trusts** – trusts that are neither complying nor foreign trusts.

1.16 It is possible for a trust to be both a complying trust and a foreign trust. This type of trust is referred to as a dual status trust in this statement.

1.17 In general, distributions to New Zealand resident beneficiaries of a trust, other than distributions that are beneficiary income, are:

- exempt income, where the distribution is made by a complying trust or dual status trust;
- a taxable distribution, where the distribution consists of:
    - accumulated income or certain capital gains derived through a transaction with an associated person distributed by a foreign trust; or
    - accumulated income or capital gains distributed by a non-complying trust; or
- a non-taxable distribution, where the distribution consists of:
    - capital gains (other than certain capital gains derived through a transaction with an associated person) of a foreign trust; or
    - corpus of a foreign or non-complying trust.

1.18 Foreign-sourced amounts distributed to non-resident beneficiaries as either beneficiary income or taxable distributions are not subject to tax in New Zealand.

1.19 The classification of trusts and the tax treatment of distributions to beneficiaries is discussed in Part 8 (Distributions from trusts). See also **IS 19/04: Income tax – distributions from foreign trusts**.

1.20 The general tax treatment discussed above applies to most trusts, including the standard family or trading trust structures often used in New Zealand. However, different tax rules apply to the following:

- charitable trusts;
- estates;
- community trusts;
- superannuation funds;
- lines trusts;
- licensing trusts;
- bare trusts;
- unit trusts;
- Māori authorities; and
- foreign investment funds.

1.21 The taxation of the above is discussed briefly in Part 9 (Special cases).

Residence

1.22 The trust rules are known as a settlor-based taxation regime. The trust rules interact with the core provisions to tax income derived by the trustees based on the residence of the settlors for foreign-sourced amounts. Foreign-sourced amounts are generally taxable in New Zealand only where the settlor is resident but exempt if the settlor is non-resident. However, all New Zealand-sourced amounts are taxed in New Zealand regardless of the residence of the settlor.

1.23 The settlor-based taxation regime was chosen instead of one based on the residence of trustees as used in most countries because it was considered too easy to avoid tax on foreign-sourced amounts under the previous 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. The taxation of trustee income is discussed in Part 7 (Trustee income). For more information on residence, see part 3 (residence and trusts) of **IS 16/03: Tax residence**.

1.24 The trust rules contain specific rules for trusts that change their status due to a change in the residence of their settlor or settlors. These rules, and the impact of

trustees and beneficiaries changing residence, are discussed in Part 10 (Transitional issues on becoming resident) and Part 11 (Transitional issues on becoming non-resident).

1.25 The residence rules for trusts that are financial institutions and must comply with the due diligence and reporting requirements in the Foreign Account Tax Compliance Act (FATCA – a 2010 United States federal law) or Common Reporting Standard (CRS) (in OECD, *Standard for Automatic Exchange of Financial Account Information in Tax Matters* (2nd ed, OECD Publishing, Paris, 2017, part II) are slightly different from the residence rules for income tax purposes. Guidance in Inland Revenue's publications on the FATCA and CRS requirements for trusts is referred to in Part 13 (Compliance).

Associated persons

1.26 The associated person rules as they apply to trusts are discussed in Part 12 (Associated persons). That part considers situations where settlors, trustees and beneficiaries are associated for tax purposes.

Compliance obligations

1.27 The trust rules contain compliance obligations for settlors, trustees and beneficiaries. These rules include:

- settlor disclosure obligations;
- trustee disclosure obligations;
- beneficiary disclosure obligations;
- records that must be kept by trustees of foreign trusts;
- sanctions for non-compliance;
- additional information that must be provided with tax returns;
- allocation of tax credits;
- withholding tax obligations; and
- agency obligations.

1.28 These compliance issues are considered in Part 13 (Compliance).

Previous statements

1.29 This statement updates and replaces IS 18/01. IS 18/01 updated the explanation of the trust rules in **Appendix: Explanation of taxation of trusts**.

1.30 IS 19/04 was published after IS 18/01 and essentially explains the concept of a trust in more detail to help determine whether amounts of money or property received by New Zealand residents from overseas are taxable under the trust rules.

Part 2: Settlors

Introduction

2.1 The term "settlor" is defined broadly in the ITA 2007. The core meaning 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 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, which creates equitable obligations on the trustee.

Significance of being a settlor

2.3 The definition of settlor is important in several respects, including:

- determining when foreign-sourced amounts derived by non-resident trustees will be assessable income (s HC 25);
- determining when foreign-sourced amounts derived by resident trustees will be exempt income (s HC 26);
- determining whether a trust is a foreign trust (s HC 11);
- determining whether a settlor may be liable for the income tax liability of a trustee (s HC 29);
- understanding the minor beneficiary rules (ss HC 36 and HC 37);
- understanding certain associated person provisions relating to trusts (ss YB 7 to YB 9); and
- calculating income for Working for Families entitlements and student loan repayment obligations (eg s MB 7 (family scheme income of settlor of trust)).

2.4 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 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 a settlor.

2.5 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 may treat all the settlements as one trust (s HC 3).

Definition of settlor

2.6 Settlor is defined in s YA 1, primarily by reference to s HC 27. A settlor has the following features:

- the core concept is of a person who transfers value to a trust;
- it includes a person who provides services to or for the benefit of the trust for less than market value but it excludes those services which are no more than incidental to its operation such as bookkeeping services;
- it has a legislative response to the decision in *Re Marshall (Deceased), CIR v Public Trustee* [1965] NZLR 851 (CA) about on-demand loans;
- rules exist for determining when a beneficiary is a settlor if they are owed money by the trustee;
- rules exist that help in determining whether a transfer of value or provision of financial assistance has been made; and
- exceptions exist for:
  - trusts for retirement benefits of employees;
  - contributions to foreign superannuation schemes; and
  - resettlements involving non-resident settlors.

2.7 A person can also be treated as a settlor under s HC 28 where:

- the person has a control interest in a company that settles an amount on a trust;
- a trustee of a head-trust settles an amount on or makes a distribution to a sub-trust;
- a person has control over a trustee or a settlor of the trust and can require the trustee to treat them, or a nominee, as a beneficiary; and
- the anti-avoidance provision applies.

2.8 Although not part of the definition of settlor, a person may be treated as one under s YB 21 if someone else settles a trust as nominee for the person. A person who makes a nominal settlement at the request of another person is treated as a nominee of that person.

2.9 Finally, as previously noted, the definition of settlor is qualified for the purposes of the minor beneficiary and associated person rules.

Person who transfers value to a trust

2.10 The core meaning of settlor is a person who transfers value to a trust. In particular, a person is a settlor of a trust under s HC 27(2)(a) if they transfer value:

- to the trust;
- for the benefit of the trust; or
- on the terms of the trust.

2.11 For simplicity, this part generally refers 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.

2.12 A person is a settlor if they transfer value at any time. 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"

Features of the definition of transfer of value

2.13 The definition of settlor uses the definition of transfer of value in s YA 1. The definition features:

- a general meaning;
- a specific inclusion relating to the release of an obligation to pay money;
- a specific inclusion relating to the disposition of property at less than market value; and
- confirmation that "transfers value", which is used in the settlor definition, has a corresponding meaning.

General meaning of transfer of value

2.14 A transfer of value from a person to a trust generally involves the person paying an amount or transferring property to the trust with the trust providing nothing in return. In such cases, the transfer of value equals the market value of the property transferred.

2.15 However, a transfer of value to a trust can also occur where the trust provides something in return.

2.16 Essentially, a transfer of value occurs 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 of transfer of value in s YA 1). In net terms, money or money's worth is being transferred from person A to person B.

2.17 Money's worth includes an amount even if it cannot be converted into money (para (b)(i) of the definition of transfer of value in s YA 1). This overcomes the decision in *Wilkins (Inspector of Taxes) v Rogerson* [1961] 1 All ER 358 (CA) at 361, which held that money's worth must be convertible into money.

2.18 "Market value" is an important concept in the definition of transfer of value. 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 must be considered. 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 and *R v Islam* [2009] UKHL 30). Where the settlement is denominated in foreign currency, the market value is the value in New Zealand dollars on the date of settlement.

2.19 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 ITA 2007 unless otherwise stated. Therefore, they may be 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 definition of settlor definition is not one of these.

2.20 Note also that the value of a settlement on a trust is unaffected by the rules in subpart FC. These rules treat the transfer of property on making a gift as taking place at market value to ensure holding gains the donor derives on revenue account property cannot be avoided. However, they do not apply for determining whether there has been a settlement (s FC 2(4)(a)). The focus for these purposes is whether an actual transfer of value has occurred.

2.21 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:

- Firstly, where a person is providing money's worth to a trust, a transfer of value could arise where the trust pays a below market value consideration (see Example | Tauira 1).

- Secondly, where a trust provides money's worth to a person, a transfer of value could arise if the person pays an above market value consideration (see Example | Tauira 2).

Example | Tauira 1: Transfer of value – below market consideration

Sara sells her car to a family trust to be used in a business the trust carries on. The sale price is $6,000, but the market value 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.

Example | Tauira 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 for the management services.

These facts could also raise other issues (involving potential avoidance considerations and the amount of income derived by the trust). However, this example is merely to illustrate the operation of the settlor definition.

2.22 Generally, in an arm's-length transaction, the Commissioner is likely to accept that the price paid for property is a market value consideration.

2.23 In determining whether a transfer of value has occurred, the Commissioner will consider the circumstances surrounding a transaction. For instance, the Commissioner acknowledges that a purchaser may pay a premium for property because, for example, they are in a hurry to purchase. Similarly, a vendor may discount the sale of property because they urgently need funds. It is unlikely Parliament would have intended such transactions, when entered into with trustees, to result in settlements. However, the onus is on the taxpayer to show the special circumstances that led to the premium or discount.

2.24 For simplicity, in discussing the transfer of value concept, this part assumes a trust does not provide anything in return. This is despite the importance of considering both the value the person provides to the trust and the value, if any, the trust provides in return.

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

2.25 The definition of transfer of value specifically includes the release of an obligation to pay money. The release may be by agreement or by operation of law (see Example | Tauira 3).

Example | Tauira 3: Settlement made by release of obligation

> Dory sells her house to a family trust that her parents settled. 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.

2.26 In some situations the obligation to pay money will have no value (eg because the trustee is insolvent). Whether this is so is a question of fact to be determined in each situation. If the obligation to pay money has no value, no settlement results from the release of the obligation.

Disposition of property at less than market value

2.27 The definition of a transfer of value specifically includes the disposition of property at less than market value. Section YA 1 defines "disposition of property" to mean an assignment, conveyance, delivery, payment, settlement, transfer or other alienation of property, whether at law or equity.

2.28 The definition of disposition of property specifically includes the:

- issue of shares in a company;
- creation of a trust;
- grant or creation of a charge, lease, licence, mortgage, power, servitude, or other estate, interest or right, in or over the property;
- the abandonment, discharge, forfeiture, release or surrender of a contract, debt or thing in action, or of an estate, interest, power or right in or over property; and for this purpose a debt or any other estate, interest or right is treated as having been released or surrendered when it becomes irrevocable or unenforceable by action or for any reason ceases to exist; and
- the exercise of a general power of appointment in favour of a person other than the holder of the power.

2.29 The definition includes a disposition by will or 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 no disposition of property occurs.

Providing services to a trust for less than market value

2.30 A settlor is a person who at any time provides services to or for the benefit of a trust for less than market value (s HC 27(2)(ab)). This includes any investment advisory services, legal and accounting services, or services relating to any business the trustee carries on.

2.31 The services must be more than incidental to the operation of the trust otherwise the person will not be a settlor. Examples of services incidental to the operation of a trust include attending trust meetings and reviewing trust documents. An example of a service not incidental to the operation of a trust is the day-to-day management of a business carried on through the trust.

Response to the decision in *Re Marshall*

2.32 Under s HC 27(2)(b), a person is a settlor if:

- they provide financial assistance (eg a loan) to or for the benefit of the trust that involves an obligation to pay on demand (eg the loan bears interest if demanded); and
- the right to demand is not exercised or is deferred.

2.33 "Financial assistance" is defined in s YA 1. It means assistance provided to or for the benefit of the person or trust that produces a financial benefit for which the person or trust provides less than market value. This could be through the provision of loans, guarantees and security.

2.34 The definition treats assistance as having been provided for less than market value where it is provided at less than market rates or where it is payable on demand and the demand is deferred or not exercised.

2.35 In the case of loans, the amount payable on demand could be the interest or the principal or both. Section HC 27(2)(b) could apply even if the interest rate is set at the market rate but the principal is repayable on demand and that demand is not exercised or is deferred. The amount payable on demand could be a fee for the guarantee or security.

2.36 Where a person is a settlor because of s HC 27(2)(b), the value transferred in the case of a loan is calculated using the following formula (s HC 31B):

benchmark interest – interest paid

2.37 In the formula:

- **benchmark interest** is the interest that would have accrued on the debt amount that is unpaid during the period if the interest had been calculated on the daily balance of the loan at either a market interest rate or the prescribed interest rate (whichever the debtor chooses); and
- **interest paid** is the total of the amount:
  - of interest that accrues on the debt amount during the period; and
  - that would have accrued as interest on the debt amount during the period if the amount had not been included in a taxable distribution to the debtor.

2.38 Where a person is a settlor under s HC 27(2)(b), a settlement exists for the purposes of the trust rules. 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*. This case 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 39(d) of the Death Duties Act 1921.

2.39 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. 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 transferring value to a trust without being treated as a settlor. Therefore, Parliament introduced s 226(2)(b) of the Income Tax Act 1976.

2.40 Note that s HC 27(2)(b) does not cover the provision of financial assistance generally. This is covered under the general definition of settlor in s HC 27(2)(a), based on the transfer of value concept.

Trustee owes the beneficiary money

2.41 Section HC 27(2)(bb) provides that a beneficiary is a settlor of the trust if they are owed money by the trustee, subject to the exceptions below. It should be noted that once a beneficiary becomes a settlor, they do not cease to be one because one of the exceptions applies at a later date.

2.42 The amount owing to a beneficiary is determined at the end of an income year by s HC 27(7). It is the amount of debt at the time adjusted to include the effect of transactions made after the end of the income year and by the date given for allocating beneficiary income in s HC 6(1B). These adjustments need to be included in the financial statements of the trust for the income year. Adjustments could result in the threshold below being exceeded and the beneficiary becoming a settlor.

2.43 The section does not apply if the amount owing is:

- not more than $25,000; or
- more than $25,000 and the trustee pays the beneficiary interest at either the market rate or a prescribed rate by the date given for the income year in s HC 6(1B).

Whether a transfer of value or provision of financial assistance is made

2.44 In the definition of settlor in s HC 27, subss (4) and (5) help determine whether value is transferred or financial assistance provided.

2.45 Firstly, s HC 27(4) provides that a person may make a transfer of value or provide financial assistance directly or indirectly and by one transaction or multiple connected transactions.

2.46 For s HC 27(4) to apply, the person must make the transfer of value or provision of financial assistance. To do so, the person must have some influence or control over the transactions involved so it can be said the person causes the transfer or provision to occur. A conclusion that a person makes a transfer or provision indirectly or by multiple transactions is more likely to be reached where associated parties are involved. This is shown in Example | Tauira 4.

Example | Tauira 4: The person must make the transfer or provision

Peter makes an unconditional gift of $100 to Ed. Ed then gives the $100 to a trust. Peter does not have any control over what Ed does with the $100. Therefore, s HC 27(4) would not treat Peter as a settlor.

If, however, Peter gave the $100 to Ed as part of a plan or understanding that Ed would settle the amount on the trust, then Peter could be said to have made the transfer (by multiple transactions) and would be treated as a settlor. Ed might also be treated as making the settlement for Peter as a nominee under s YB 21 (discussed further from [2.93]), in which case, Peter would be treated as making the settlement.

2.47 A person may also be a settlor if they transfer property to an entity owned by a trust. Value is effectively transferred to the trust in these circumstances because the value of the trust's ownership of the entity increases. This is an indirect transfer of value. The trust receives a transfer of value indirectly through its ownership of the entity, rather than receiving a direct transfer of value (s HC 27(4)). The transfer is also a transfer for the benefit of the trust in terms of s HC 27(2)(a)(ii).

2.48 Secondly, s HC 27(5) provides that the fact a person is or will become a beneficiary of a trust does not constitute the giving or receiving of value. Section HC 27(5) is intended to forestall an argument that might otherwise be made about whether a person transfers value to a trust when the person provides money or money's worth to a trustee. The argument is that the person, if they are or become a beneficiary of the trust, receives value by having a claim on the property that they settle on the trust meaning no transfer of value occurs, so there is no settlement. As no value is placed on the beneficiary relationship, this argument cannot succeed.

Exceptions

2.49 The definition of settlor has three exceptions:

- trusts for retirement benefits of employees (s HC 27(3));
- contributions to foreign superannuation schemes (s HC 27(3C)); and
- resettlements when the settlors are non-residents (s HC 27(3D)).

Exception – trusts for retirement benefits of employees

2.50 Under s HC 27(3), a person will not be a settlor of a trust if the:

- person is a New Zealand resident; and
- person makes a settlement on a trust as an employer for the benefit of one or more employees; and
- trust is established or created mainly to provide retirement benefits to natural persons (which if satisfied would also make the trust a "superannuation scheme"); and
- trust is not a "foreign superannuation scheme" under s YA 1 (which is a superannuation scheme constituted outside New Zealand); and
- trust is not a "superannuation fund" (one of several registered schemes referred to in s 6(1) of the Financial Markets Conduct Act 2013).

2.51 One situation in which s HC 27(3) will be relevant is where:

- an existing trust settlement satisfies the requirements of the exception in s HC 27(3); and
- the settlor has left New Zealand since settling the trust and the trustee is also non-resident; and
- a New Zealand resident employer makes a further settlement on the trust for the benefit of one or more employees.

2.52 In this situation, the effect of the exception is that the New Zealand resident employer is not treated as a settlor of the trust because of the settlement. This ensures the trustee does not lose their exemption from income tax for foreign-sourced amounts under s HC 25 and the New Zealand resident employer is not liable for the income tax payable by the trustee.

Exception – contributions to foreign superannuation schemes

2.53 Under s HC 27(3C), a person who contributes to a trust that is a foreign superannuation scheme is not a settlor of the trust.

2.54 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.

Exception – resettlements when the settlors are non-residents

2.55 Where a New Zealand resident trustee of a trust (the head-trust) resettles property on or makes a distribution to a second trust (the sub-trust), s HC 27(3D) ensures the person is not a settlor of the trust if at the time of the settlement or distribution:

- a settlor of the head-trust exists and each settlor is a non-resident; or
- no settlor of the head-trust exists and the last surviving settlor of the head-trust was a non-resident.

2.56 This means both the head-trust and sub-trust can be treated as foreign trusts if all the settlors are or were non-residents.

Activities treated as those of a settlor

2.57 A person may be treated as a settlor of a trust under s HC 27(2)(c) if s HC 28 applies. Section HC 28 is relevant where:

- a person has a control interest of 10% or more in a company that settles an amount on a trust;
- a trustee settles an amount on or makes a distribution to a sub-trust;
- a person has control over a trustee or a settlor of a trust and can require the trustee to treat them, or a nominee, as a beneficiary; or
- the anti-avoidance provision s HC 28(2) applies to the person.

2.58 These situations are discussed further below.

Person who has a control interest of 10% or more in a company that settles an amount on a trust

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

- a controlled foreign company (CFC) settles an amount on the trust; and
- at the time of settlement or at any time during the accounting period of the CFC in which the settlement occurs, the person has a control interest of 10% or more in the CFC.

2.60 CFCs and control interests are defined in subpart EX. Briefly, a CFC is a foreign company controlled by New Zealand residents. It is not resident in New Zealand or treated as not being resident under a double tax agreement. 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.

2.61 Under s HC 28(4), the same treatment that applies under s HC 28(3) applies to a company that settles an amount on trust and:

- it would have been a CFC at the date of settlement if it had been a foreign company at the time, and
- the person would be treated as having a control interest of 10% or more in the company if it were a foreign company at the time of the settlement or for the accounting period of the company in which the settlement occurs under s EX 1(3).

2.62 The objective of subss (3) and (4) of s HC 28 is to ensure the trust rules will apply where a person uses a company they control, whether it is a domestic or foreign company, to establish a trust and then winds it up. The provisions recognise that where a company a person controls is used to settle a trust, the company is being used as a vehicle for the settlement. Therefore, it is appropriate to look through the controlled company to the real settlor.

2.63 It is possible more than one person could be treated as a settlor of a trust because of a settlement by a controlled company. This is because more than one person may have a control interest of 10% or more in the controlled company.

2.64 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. Further, a control interest of a person includes direct and indirect control interests as calculated in subpart EX (see Example | Tauira 5).

Example | Tauira 5: Settlor – multiple layers of controlled companies

Jack has a direct control interest of 15% in Holdings Ltd, which is a controlled foreign company. Holdings Ltd has a direct control interest of 100% in Operations Ltd. Operations Ltd settles an amount on a trust. Jack is treated as a settlor of the trust for two reasons. Firstly, Jack has a control interest in Operations Ltd (via Holdings Ltd) of 15%, which is more than the 10% required to be a settlor under s HC 28(3). Secondly, Jack has a control interest in Holdings Ltd of 10% or more and Holdings Ltd is treated as having settled the trust that was settled by Operations Ltd (because it has a control interest in Operations Ltd of 10% or more). Operations Ltd (which made the actual settlement) and Holdings Ltd (which has a control interest of 10% or more in Operations Ltd) would also be treated as settlors.

2.65 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. 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

2.66 Under s HC 28(5), a person is treated as a settlor of a trust (sub-trust) if:

- the person is a settlor of a trust (head-trust); and
- a trustee of the head-trust:
  - settles an amount on the sub-trust; or
  - makes a distribution to or on the terms of the sub-trust.

2.67 Note that sub-trust is a term used in s HC 28(5). For taxation purposes, this is a wider term than for trust law purposes.

2.68 Where s HC 28(5) applies, the settlor of the head-trust is treated as the settlor of the sub-trust. In addition, the trustee of the head-trust is also a settlor of the sub-trust under s HC 27(2) (as the person who made the settlement or distribution).

2.69 The purpose of s HC 28(5) is to treat a person as settlor if they use one trust as a vehicle to settle or to make distributions to another trust. It means the sub-trust continues to have a settlor (ie the settlor of the head trust) even if the head trust is wound up. This is particularly relevant to the potential liability of a settlor for income tax payable by a trustee under s HC 29.

2.70 "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.

2.71 Section HC 28(5) can apply through multiple layers of trusts. In other words, it can apply to a settlor of a head-trust by virtue of an earlier application of s HC 28(5). This is shown in Example | Tauira 6.

Example | Tauira 6: Settlor – multiple layers of trusts

> If Gene settles Original Trust and the trustee of Original Trust settles Next Generation Trust and the trustee of Next Generation Trust settles Deep Space Trust, then Gene is treated as settlor of all three trusts.

Control over a trustee or a settlor

2.72 Under s HC 28(6), a person is treated as a settlor if:

- they acquire, directly or indirectly, rights or powers in relation to a trustee or a settlor of a trust; and
- 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.

2.73 "Acquire" is not defined in the ITA 2007 for the purposes of the trust rules. It is defined in the *Concise Oxford English Dictionary* (12th ed, Oxford University Press, New York (2011)) as "come to have or possess (something)". This ordinary meaning is wide and suggests a person could acquire something actively or passively. In addition, the words "directly or indirectly" following acquire support a wide interpretation.

2.74 A person could acquire rights or powers in relation to a trustee of a trust by obtaining ownership of a corporate trustee. This could allow the person to appoint themselves, or a person who will follow their instructions, as the sole director of the corporate trustee. A person could acquire rights or powers in relation to a settlor by acquiring the settlor (if it is a company, which could include the corporate trustee of another trust).

2.75 A person could also acquire rights or powers in relation to a trustee by being given the right to appoint and remove trustees. This is because the person could remove the trustees and appoint themselves (or an entity they control) as trustee. If, as trustee, they had the power to appoint or remove beneficiaries, the effect of the acquisition would be to enable the person to require the trustee to treat the person, or a nominee, as a beneficiary of the trust.

2.76 In addition, a person could acquire rights or powers in relation to a trustee of a trust by being appointed as a protector of the trust. The powers that are conferred on a protector can vary from trust to trust. Whether those powers enable the person to require the trustee to treat the person, or a nominee, as a beneficiary of the trust depend on the extent of the powers given to the person. Not all protectors will be affected. If, for example, the powers given to a protector are limited to approving major transactions, then the appointment of the person as a protector would not result in the person being a settlor under s HC 28(6).

2.77 The second part of the test is that the purpose or effect of the acquisition is to enable the person to require the trustee to treat the person, or a nominee, as a beneficiary of the trust. It is not necessary that the person uses the ability.

2.78 "Require" is defined in the *Oxford English Dictionary* as "**v … 5** instruct or oblige (a person) to do something".

2.79 For s HC 28(6) to apply, the trustee referred to in para (b) would need to have or be given the discretion under the terms of the trust to treat a person, or their nominee, as a beneficiary. If a person acquires rights or powers in relation to only one trustee and the approval of more than one trustee is necessary to treat a person as a beneficiary of the trust, then this requirement is not met.

2.80 A person would be able to require a trustee to treat the person, or a nominee, as a beneficiary of the trust if they appointed themselves as the sole trustee, if, as trustee, they had the required power.

2.81 The use of the phrase "purpose or effect" in s HC 28(6)(b) suggests an objective test. It is not necessary to show the person has a subjective purpose or intention. The phrase in this context also suggests the provision has an anti-avoidance nature.

2.82 Section HC 28(6) could apply to a person who is already a beneficiary. This would occur where the person acquires rights or powers in relation to a trustee or settlor and the purpose or effect of the acquisition enables the person to require the trustee to also treat a nominee of the person as a beneficiary of the trust. The nominee could be a company controlled by the person.

2.83 Section HC 28(6) could, if interpreted literally, apply in situations in which Parliament would not have intended, for example, where a professional advisor is given the right to appoint or remove trustees on the death of the previous right holder. Given this, and the apparent anti-avoidance nature of the provision, the Commissioner will take a purposive interpretation of s HC 28(6) to ensure the provision does not apply in situations in which Parliament would not have intended.

2.84 The Commissioner will consider the circumstances surrounding the acquisition of the rights or powers, including:

- existing relationships between the person and the settlor, trustee and beneficiaries (the absence of such relationships may support the application of the provision);
- whether consideration was provided by the person for the rights or powers acquired;
- whether the acquisition of the rights or powers by the person could have been expected as an ordinary incident of the administration of the trust; and
- whether the person is in the business of providing trust administration services, since it might be that the appointment of such a person could be expected under the terms of the trust.

2.85 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.

2.86 Example | Tauira 7 and Example | Tauira 8 show how some of these provisions apply practically.

Example | Tauira 7: Control over a trustee

A Hong Kong resident, Jenny, makes an initial settlement of $990,000 on Dragon Trust, which is a discretionary trust. The trustee of Dragon Trust, Dragon Co, is a company owned by Jenny. Dragon Co has the power to appoint and remove beneficiaries. Apart from the $990,000 of trust property, Dragon Co does not have any assets. A New Zealand resident, Steve, acquires Dragon Co for $1 million. Steve appoints himself as director of Dragon Co. There is no indication that Jenny settled the trust as a nominee for Steve.

By acquiring Dragon Co and appointing himself as director, Steve has acquired rights or powers over the trustee that enable him to require Dragon Co to treat Steve, or his nominee, as a beneficiary of Dragon Trust. This is an effect of the acquisition of the rights or powers. In addition, the fact Steve paid $1 million to acquire Dragon Co, a company that does not have any assets of its own, suggests the purpose of the acquisition was to enable him to require Dragon Co to appoint Steve, or his nominee, as a beneficiary of Dragon Trust.

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

Example | Tauira 8: Acquiring rights under the terms of the trust

The original settlor of Mete Trust dies and triggers a provision in the trust deed passing on the power to appoint or remove trustees to Grace, the trust's lawyer. Under the trust deed, the power to appoint or remove beneficiaries passes to the trustees.

As a result, Grace has acquired rights or powers over the trustees of the trust. The acquisition of these powers enables Grace to remove the existing trustees and appoint herself as the sole trustee of the trust (subject to the terms of the trust deed). Grace could then appoint herself, or a nominee, as a beneficiary of the trust. Grace may have no intention of doing this, but it is an effect of the acquisition that she could require the trustee to treat Grace, or a nominee, as a beneficiary.

Therefore, it appears at first that s HC 28(6) applies to treat Grace as a settlor of the trust. However, taking into account the purpose of the provision and the circumstances of Grace's acquisition of the right, it is considered Parliament would not have intended s HC 28(6) to apply. Grace is in the business of providing trust administration services. The appointment of Grace could have been expected under the terms of the trust as an ordinary incident of the administration of the trust. The circumstances do not suggest Grace was attempting to avoid settlor status by acquiring rights or powers in relation to an existing trust. Therefore, Grace would not be treated as a settlor in this situation.

Anti-avoidance provision

2.87 Under s HC 28(2), a person is treated as a settlor if, in relation to a trust:

- they act, refrain from acting, or enter into a transaction or series of transactions; and
- this has the effect of defeating the intent and application of the trust rules.

2.88 This provision is an anti-avoidance rule to reinforce the definition of settlor.

2.89 Historically, the provision was intended to cover transactions of the type described in para (f) of the definition of "disposition of property" in s 2 of the Estate and Gift Duties Act 1968. However, it was also intended to cover actions and transactions falling outside that definition as it was seen as being defective.

2.90 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.

2.91 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. 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. One of the intentions of the trust rules is to treat any person who transfers value to a trust as a settlor (see Example | Tauira 9).

2.92 One situation in which s HC 28(2) could apply is where a person is not caught by s HC 28(6) because their rights or powers are informal.

Example | Tauira 9: Avoidance arrangement

Ace Ltd is owned by Harriet and James, with each holding 100 shares. Harriet and James are also the directors of Ace Ltd. Harriet would like to transfer half of her ownership interest in Ace Ltd to Harry's Trust, a trust of which she and her family are beneficiaries. However, Harriet would prefer not to become a settlor of the trust.

At a shareholders' meeting for Ace Ltd, Harriet proposes a resolution to issue 100 new shares to Harry's Trust and 100 new shares to Jimmy's Trust (a trust of which James and his family are beneficiaries), in each case for no consideration. James abstains from voting and the resolution is passed. James is indifferent to whether he or Jimmy's Trust owns shares in Ace Ltd.

After the issue of the new shares, Harriet and James' interest in the company is diluted by 50% and valuable shares are now owned by Harry's Trust and Jimmy's Trust.

This example illustrates how s HC 28(2) applies. This is for two reasons:

- Firstly, Harriet has acted by proposing a resolution and voting in favour of it. James has refrained from acting by abstaining from the vote.
- Secondly, what has been done (or not done) would (if not for s HC 28(4)) have had the effect of defeating the intent and application of the trust rules. One intention of the trust rules is to treat a person who transfers value to a trust as a settlor. The commercial and economic reality of what has been done (or not done) is that Harriet and James have each transferred value to the two trusts.

In this example, Harriet arguably has a purpose of avoiding settlor status. James, on the other hand, may not be aware of the implications of the arrangement for the trust rules and may have no purpose of avoiding settlor status. Nevertheless, Harriet and James will both be treated as settlors of the trusts because s HC 28(2) involves an objective test that focuses on the purpose or effect of the action or inaction, not the subjective purpose of the party involved.

In this example, Harriet and James would both be treated as settlors of trusts under s HC 28(4) (shareholders in companies) and it would not be necessary to apply s HC 28(2). The broad definition of settlor means it is difficult to construct an example where another provision would not apply.

Nominee settlor

2.93 Although not part of the definition of settlor, s YB 21 is relevant to the concept. 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, person A may still have disclosure obligations in relation to the settlement as discussed in Part 13 (Compliance)).

2.94 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)).

2.95 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 as a nominee in relation to the settlement. The Commissioner is likely to regard a settlement of less than $100 as a nominal settlement.

2.96 The objective of this provision is to ensure persons acting as nominees are not treated as settlors. Often professional advisors 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 advisor or relative to a potential tax liability under s HC 29 (settlor liable for income tax liability of trustee). The professional advisor 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 advisor 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.

2.97 The nominal settlement rule applies only where the settlement was made at the request of another person. If a person settles a nominal amount on trust on that

person's own initiative, they are not a nominee. This is also implicit in the nominee concept generally.

2.98 Note that a direction or request to settle an amount on trust can be made directly or indirectly (see Example | Tauira 10).

Example | Tauira 10: Settlement by a person's lawyer – delegated

A client of a law firm asks their lawyer to establish a trust by making a settlement on their behalf. If the lawyer then delegates this request to a colleague, the colleague is regarded as having settled the trust at the direction or request of the client.

Minor beneficiary rule

2.99 The definition of settlor in s YA 1 is narrowed for the purposes of the exclusions from the minor beneficiary rule. The effect of this is to make it easier to fall within the exclusions to the rule. The minor beneficiary rule is discussed in Part 6 (Minor beneficiary rule).

Associated person rules

2.100 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.

2.101 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. This is significant because it may mean the person is not associated with a settlor, trustee or a beneficiary of the trust under ss YB 7 to YB 9.

2.102 Section YB 10 applies to any person who provides services to a trust for less than market value. A common example would be a professional advisor or trustee who provides services to a trust at no charge.

Part 3: Trustees and beneficiaries

Trustees

3.1 A trust is not a legal person for income 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 has a capacity that is separate from the individual capacity 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". Further, s YA 5(1) states that a person who is acting as a trustee of a trust is acting in a capacity that is separate from their other capacities, such as their personal capacity. The definitions of company and natural person exclude a person acting in the capacity of a trustee. In the TAA, a "natural person" is defined in s 3 to not include a person in their capacity as a trustee except for the purposes of s 177 and 177A, which deal with financial relief and hardship.

3.3 There are exceptions. When determining the residence of a natural person, s YD 1(12) provides that a natural person includes a natural person in their capacity as trustee. Similarly, when determining the residence of a company, s YD 2(1B) provides that a company includes a company in its capacity as trustee.

3.4 The definition of trustee includes all the persons who are trustees for the time being of the trust. Even if the trustees change from time to time, the trust's IRD number remains the same.

3.5 Under s HC 2(2), joint trustees are treated as a notional single person with each being jointly and severally liable for satisfying all trustee obligations under s BB 2. Trustees are also jointly and severally liable for tax as agent for beneficiaries on beneficiary income and taxable distributions.

3.6 When a trustee resigns, s 48 of the Trusts Act 2019 requires that the trustee gives at least one replacement trustee or continuing trustee the documents that the trustee holds at the time. Section 118 of the Trusts Act 2019 requires a retiring trustee to assist in the transfer of trust property. Outside meeting specific legal requirements, best practice is for the retiring, replacement and continuing trustees to co-operate to effect a smooth transition. This process could include finalising financial statements or tax returns.

3.7 A trustee is treated as liable up to the date of their resignation. In practice, the Commissioner will generally hold a trustee liable to the end of the tax period before resignation because that is the last period in which the trustee had any control over the tax position taken. This was endorsed in *Case 5/2013* [2013] NZTRA 05, (2013) 26

NZTC 2-004 and will be the case unless the features of a particular situation require an alternative approach.

3.8 The Commissioner recommends that trustees advise Inland Revenue of any retirements or resignations as soon as possible to make sure our records are kept up to date. Note that different rules apply for GST purposes under s 57(3B) of the Goods and Services Tax Act 1985. A trustee of an unincorporated body does not stop being a trustee until the date on which the Commissioner is notified of a change in the membership of the body.

3.9 The definition of trustee also includes executors and administrators of estates for tax administration purposes. While an estate is not a trust at common law, specific rules in subpart HC apply to estates. For details on estates, see Part 9 (Special cases).

3.10 In addition, the definition of trustee includes the Public Trust, the Māori Trustee, the manager or controller of the investments of a superannuation scheme that is a trust, and a group of persons appointed to administer an exempt employee share scheme.

3.11 A trustee has an obligation under s HC 24(1) to satisfy the liability for their taxable income "as if they were an individual beneficially entitled to the trustee income". Consequently, it makes no difference to the tax treatment if a trustee is a company or a natural person. The rate of tax is the trustee tax rate in both cases.

3.12 A trustee's residence is relevant in several situations, in particular for compliance and enforcement. This is because a trust is not a legal entity and does not have a residence as such. The residence of the trustee is determined under the rule in s YD 1 for natural persons and under s YD 2 for companies.

3.13 When a trust has more than one trustee, the trustees are treated as a notional single person under s HC 2(2). Where one of the trustees is resident, then the notional single person is resident under s HC 2(3)(a). If none of the trustees is resident in New Zealand, the notional single person is non-resident.

3.14 This treatment is subject to no election having been made under s HC 33. In that case, s HC 33(1C) states that a trustee's obligations are determined on the basis that the trust has a trustee and settlor who are New Zealand residents. Elections are discussed in Part 10 (Transitional issues on becoming resident) and Part 11 (Transitional issues on becoming non-resident).

3.15 As noted in [7.18], non-resident trustees may be treated as resident for certain provisions if s HC 25 applies because of a non-resident trustee and a New Zealand settlor.

3.16 In a practical sense, if trustees have mixed residence, the filing and return obligations typically fall on a resident trustee. If all the trustees are non-resident, a tax agent in New Zealand would usually attend to the obligations for a complying trust.

3.17 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 tax treatment of a trustee in a few special situations. No specific charging provision exists for the New Zealand–sourced and foreign-sourced income of trustees. In contrast, subpart CV specifically lists the amounts derived from a trust that are included as income.

3.18 New Zealand–sourced income derived by a trustee is always subject to tax in New Zealand. However, foreign-sourced amounts have special treatment. The rules determining whether foreign-sourced amounts are taxable in New Zealand depend on several factors. In summary, however, foreign-sourced amounts derived by a:

- non-resident trustee will generally be taxed in New Zealand if a settlor is resident in New Zealand (not including a transitional resident) at any time during that income year; and
- resident trustee will generally not be taxed in New Zealand if no settlor is resident in New Zealand (not including a transitional resident) at any time during the income year in which that amount was derived.

3.19 For details on the taxation of trustee income, see Part 7 (Trustee income).

3.20 The tax treatment of passive income, such as interest and dividends, that has a New Zealand source is based on the residence of the trustee as a notional single person. If the trustee is non-resident and derives non-resident passive income as defined in s RF 2, non-resident withholding tax (NRWT) will be payable on the amount. In contrast, unless the trustee has resident withholding tax (RWT) exempt status, RWT is deducted from passive income paid to resident trustees. If an election has been made under s HC 33(1), non-resident passive income derived by a non-resident trustee is excluded as non-resident passive income from the effective date of the election and RWT should be deducted.

3.21 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 the associated person rules and their impact on trusts are in Part 12 (Associated persons).

Beneficiaries

3.22 Beneficiaries are the objects of a trust, and the trust's property is held for their benefit. The term "beneficiary" is not defined in the ITA 2007 except for the purposes of s DX 1, which deals with testamentary annuities. However, s YA 1 defines "beneficial interest" for tax purposes and this "includes an interest that is contingent,

discretionary or unvested". Section YA 1 also defines "beneficiary income", which simply refers to s HC 6. This section is discussed in Part 5 (Beneficiary income).

3.23 A beneficiary's entitlements stem from the terms of the trust deed, or functionally-equivalent document, and the exercise of discretions by the trustees. As a result, the nature of a beneficiary's interest in trust property varies accordingly.

3.24 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 (Beneficiary income), Part 6 (Trustee income) and Part 8 (Distributions from trusts).

3.25 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 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 details on how a beneficiary is treated under the associated person rules, see Part 12 (Associated persons).

Part 4: Income derived by trustees

Introduction

4.1 The trust rules are largely concerned with the taxation of income derived by trustees. These rules determine whether the income is beneficiary income or trustee income for the purpose of determining tax liabilities.

4.2 The concepts of beneficiary income and trustee income are discussed in Part 5 (Beneficiary income) and Part 7 (Trustee income), respectively.

4.3 However, generally, 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 this requirement.

Income derived by a trustee compared with trustee income

4.4 The concept of "income derived by a trustee" is not the same as the concept of "trustee income" in the trust rules. "Income" is defined in s YA 1 as meaning income of the person under s BD 1(1). This section then refers to an amount of income under a provision in part C. Therefore, some amounts derived by a trustee, such as capital gains, may not be income derived by a trustee.

4.5 Generally, trustee income is income derived by a trustee that is not beneficiary income.

Income is a gross concept

4.6 Income means an amount that is income under a provision in part C. This means income is a gross concept and does not take into account any deductions that may be claimed in the calculation of net income. The ability to claim deductions is discussed in Part 7 (Trustee income).

Income includes deemed income

4.7 Income 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"). An example is foreign investment fund income under s CQ 4. 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**.

Dual derivation

4.8 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 in the case of a complying trust (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)). 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.

4.9 In contrast, where a foreign or non-complying trust makes a taxable distribution to a beneficiary (eg a distribution of prior years' income), this income may be taxed twice, once to the trustee as trustee income and then again to the beneficiary.

Part 5: Beneficiary income

Introduction

5.1 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 is trustee income.

5.3 Beneficiary income is included in the income of the beneficiary and, if assessable, is subject to tax at the beneficiary's marginal tax rate. An exception to this is beneficiary income to which the minor beneficiary rule applies. This income 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 sch 1 of the ITA 2007 at cl 3 of part A. The minor beneficiary rule is discussed in Part 6 (Minor beneficiary rule).

5.4 Generally, the obligation to satisfy the income tax liability on beneficiary income is on the trustee acting as agent for the beneficiary as discussed in Part 13 (Compliance).

Definition of "beneficiary income"

5.5 Beneficiary income is defined in s HC 6(1) as an amount of income derived in an income year by a trustee to the extent to which it:

- vests absolutely in interest in a beneficiary of the trust in the income year; or
- is paid to a beneficiary in the income year or within the extended period for payment described in s HC 6(1B).

5.6 Section HC 6(1C) provides that beneficiary income includes an RWT substitution payment made under s RE 2(7) to the extent to which the payment meets the definition of being beneficiary income. RWT substitution payments are discussed in Part 13 (Compliance).

5.7 Under s HC 6(2), beneficiary income does not include:

- income derived by a trustee of a trust that is a superannuation fund;
- income derived by a trustee of a trust that is an approved unit trust;
- 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 arrangements rules where debt owed by a trustee of a trust is forgiven);
- an amount by which a tax credit of a beneficiary for resident withholding tax is reduced under s LB 3(6) (relates to RWT substitution payments); or

- an amount of a tax credit of a beneficiary allocated under s LB 3(5) (relates to RWT substitution payments).

5.8 The elements of the definition of beneficiary income discussed further below are:

- income must first be derived by a trustee (from [5.10]);
- vesting and paying amounts (from [5.14]);
- vesting absolutely in interest (from [5.19]);
- paid to a beneficiary (from [5.27]); and
- the extended period for payment in s HC 6(1B) (from [5.42]).

5.9 This is followed by a brief discussion of s GB 22 (from [5.48]), 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 must first be derived by a trustee

5.10 As mentioned in Part 4 (Income derived by trustees), for there to be beneficiary income, a trustee must first derive an amount of income. Income means an amount that is income under a provision in part C (see the definition of income in s YA 1 and s BD 1(1)). For example, if a trustee derives an amount from the sale of a rental property and the amount is not income under part C, then the amount cannot be beneficiary income if vested in or paid to a beneficiary.

5.11 Income is a gross concept as noted in Part 4 (Income derived by trustees). When a trustee distributes income to a beneficiary, they are distributing gross income derived by the trustee. The amount of income that a trustee can distribute may be limited by the terms of the trust to an amount equal to the net income (income less expenditure) of the trust. However, if the terms of a trust so permit, a trustee could distribute all the income (gross income) the trustee derived to a beneficiary. This would mean the trustee would have to pay for any expenditure out of previous years' income, capital funds or corpus. It could also lead to the trustee making a net loss for the income year. (For further discussion on losses, see Part 7 (Trustee income)).

5.12 If an amount of income a trustee derives 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 NRWT if it has a New Zealand source, as discussed in Part 13 (Compliance).

5.13 Similarly, as alluded to in the example above, 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 is assessable income for the beneficiary. Beneficiary income will not be assessable income if the amount is not New Zealand sourced and the beneficiary is a non-resident when it is derived (ss BD 1(4) and BD 1(5)(c)). However, special rules apply where a New Zealand resident becomes non-resident, receives distributions from a foreign or non-complying trust and becomes resident again within five years – see [10.85].

Vesting and paying amounts

5.14 An amount must be vested or paid in accordance with the terms of the trust to be a valid distribution. The terms of the trust will dictate what can be distributed to each beneficiary. Subject to this, the following principles need to be considered.

5.15 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 (provided the distribution is of the income derived by the trustee). However, a distribution of the assets might give rise to further income tax consequences for the trustee (eg income on the disposal of revenue account property).

5.16 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 if 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 is then possible to calculate the amount of beneficiary income for the income year (*Davidson v CIR* [1976] 2 NZLR 705 (SC) at 713).

5.17 Where an amount is future property or an expectancy, the vesting or payment of the amount is not effective until the amount is received or receivable (*Hadlee and Sydney Bridge Nominees Ltd v CIR* (1989) 11 NZTC 6,155 (HC)).

5.18 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 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

5.19 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 (s HC 6(1)(a)).

5.20 An amount may vest in a beneficiary because of a clause in a trust deed or the exercise of a discretion given to a trustee.

5.21 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.

5.22 Vesting in interest means 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.

5.23 Even if a right to present possession exists, the trustee may hold the amount until the beneficiary demands it. There is no requirement for the amount to be placed beyond the trustee's possession and control.

5.24 The vesting cannot be subject to a condition being met or to an event occurring. Example | Tauira 11 and Example | Tauira 12 illustrate unconditional and conditional vestings, respectively.

Example | Tauira 11: Vesting in interest – unconditional

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 is 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 | Tauira 12: No vesting – conditional allocation

A resolution by a trustee that an amount of income will be allocated to a beneficiary if they reach the age of 18 will not vest that amount of income in the beneficiary unless and until that condition is satisfied. The resolution is conditional on the beneficiary reaching the age of 18. If the beneficiary dies before reaching that age, the condition in the resolution will not be met and the amount will remain trust property. The income will be trustee income in the year it is derived.

5.25 The word "absolutely" reinforces the indefeasible nature of the vesting and the fact the vesting results in the beneficiary receiving the beneficial ownership of the amount.

5.26 The phrase "vests absolutely in interest" is discussed in more detail in IS 12/02.

Paid to a beneficiary

5.27 The definition of beneficiary income refers to income a trustee derives during an income year to the extent it is paid to a beneficiary. The definition of "pay" in s YA 1, for an amount and a person, includes to:

- distribute the amount to the person;
- credit the person for the amount; or
- deal with the amount in the person's interest or on their behalf in some other way.

5.28 The definition of pay includes grammatically associated terms such as pays, paid and payment. It expands the ordinary meaning to include situations where amounts are distributed, credited or dealt with in some way.

5.29 Although the definition of beneficiary income suggests the income must be paid **to** the beneficiary, the definition of pay means 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) and *CIR v Simpson* (1989) 11 NZTC 6,140 (CA) at 6,144).

5.30 An amount is dealt with in a minor beneficiary's interest and paid to the beneficiary if it is transferred to the beneficiary's parents or guardians for expenditure on behalf of the beneficiary. This is a distribution to the beneficiary and not to the parent or

guardian. 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 discussed in Part 6 (Minor beneficiary rule), in which case they will be taxed at the trustee's tax rate.

5.31 An amount is dealt with on the beneficiary's behalf and paid to the beneficiary if the trustee makes a payment of income to a person other than the beneficiary that discharges an obligation of the beneficiary. 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.

5.32 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 definitions 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 Under the trust deed, the trustee held the trust property, including any income arising from it, on trust for the children of Mr and Mrs Ward. A child would become entitled to a share of the trust property if they reached the age of 21. The trust deed provided that if any such child died before the trust property was distributed and the child left behind children of their own those children would take the interests that their parent would have taken. The trust deed also allowed the trustee to make a payment of the trust property to any of the children entitled under the trust notwithstanding that the children may not have reached the age of 21. The resolution in question was consistent with this later ability.

5.35 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 children. Having the absolute property meant that if one of the children died, the income distributed to the child would become part of the child's estate, even if they died before reaching the age of 21. That is, the children's interests in the income were no longer contingent on them reaching the age of 21.

5.36 *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 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).

5.37 The making of a loan to a beneficiary will not constitute a payment for the purposes of the beneficiary income definition. This is because the beneficiary has an obligation to repay the loan amount. This is the case even if the loan is repayable on demand. Although a loan itself will not give rise to beneficiary income, consideration should be given to whether the financial arrangements rules apply.

5.38 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 (being essentially the same as the definition of pay that applies for the purposes of s HC 6).

5.39 The decision in *Albany Food Warehouse* on the meaning of paid suggests 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.

5.40 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 CIR* [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 it is the resolution that is the trigger for the application of income not the book entries as these merely record earlier decisions of the trustees.

5.41 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 Ltd (in liq); alt cit Walker v Campbell* (HC Christchurch CIV 2003-409-2094, 30 September 2004) 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. However, in some circumstances a resolution can be prepared to ratify a prior decision where that decision is not valid until ratified. See, for example, the discussion in *Hansard v Hansard* [2014] NZCA 433 from [45].

Extended period for payment in s HC 6(1B)

5.42 Income derived by a trustee during an income year may be taxed as beneficiary income if it is paid to the beneficiary within the extended period described in s HC 6(1B) (if the trust deed permits).

5.43 The extended period is the later of:

- six months following the end of the income year in which the trustee derived the income (s HC 6(1B)(a)); or
- the earlier of the date:
  - on which the trustee files the return of income for the income year (s HC 6(1B)(b)(i)); or
  - 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)).

5.44 The date by which the trustee is required to file a return may vary. Most trustees with tax agents and a balance date of 31 March have a return filing extension until 31 March in the following year. Trustees who do not have tax agents may also apply for an extension of time. For trustees without an extension, the extended period is likely six months following the end of the income year because the standard time for filing returns is shorter (just over three months from the end of the income year).

5.45 This extended 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 as they may be unable to calculate the amount of income available for distribution to the beneficiaries until after the end of the income year.

5.46 Beneficiary income that is paid to a beneficiary within the extended period is treated under s HC 6(3) 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 (see Example | Tauira 13).

Example | Tauira 13: Extended period for allocating beneficiary income

The XYZ Trust has a 31 March balance date. The trustee uses an agent who has an extension of time to file the 2022 return until 31 March 2023 but files it on 4 November 2022. This date is compared with that which is six months after the balance date. As 4 November 2022 is later than 30 September 2022, the trustee has until 4 November 2022 to allocate income as beneficiary income otherwise it will be taxed as trustee income.

5.47 The Commissioner's view is that a beneficiary paid in the extended period must exist as a beneficiary in the income year preceding the extended period. The purpose of the extended period is to provide trustees with additional time to finalise the trust's financial statements for an income year before making payments of income to the beneficiaries.

Section GB 22 – anti-avoidance

5.48 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:

- an arrangement involves a trustee transferring property or providing services or other benefits to a person other than a beneficiary of the trust;
- 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
- the trust is not a Māori authority.

5.49 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 is taxed accordingly.

5.50 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 definitions of beneficiary income and distribution 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.

5.51 Section GB 22 is also relevant to taxable distributions (discussed in Part 8 (Distributions from trusts)).

Part 6: Minor beneficiary rule

Purpose

6.1 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 a trustee and a minor beneficiary. A minor beneficiary is likely to be on the lowest marginal tax rate which is lower than the trustee tax rate.

6.2 The rule addresses the concern that a family with a trust could gain a tax advantage over a family without one by using the income of a trust to meet the family's expenses.

Beneficiary income of a minor may be treated as excluded income of the minor

6.3 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 no income tax liability arises in the minor's name.

Treated as trustee income

6.4 Instead, the trustee is liable to pay the tax at the trustee tax rate by including the beneficiary income in the trust's 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:

- determining the tax rate that will apply;
- paying the tax; and
- providing returns of income.

6.5 This means the income must be included in the trustee's income for provisional tax purposes 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).

6.6 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 must return and pay the tax does not change the fact the tax is on beneficiary income derived by the beneficiary (see Example | Tauira 14).

Example | Tauira 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 has a credit of $1,340 in their account with the trust. The beneficiary cannot demand payment of $2,000 on the basis that the liability to pay tax was on the trustee.

6.7 If a resident trustee distributes foreign-sourced amounts to a minor as beneficiary income and the minor beneficiary rule applies (noting that a minor is defined as being a New Zealand resident), the beneficiary income will be treated as if it were trustee income. Section HC 26(1) excludes it from being exempt income of the trustee under s CW 54.

6.8 If the trustee is non-resident, the amount cannot be excluded as non-residents' foreign-sourced amounts under s BD 1. This is because the treatment as trustee income is only for the purposes of determining the rate of tax, who pays the tax and who provides the return of income. The income is still income (albeit excluded income) of a New Zealand resident and is taxable in New Zealand.

Imputation credits

6.9 As an amount of beneficiary income to which the minor beneficiary rule applies is treated as if it were trustee income for the purposes of paying tax on that income, dividend income distributed by a trustee to a minor beneficiary is a dividend included in the trustee's assessable income.

6.10 The trustee is treated as deriving the minor's beneficiary income as a beneficiary to the extent that s HC 7(2) applies (ss LE 1 and LE 4) and can use the imputation credits. The amount that can be used is determined by the formula in s LE 5. For the purposes of the formula, the trustee is treated as a beneficiary. The formula prevents the streaming of imputation credits to those who can best use them (see Part 13 (Compliance)).

Definition of "minor"

6.11 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 natural person resident in New Zealand; and
- under 16 years of age on the trust's balance date for the income year.

6.12 The rule applies for ss HC 35 to HC 37 (which describe the minor beneficiary rule) and LE 4 (which deals with imputation tax credits).

6.13 Section HC 35 overrides several sections in the trust rules: ss HC 5 (amounts derived by trustees), HC 18 to HC 20 (taxable distributions from foreign and non-complying trusts and distributions from complying trusts), HC 22 (use of tax losses to reduce taxable distributions from non-complying trusts), HC 23 (temporary absences of beneficiaries) and HC 32 (liability of trustee as an agent).

Exclusions

6.14 The three types of exclusion from the minor beneficiary rule are:

- a *de minimis* exclusion of $1,000 per beneficiary per trust in s HC 35(4)(a);
- exclusions relating to beneficiary income derived from particular sources or due to the identity of the beneficiary (s HC 35(4)(b)(iii) to (v)); and
- exclusions based on settlements on a trust as described in ss HC 36 and HC 37 (s HC 35(4)(b)(i) to (ii)).

De minimis exclusion

6.15 The *de minimis* rule is in s HC 35(4)(a). This section provides that the minor beneficiary rule does not apply if the total amount of beneficiary income derived by a minor from a trust in the income year is $1,000 or less. The minor's marginal tax rate applies instead. Note that s CW 55BB(2)(a)(iiib) exempts certain income of minors but it does not apply to beneficiary income.

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 the minor beneficiary derives.

6.17 This exclusion applies on a per beneficiary per trust basis. This means the exception may apply even if a 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 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 whether the general anti-avoidance rule in s BG 1 applies. See **QB 07/02: Whether the minor beneficiary rule exemption in section HH3B applies on a $1,000 "per beneficiary" or on a $1,000 "per beneficiary per trust basis"**.

Exclusions for beneficiary income derived from particular sources or due to the identity of the beneficiary

6.18 The minor beneficiary rule does not apply to an amount of beneficiary income derived from a Māori authority. The exclusion 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)).

6.19 The minor beneficiary rule also does 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.

6.20 Further, the minor beneficiary rule does not apply to beneficiary income derived by a minor who is in receipt of a child disability allowance under the Social Security Act 2018. 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 an allowance is intended to exempt trusts set up for children with severe disabilities. The receipt of the allowance is intended to provide an objective basis for determining whether a child has a severe disability.

Exclusions based on settlements on a trust

6.21 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.

6.22 These exclusions are discussed in more detail below. However, two points are worth noting first:

- A trustee may treat multiple settlements made on the same terms as one trust.
- 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

6.23 Sections HC 36(1) and HC 37(1) impose requirements that must be met in relation to "all settlements on the trust".

6.24 This 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. However, under s HC 3, a trustee may treat multiple settlements made on the same

terms as one trust. Section HC 3 is consistent with the common practice in trust administration of treating multiple settlements on the same terms as one trust.

Meaning of settlement is narrowed

6.25 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) and be excluded from the minor beneficiary rule.

6.26 The modification is made to the definition of settlor in s YA 1 (settlement is defined in relation to the term settlor). 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.

6.27 This general definition of settlor is modified 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, so no settlement, if the transfer of value in s HC 27(2) is the provision of:

- financial assistance by way of a loan for less than market value; and
  - the loan ceased to exist before 1 April 2002; or
  - if the loan existed on or after 1 April 2002, in each tax year of the trust's existence, the interest rate on the amount borrowed is less 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);
- financial assistance by way of guarantee and the guarantee has not been called on;
- financial assistance by way of security and the security has not been called on; and
- services that are incidental to the operation of the trust (eg bookkeeping or accounting services, or services as a trustee).

6.28 These excluded settlements are, therefore, ignored when determining whether all the settlements on the trust meet the requirements of ss HC 36(1) and HC 37(1) (see Example | Tauira 18).

Settlements made by a relative, a guardian or their associate

6.29 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 does not apply (s HC 36(1)(a)). This means the rule applies only in those situations where families can potentially gain a tax advantage from using a trust.

6.30 For the purposes of the minor beneficiary rule, s HC 36(5) defines "relative" as a person referred to in para (a) of the definition in s YA 1. This is extended to include being in a marriage, civil union or de facto relationship with a person connected to the other through guardianship.

6.31 The definition of relative in para (a) of s YA 1 means a person connected with another person by being:

- within the second degree of blood relationship with the other (eg a grandfather and granddaughter or a sister and brother);
- in a marriage, civil union or de facto relationship with the other;
- 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); or
- the trustee of a trust under which a relative has benefited or is eligible to benefit.

6.32 The definition of "guardian" in s HC 36(5) has the meaning set out in s 15 of the Care of Children Act 2004. 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. It does not include a guardian appointed under:

- s 110(1)(a) to (d) of the Oranga Tamariki Act 1989;
- s 31 of the Care of Children Act 2004;
- s 53 of the Public Trust Office Act 1957 by a court order; or
- s 7(4) of the Adoption Act 1955.

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

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

- 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, a guardian or their associate. This exception applies, for example, if accident compensation were paid on behalf of a disabled child to the child's parent, who then settles the money on a trust.
- The relative, the guardian or their associate is required by a court order to pay damages or compensation to the minor.
- The minor is a protected person (as defined in s 8 of the Family Violence Act 2018), 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 does not qualify. Settlements made before the protection order is removed continue to satisfy the requirements of the exclusion after the protection order is removed. A settlement that is made jointly by two people (eg both parents) satisfies the requirements of the exclusion even if the protection order is in force against only one of the settlors.

6.35 If a settlement does not meet the requirements of s HC 36(1)(a) or s HC 36(1)(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 from [6.39].

Settlement made on the death of a settlor

6.36 Section HC 37 deals with settlements made under a will, a codicil (ie an amendment to a will), an intestacy or a court variation. The purpose of this section is to exclude beneficiary income derived by a minor from a trust where it 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 also applies to beneficiary income derived by a minor who has a sibling who was alive within 12 months after the settlor's death.

6.37 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. This is shown in Example | Tauira 15.

Example | Tauira 15: Extension to siblings

Richard Stark dies on 1 January 2010. 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 2010. Rob's brother, Brandon, is born five years later. In 2022, the current trustee makes a distribution of beneficiary income to Brandon, who is now 7 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 does not apply to the beneficiary income derived by Brandon in 2022. 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.

6.38 If a settlement 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.

Mixed trust rule

6.39 Generally, the mixed trust rule in ss HC 36(2) and HC 37(2) allows the exclusions from the minor beneficiary rule in ss HC 36(1) and HC 37(1) to apply if some settlements do not meet the requirements of those sections, but at least one settlement 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 and significant services must not have been provided to the trust by a relative, guardian or their associate.

6.40 The exclusions to the minor beneficiary rules may still apply if the only settlements that fail to meet the requirements of s HC 36(1) or s HC 37(1) meet the requirements of s HC 36(3). Subsection (3) requires the settlements are made through:

- the disposal of property for less than market value, where the total value of settlements made in this way (in the current and previous income years) is no more than $5,000 at the end of the trust's income year (the value of each settlement is to be determined as at the date of settlement) (s HC 36(3)(a)); or
- 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)).

6.41 However, s HC 36(3) does not apply if services are provided to the trust by a relative, guardian or associated person (s HC 36(4)). The last requirement applies whether or not the trust pays for the services. 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). This rule is turned off though if the services are incidental to the operation of the trust such as bookkeeping, accounting or trustee services.

6.42 How the mixed trust rules apply is shown in Example | Tauira 16, Example | Tauira 17, and Example | Tauira 18.

Example | Tauira 16: 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 settlement of $5,000 by a parent of the minor; and
- an interest-free loan to the trust of $800 by a parent in the income year.

The minor beneficiary rule still applies as neither settlement meets the requirements of s HC 36(1) as both are settlements by a parent.

Variation

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 listed above could be considered in terms of s HC 36(3).

The first settlement meets the requirements 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 meets the requirements of s HC 36(3)(b) because the loan was not more than $1,000 on any day in the income year.

The minor beneficiary rule would not apply as there is a qualifying settlement and the non-qualifying settlements are small in value and permitted.

Example | Tauira 17: Parent of minor 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:

- 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));

- a second settlement made under the terms of a grandmother's will, where the minor 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.

As a parent of the minor provides services to the trust that are not incidental to its operation, s HC 36(4) provides that the mixed trust rule does not apply. It does not matter that the parent is paid a market value salary. Therefore, the minor beneficiary rule applies to the beneficiary income derived by the minor.

Variation

If no services were provided to the trust by the parent, the result would be different. 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(1). As there is one qualifying settlement, s HC 36(3) can be considered.

The non-qualifying settlement by the parent satisfies the requirements of 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. Therefore, the minor beneficiary rule would not apply as there is a qualifying settlement and the non-qualifying settlement is small in value and permitted.

Example | Tauira 18: 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:

- 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.
- The parent made a further $1,000 interest-free loan to the trust, which is still outstanding.
- The third settlement was made under the terms of a 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 s HC 36(1) or s HC 37(1) and one does not. Therefore, this is a mixed trust and s HC 36(3) can be considered.

Because the non-qualifying settlement is an interest-free loan for no more than $1,000, it meets the requirements of s HC 36(3)(b). Therefore, the minor beneficiary rule does not apply as there is a qualifying settlement and the non-qualifying settlement is small in value and permitted.

Part 7: Trustee income

Definition of trustee income

7.1 "Trustee income" is defined in s HC 7(1) as an amount of income derived by a trustee to the extent to which it is not beneficiary income.

7.2 Under s HC 7(2), it also includes an amount of minor's beneficiary income to which s HC 35 applies as if it were trustee income for the purposes of determining the tax rate, paying tax on the income, and providing returns of income. The minor beneficiary rule is discussed in Part 6 (Minor beneficiary rule).

7.3 Section HC 7(3) extends trustee income to include the market value of any property settlement a trust receives that is excluded from corpus under s HC 4(3) to (5). The amount is reduced by the market value that the trustee treats as beneficiary income or as a taxable distribution in the income year. Section CV 13(b) includes such amounts in the income of the trustee.

7.4 The purpose of ss HC 7(3) and CV 13(b) is to ensure certain settlements excluded from corpus are taxed in the year of the settlement to prevent a deferral of tax on undistributed income by resettling amounts on a sub-trust.

Income

7.5 Income derived by a trustee is determined according to the general rules in part C (s BD 1(1)). Trustee income is income derived by a trustee that is not beneficiary income.

7.6 New Zealand–sourced income derived by a trustee is generally assessable income (where it is not exempt or excluded income) regardless of the residence of the trustee or settlor (s BD 1(5)). 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.

7.7 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 are assessable as trustee income when the settlor is resident in New Zealand and exempt when the settlor is not resident. 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

7.8 A foreign-sourced amount derived by a non-resident is normally non-residents' foreign-sourced income (s BD 1(4)) and not assessable income (s BD 1(5)(c)). However, under s HC 25(2), when a non-resident trustee derives, as trustee income, a foreign-sourced amount that would be assessable income if derived by a New Zealand resident, it is assessable income of the trustee (subject to the exceptions discussed in this part). This applies if, at any time in the income year:

- a settlor of the trust is a New Zealand resident who is not a transitional resident; or
- the trust is a superannuation fund; or
- the trust is a testamentary trust or an *inter vivos* trust, of which:
  - a trustee is resident in New Zealand; and
  - a settlor died resident in New Zealand (whether or not they died in the income year) or, in the case of a corporate settlor, the last surviving settlor was resident in New Zealand when that settlor ceased to exist.

7.9 Section HC 25(2) applies so 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. The amount must be one that would be assessable income if derived by a person resident in New Zealand, so it excludes, for example, some capital gains.

7.10 Foreign-sourced amounts derived by a non-resident trustee are also assessable if a settlor died resident in New Zealand and a trustee is resident in New Zealand at any time in the year. It does not matter whether the settlor died in the income year. 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.

7.11 The rule also applies if the last surviving settlor is a corporate settlor and that settlor ceases to exist. The residence of the settlor is determined by the residence of that corporate settlor.

7.12 There are two exceptions to the general rule. If the exceptions apply, foreign-sourced amounts derived by a non-resident trustee are not income in New Zealand.

7.13 Both exceptions require the trustee to be resident outside New Zealand at all times in the income year. This means if a trustee is resident in New Zealand for even a day, the exceptions do not apply.

7.14 The first exception also requires that no settlement has been made on the trust since 17 December 1987 and, if an election has been made under s HZ 2 for the trust to pay tax on all its income, it was not made by the trustee (s HC 25(3)). The election in s HZ 2 relates to a choice on or before 31 May 1989 under s 228(7) of the Income Tax Act 1976 to pay income tax on trustee income derived from and including the 1989 tax year.

7.15 The second exception also requires that if a settlement were made on the trust after 17 December 1987, it was made only 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)). This means non-residents who settled trusts before becoming resident do not automatically create a liability on foreign-sourced income derived by the non-resident trustee.

7.16 Although subss (3) and (4) of s HC 25 mean certain non-resident trustees are not required to pay tax on foreign-sourced amounts, those provisions do not affect the settlor's income tax liability under the trust rules (s HC 25(5)(a)). A New Zealand resident settlor may still be liable as agent of the non-resident trustee for income tax payable by the trustee under s HC 29, subject to the exceptions discussed in Part 13 (Compliance). A settlor will also have an income tax liability if they have made an election under s HC 33.

7.17 Subsections (3) and (4) of s HC 25 also have no effect when determining whether the tax obligations on the trustee's income tax liability are met for the purposes of s HC 10(1)(a)(ii) and meeting the requirements for a complying trust (s HC 25(5)). To achieve complying trust status, the trustee must pay tax on the trustee's worldwide income for the life of the trust (s HC 10(1)(a)(i)). This is not achieved if the exceptions apply. However, a trustee, settlor or beneficiary of a trust can elect, under s HC 33, to satisfy the income tax liability on the worldwide income of a trust to gain or maintain complying trust status (see Part 10 (Transitional issues on becoming resident)).

7.18 Where the trustees are non-resident and foreign-sourced amounts are assessable as trustee income under s HC 25(2), the trustees are treated as resident in New Zealand under other provisions in calculating the taxable income of the trustees. These provisions are:

- ss EW 9 and EW 11 (which state the situations where the financial arrangements rules will or will not apply);
- s LJ 2 (which states when a person can claim a tax credit for foreign income tax paid);
- s OE 1 (which states when a person can choose to be a branch equivalent tax account person); and

- 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).

7.19 The residence of a trust was discussed in Part 1 (Introduction) and Part 3 (Trustees and beneficiaries).

Foreign-sourced amounts – resident trustees

7.20 A foreign-sourced amount derived by a resident is normally assessable income. However, s HC 26 provides that if a resident trustee of a trust derives a foreign-sourced amount that is included in trustee income, it is exempt income under s CW 54 if no settlor:

- is at any time in the income year a New Zealand resident who is not a transitional resident; or
- exists in the income year and the last surviving settlor was a non-resident when that settlor ceased to exist.

7.21 Where one of the situations listed above exists, the following conditions must also be met:

- no election has been made under s HC 33 (which relates to paying tax on worldwide income);
- 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); and
- the trust:
  - has a trust deed or will or other document that creates and governs the trust;
  - it is registered under s 59B of the TAA at the beginning of the income year, and when the foreign-sourced amounts are derived;
  - has a trustee that complies with the requirements under ss 22, 59B, 59C and 59D of the TAA (discussed in Part 13 (Compliance)) during the income year; and
  - the amount is not beneficiary income derived by a minor that is treated as if it were trustee income.

7.22 For trusts that are not registered under s 59B of the TAA at the beginning of an income year, transitional rules apply. The resident trustee essentially qualifies for the exemption in ss HC 26 and CW 54 for all foreign-sourced amounts derived, if the:

- 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 trustee);
- trust has a trust deed or will or other document that creates and governs the trust;
- trust is registered when the foreign-sourced amount is derived; and
- trustee complies with the requirements under ss 22, 59B, 59C and 59D of the TAA (discussed in Part 13 (Compliance)) during the income year.

7.23 If the 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

7.24 Section DV 9(2) applies for the purpose of calculating a trustee's deductions from trustee income (s HC 24(4)).

7.25 Section DV 9(2) states that beneficiary income in the income year is treated as trustee income for the purpose of determining the deductions that a trustee is allowed in that year. Section DV 9(3)(b) provides that 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 for a trustee to establish the required nexus for expenditure incurred in deriving this income.

7.26 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. Section DV 9(3)(a) provides that this provision overrides the general permission; instead, any deductions relating to this income are deducted from trustee income (see Example | Tauira 19).

Losses

7.27 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 loss can be carried forward to be subtracted from the net income (being trustee income that has not been distributed as beneficiary income less annual total deductions) for a future year in accordance with the provisions in part I (s BC 4(4)).

7.28 A trustee cannot distribute net losses to beneficiaries (see Example | Tauira 19).

Example | Tauira 19: Calculation of trustee income

The trustees of Dublin Trust derive passive income and incur related expenses. The trust deed requires $1,000 to be distributed to each of the four beneficiaries of the trust as beneficiary income each year.

The calculation of trustee income will be:

Rental income	$5,000
Dividends	$500
Interest income	$200
Total income	$5,700
Less Beneficiary income	$4,000
Trustee income	$1,700
Less Rates	$800
Less Interest expense	$1,000
Loss to carry forward	$100

The beneficiaries will return $1,000 each in their tax returns as beneficiary income.

The expenses of the trustees cannot be offset by the beneficiaries against beneficiary income or claimed in any other part of the return. The expenses are only able to be deducted by the trustee against trustee income.

Nor can the loss be distributed to the beneficiaries. However, the trustee is permitted to carry this loss forward.

Variation

If rates were $400, the trustee would have assessable income of $300 and pay tax at the trustee rate on this.

As in the first example, the beneficiaries cannot claim any expenses of the trustee against their beneficiary income.

Tax liability of trustee

7.29 A trustee 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)). This applies whether the trustee is a natural person or a company. 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 derives the trustee income in a separate capacity, so must return the taxable income separately. This is done using **Income Tax Return: Estate or trust – IR6**. Trustee income is taxed at the trustee rate (sch 1, part A, cl 3).

7.30 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 certain gifts) (s HC 24(2)).

7.31 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 in Part 13 (Compliance).

Part 8: Distributions from trusts

Introduction

8.1 The income tax treatment of amounts that are beneficiary income is discussed in Part 5 (Beneficiary income). This part discusses the income tax treatment of distributions. A distribution is broadly a transfer of value to a person made because the person is a beneficiary of the trust.

8.2 In determining the tax treatment of distributions made by trustees to beneficiaries, trusts are classified into three categories:

- complying trusts;
- foreign trusts; and
- non-complying trusts.

8.3 A distribution from a complying trust of an amount that is not beneficiary income is exempt income of a beneficiary. However, this may not apply if the trust is a community trust. Community trusts are discussed in Part 9 (Special cases).

8.4 Certain distributions from foreign and non-complying trusts may be "taxable distributions" and taxed to a beneficiary. Other distributions are not taxable.

8.5 An example of different tax treatment arising from the classification of a trust is where a trustee permits beneficiaries to reside in a property owned by the trust without paying market value rent. For a beneficiary of a complying trust, the distribution is exempt income under s HC 20. However, for a beneficiary of a foreign 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.

8.6 Where a distribution consists of a mix of elements such as accumulated trustee income and capital gains, the ordering rules may determine what has been distributed. These rules apply to foreign and non-complying trusts.

8.7 This part discusses:

- the definition of "distribution" (from [8.8]);
- the three categories of trusts and dual status trusts (from [8.18]);
- taxable distributions (from [8.59]);
- the ordering rules (from [8.113]); and
- resettlements (from [8.153]).

Definition of distribution

8.8 A trustee makes a distribution when they transfer value to a person because the person is a beneficiary of the trust (s HC 14).

8.9 Section YA 1 defines "transfer of value". It is a net concept in the sense it compares the market value of what the trustee provides and the market value of what (if anything) the beneficiary provides in return. The definition was discussed in more detail in Part 2 (Settlors) in the context of the definition of settlor.

8.10 A distribution can include a settlement by the trustee of a trust on another trust (resettlement) for the benefit of a beneficiary of the first trust. However, this will be the case only if (s HC 14(2)):

- 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
- s EW 50 or s EZ 39 (which relate to forgiveness of debt) applies, if the property being settled is an amount forgiven and treated as paid under s EW 44(1) or (2) (consideration when debt forgiven for natural love or affection) or s EZ 39(1).

8.11 Resettlements are discussed further from [8.153].

8.12 Where a trustee pays interest on an amount owed to the beneficiary, the payment is not a distribution under s HC 14(2B) except to the extent the interest paid exceeds the amount calculated by the greater of the:

- market rate; and
- prescribed rate of interest.

8.13 The excess amount is the distribution (see Example | Tauira 20).

Example | Tauira 20: Interest payment not a distribution

The trustees of Anniversary Trust pay interest to a beneficiary on a loan. The greater of the market rate of interest and the prescribed rate is 6%. The trustee pays the beneficiary a rate of 7%. As 7% is higher than 6%, the difference of 1% is a distribution.

8.14 Section HC 14(3) provides that a distribution is made to a person when what is transferred:

- vests absolutely in interest in the person; or
- is paid to the person.

These concepts were discussed from [5.14].

8.15 Section HC 14(4) provides a distribution may be made directly or indirectly, or by one transaction or multiple transactions, whether related, connected or otherwise.

8.16 In determining whether a transfer of value occurs, the fact a person is, or will become, a beneficiary of a trust does not constitute the giving or receiving of value (s HC 14(5)). This is intended to forestall an argument that might otherwise be made about whether a trustee transfers value to a beneficiary when the trustee vests or pays an amount to the beneficiary. The argument is that a beneficiary's existing claim on the trust property is of value and this is given up as consideration when a trustee vests or pays the property to the beneficiary, meaning there is no transfer of value and no distribution.

8.17 Sections FC 1 and FC 2 set a value for these distributions for the trustee and beneficiary for tax purposes. Section FC 2(1) treats a distribution of property from a trustee to a beneficiary under s FC 1(1)(c) as a disposal and acquisition at market value. This may result in the trustee deriving income from depreciation recovery or a gain in the case of revenue account property. The market value also becomes the cost of the property to the beneficiary. The rule in s FC 2 does not apply for the purposes of determining whether a transfer of a property is a distribution in s HC 14. This is determined by whether an actual transfer of value occurs and not by the deemed value in s FC 2.

Categories of trusts

8.18 In determining the tax treatment of distributions trustees make to beneficiaries, trusts are classified into three categories: complying, foreign and non-complying. There is also a type of trust referred to in this statement as a dual status trust.

Complying trusts

Description

8.19 Complying trusts are essentially trusts where tax has always been paid in New Zealand on the worldwide income derived by the trustee, whether by obligation or election, and the tax obligations relating to the trustee's income tax liabilities have been satisfied.

Significance

8.20 Distributions from complying trusts (other than community trusts) are exempt income of beneficiaries if the amounts are not beneficiary income (ss HC 20 and CW 53). This contrasts with foreign and non-complying trusts where distributions of amounts other than beneficiary income may be taxable.

8.21 The reason for this different treatment is that trustee income of complying trusts has already been liable to New Zealand income tax. This may not be so in the case of trustee income of foreign and non-complying trusts. Consequently, income accumulated by such trustees is taxed when it is distributed to a beneficiary.

Requirements

8.22 A trust is treated as a complying trust for a distribution if the following requirements are met for the life of the trust up to the time of the distribution (s HC 10(1)(a)):

- no trustee income derived includes an amount of:
  - non-resident passive income (defined in s RF 2);
  - non-residents' foreign-sourced income (defined in s BD 1(4)); or
  - exempt income under s CW 54 (foreign-sourced income of a resident trustee under s HC 26); and
- the tax obligations relating to the trustee's income tax liability have been satisfied for every tax year.

8.23 If the requirements of s HC 10(1)(a) are not met, a trust can still be a complying trust if one of the following three requirements are met (s HC 10(1)(ab) and (ac)):

- a person makes an election meeting the requirements of s HC 30(2) and s HC 10(2) (applies to foreign trusts that make an election in time);
- a person makes an election meeting the requirements of s HC 33(1), and for all income years beginning on the date from which the election applies until before the time of distribution, the tax obligations relating to the trustee's income tax liability for the trustee income determined consistently with s HC 33(1C) are satisfied (applies to all trusts that are not complying trusts); or
- the distribution meets the requirements of s HC 30(4)(ab) (applies to foreign trusts that make voluntary disclosures of a tax shortfall or elections after the election expiry date).

8.24 A superannuation fund is a complying trust under s HC 10(1)(b) (see Part 9 (Special cases)).

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

8.25 Most trusts established by New Zealand resident settlors with trustees who are also resident in New Zealand will satisfy the requirements of s HC 10(1)(a) and be a complying trust in relation to a distribution. This is because the trustee's worldwide income will have been liable to tax from the date on which the settlement was first made.

8.26 The trust will not meet the complying trust requirements if some of the income is:

- non-resident passive income such as interest or dividends derived by a non-resident trustee from a New Zealand source;
- non-residents' foreign-sourced income, which is income derived by a non-resident trustee from a foreign source; or
- exempt because it is a foreign-sourced amount derived by a resident where the settlor is non-resident.

8.27 If a trustee derives income of the type above, they could distribute it as beneficiary income so it is no longer trustee income and maintain complying trust status. Alternatively, a trustee, settlor or beneficiary could elect to pay tax on the trustee's worldwide income.

8.28 Trustee income is a gross concept. This means a trustee has trustee income even if available deductions exceed the trustee's income for the income year or the trustee has losses available to offset their net income.

8.29 The fact a trustee may have no trustee income (whether this is because the trustee derives no income or because it is distributed as beneficiary income) in an income year does not prevent the trust from being a complying trust.

8.30 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.

Tax obligations relating to the trustee's income tax liability must have been satisfied for every tax year

8.31 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 tax obligations relating to the trustee's income tax liability have been satisfied for every tax year.

8.32 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 a trust

may still be a complying trust where the trustees have entered into deferred payment arrangements with the Commissioner.

8.33 An election under s HC 33 can also be made by a settlor or beneficiary in which case that person has the obligation to satisfy the income tax liability of the trustee.

8.34 Section HC 32 requires that the trustee, in their capacity as agent, must satisfy the income tax liability of the beneficiary for their beneficiary income and taxable distributions derived. If the tax paid by the trustee falls short of the amount payable by the beneficiary, the beneficiary must file a return and pay the shortfall. If the beneficiary does not pay the shortfall, the trustee is liable for this jointly and severally. A trust retains its complying trust status in these circumstances under s HC 10 regardless of whether the shortfall is paid. This is because the tax obligation of the trustee as agent for the beneficiary's income tax liability is not an obligation relating to the trustee's income tax liability.

8.35 The requirements of s HC 10 apply for the life of the trust until the time of distribution. This includes income years before the present trust rules were introduced.

8.36 Nevertheless, trusts with non-resident trustees that were settled on or before 17 December 1987 and had foreign-sourced income or non-resident passive income sourced in New Zealand in the 1988 and earlier income years, were able to become complying trusts. This required an election under s 228(7) of the Income Tax Act 1976 to be liable for income tax on trustee income for the 1989 and subsequent income years. The election had to be made on or before 31 May 1989 by a settlor, trustee or beneficiary of the trust.

8.37 A trust for which an election was made in accordance with s 228(7) of the Income Tax Act 1976 is treated as satisfying the requirements of s HC 10(1)(a) for the income years before the introduction of the trust rules (s HZ 2).

Converting to be a complying trust by election

8.38 Section HC 10(1)(ab) allows trusts that may not have paid tax on worldwide income because of non-resident trustees or settlors or both to elect to be complying trusts. These rules could apply to an immigrating settlor of a foreign trust and an emigrating settlor of a trust that would otherwise become a non-complying trust.

Converting to be a complying trust by making a voluntary disclosure

8.39 The tax obligations relating to the trustee's income tax liability of a foreign trust may not have been met when a settlor becomes resident and does not make an election. Section HC 10(1)(ac) allows a trustee to make a voluntary disclosure of a tax shortfall

and become a complying trust if the tax liabilities and any penalties are paid before a distribution.

8.40 For more details on elections and voluntary disclosures, see Part 10 (Transitional issues on becoming resident) and Part 11 (Transitional issues on becoming non-resident).

Foreign trusts

Description

8.41 In general, foreign trusts are trusts that have not had a New Zealand resident settlor at any time since 17 December 1987.

Significance

8.42 A distribution of accumulated income (ie income that was not beneficiary income) by a trustee of a foreign trust to a resident beneficiary is a taxable distribution and included in the beneficiary's income. However, distributions of capital gains (unless certain gains are made with parties associated with the trustee) and corpus are not taxable distributions. The terms capital gain and corpus are discussed in more detail from [8.72] when discussing the term taxable distribution. Current year income distributed to a resident beneficiary is taxed as beneficiary income at their marginal rate of tax.

Requirements

8.43 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 it is necessary to determine whether the trust is a foreign trust.

8.44 Section HC 11 refers to the point when it is necessary to determine whether the trust is a foreign trust as a "moment in time". A moment in time is generally when the trust makes a distribution as that is when the status of the trust must be determined. The tax treatment of the distribution follows from this determination (see Example | Tauira 21).

Example | Tauira 21: No resident settlor

> Piwakawaka Trust is settled on 1 September 2021 by Kazuko, a resident of Japan. The trustee is resident in New Zealand. Section 59B of the Tax Administration Act 1994 requires the registration of a foreign trust if it has a resident trustee. On settlement, the trust is a foreign trust as no settlor has been resident in New Zealand starting on 1 September 2021 and ending on the same day.
>
> On 25 March 2022, the trustee decides to distribute all the trust's foreign-sourced income to Kazuko's children in Brazil. It is necessary to determine whether the trust is a foreign trust for the distribution in terms of s HC 15(3). The trust is a foreign trust as no settlor has been resident in New Zealand starting on 1 September 2021 and ending on 25 March 2022.

8.45 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 on or after 17 December 1987.

8.46 A trust may be a foreign trust if a settlor was resident in New Zealand after the later of 17 December 1987 and the date of first settlement of the trust, but was not a settlor while resident in New Zealand (see Example | Tauira 22).

Example | Tauira 22: Not a settlor while resident

> Maria, a non-resident, settles a trust on 1 June 2021 with a resident trustee while Joseph, a friend of Maria, is resident in New Zealand. Joseph, after ceasing to be resident in New Zealand, marries Maria and settles property on the same trust on 1 October 2022. The trust is a foreign trust because Joseph was not a settlor of the trust while he was resident in New Zealand.

8.47 Where a trust was first settled before 17 December 1987 and the settlor died resident in New Zealand before that date, the trust is technically a foreign trust but for so long as it satisfies the definition of complying trust it is treated as a complying trust. See para 4.64 in Appendix: Explanation of taxation of trusts.

8.48 Part 10 (Transitional issues on becoming resident) explains the rules that apply if a settlor becomes resident in New Zealand.

Non-complying trusts

Description

8.49 Non-complying trusts are trusts that are neither complying nor foreign trusts.

Significance

8.50 Distributions from a trustee of a non-complying trust to a beneficiary of accumulated income (ie income that was not beneficiary income) and capital gains, but not corpus, are taxable distributions. The terms capital gain and corpus are discussed in more detail from [8.72] when discussing the term taxable distribution.

8.51 As with other categories of trusts, 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 trustee income and taxed at the trustee tax rate).

8.52 Taxable distributions from non-complying trusts are treated as excluded income of the beneficiary (ss HC 19 and CX 59). They are taxed at a non-complying trust rate, which is currently 45% (ss HC 34 and BF 1(b)). Section HC 22 may apply where the beneficiary has tax losses to reduce the amount of the taxable distribution. The rate for non-complying trusts and the inclusion of capital gains in taxable distributions reflects the fact New Zealand income tax may have been deferred using this type of trust.

Requirements

8.53 Under s HC 12, non-complying trusts are all trusts other than complying trusts and foreign trusts.

8.54 Non-complying trusts can arise, for example, where:

- a New Zealand resident settles a trust overseas with a non-resident trustee and the trustee derives non-resident passive income;
- the tax obligations relating to a trustee's income tax liability have not been satisfied for every year; or
- a non-resident settlor becomes resident in New Zealand and does not make an election for the trust to be treated as a complying trust before the election expiry date in s HC 30(5).

8.55 It is possible to convert a non-complying trust into a complying trust. Part 10 (Transitional issues on becoming resident) and Part 11 (Transitional issues on

becoming non-resident) explain the rules concerning elections and voluntary disclosures.

Dual status trusts

Description

8.56 For the purpose of this statement, dual status trusts are trusts that satisfy the requirements to be a complying trust from inception but have a non-resident settlor so they are also foreign trusts. Typically, such trusts have a New Zealand trustee and only derive New Zealand-sourced trustee income from New Zealand property.

Significance

8.57 A dual status trust is treated like a complying trust for the income tax treatment of distributions. A distribution of other than beneficiary income from a dual status trust is not assessable income for a beneficiary.

Requirements

8.58 A complying trust may also have a dual status as a foreign trust where it has only a non-resident settlor and a resident trustee. This could arise, for example, where a non-resident has settled a rental property in New Zealand on trust. All trustee income of a dual status trust is taxable at the trustee tax rate, and the tax obligations relating to the trustee's income tax liability must have been satisfied since the trust's inception.

Taxable distributions

Introduction

8.59 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.

8.60 The concept of a taxable distribution applies only for 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 beneficiary income. All other distributions from a complying trust to a beneficiary are exempt (except for distributions from community trusts).

Definition of taxable distribution

8.61 Section HC 15 defines taxable distribution. The definition is wider for a non-complying trust than a foreign trust. The wider definition for a non-complying trust reflects the risk that New Zealand income tax may have been avoided or deferred by having income accumulated in such a trust.

8.62 For a non-complying trust, a distribution is a taxable distribution under s HC 15(2) to the extent to which it is not a distribution of:

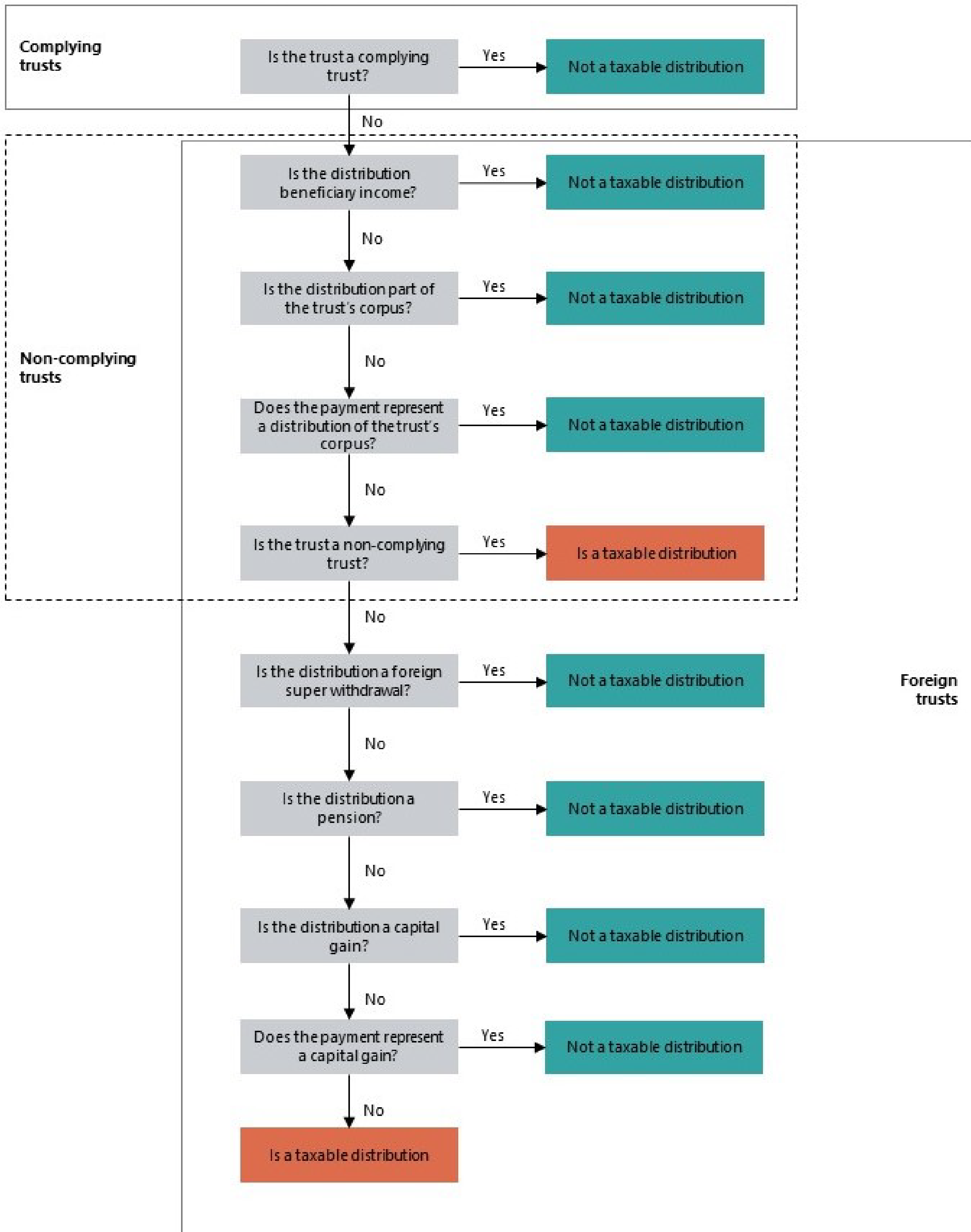
- beneficiary income;
- a part of the corpus of the trust; or
- a payment or transaction that represents a distribution of the corpus of the trust.

8.63 For a foreign trust, a distribution is a taxable distribution under s HC 15(4) to the extent to which it is not a distribution of:

- beneficiary income;
- a part of the corpus of the trust;
- a profit from the realisation of a capital asset or another capital gain (other than certain capital gains made with an associated person);
- a foreign superannuation withdrawal;
- a pension; or
- a payment or transaction that represents a distribution of either the corpus of the trust or a capital gain.

8.64 A taxable distribution is generally made up of accumulated income, capital gains or both. Distributions of amounts that are beneficiary income and corpus from non-complying and foreign trusts are not taxable distributions. This is because beneficiary income is taxable to the beneficiary and corpus is a return of capital. Distributions of certain capital gains from foreign trusts are also not taxable distributions. This is summarised in Figure | Hoahoa 1.

Figure | Hoahoa 1: Flowchart to determine whether a distribution from a non-complying or foreign trust is a taxable distribution



8.65 The definition of taxable distribution in s HC 15 must be interpreted together with the ordering rules in s HC 16. 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 depends on several factors, including the timing of the distribution and the ordering rules.

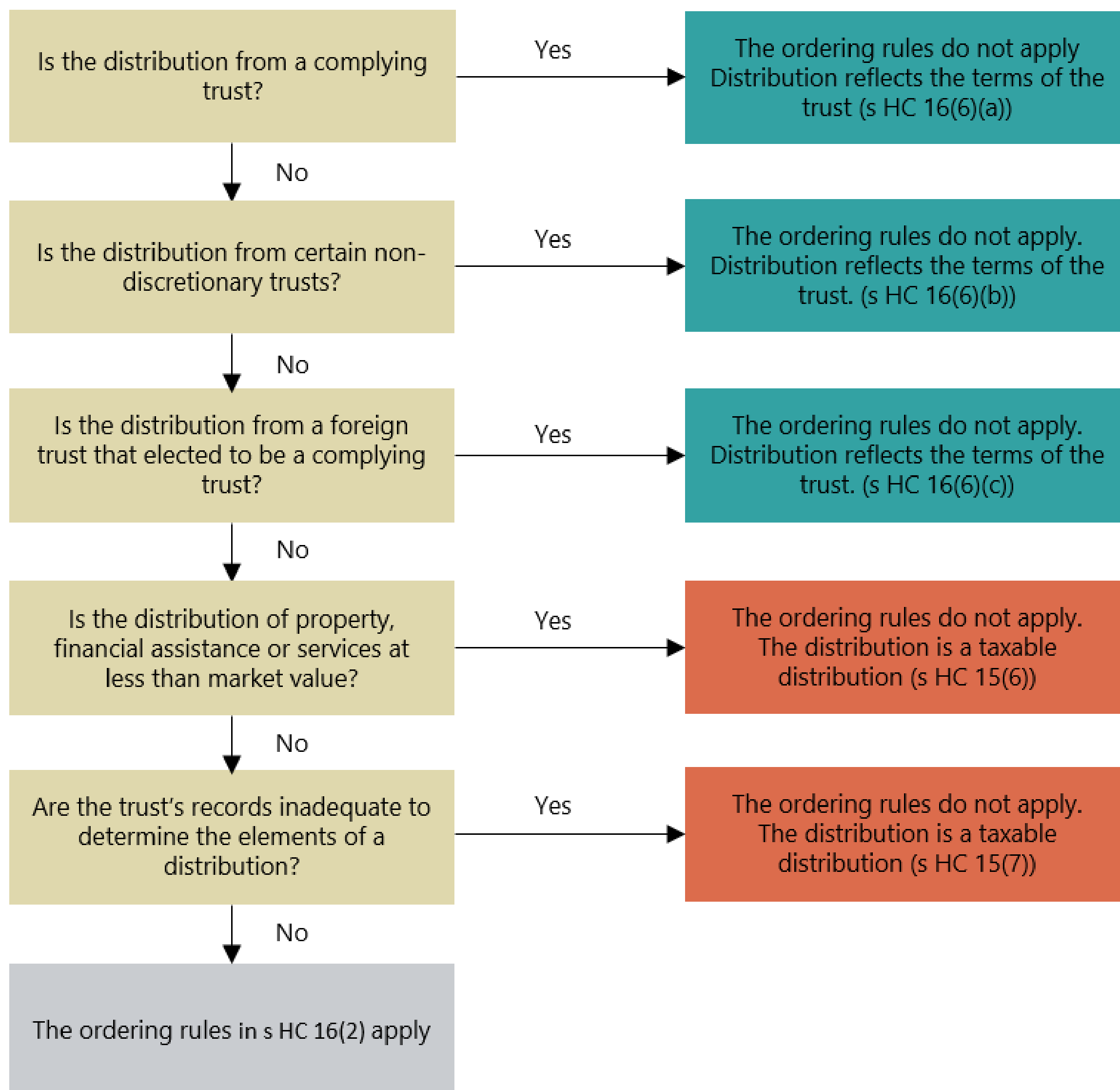
8.66 A distribution is a taxable distribution and not subject to the ordering rules in two circumstances. Firstly, the distribution is a taxable distribution if it is made to a beneficiary by a foreign or non-complying trust to the extent it involves disposing of property at less than market value or providing financial assistance or services at less than market value (s HC 15(6)). A distribution made by disposing of property at less than market value occurs, for example, where a trust's asset is sold or leased to a beneficiary at a discounted price.

8.67 Secondly, a distribution is also a taxable distribution and not subject to the ordering rules if the trustee of a foreign or non-complying trust does not keep records that allow the elements of the amount distributed to be accurately determined (s HC 15(7)). The focus is on the accuracy of records relating to a particular distribution. This means, for example, that if a trust has 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.

8.68 However, where a trust has inaccurate records relating to income, but accurate records in relation to capital gains and it purports to make a distribution of a capital gain, there is no certainty that the trust has distributed all 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.

8.69 See Figure | Hoahoa 2 for a summary of whether the ordering rules apply.

Figure | Hoahoa 2: Do the ordering rules in s HC 16(2) apply to the distribution?



8.70 A distribution is not a taxable distribution if it is a distribution of income or a capital gain from a trust (other than a unit trust, group investment fund or superannuation scheme) that was derived in the 1988 or earlier tax years (ss HZ 1 and HC 1(2)(d)).

8.71 The ordering rules are discussed further from [8.113].

Capital gains included in taxable distributions from foreign trusts

8.72 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. This is because distributions of some capital gains are taxable distributions and some are not.

8.73 The definition of taxable distribution in s HC 15(4) excludes all distributions to the extent it is "a profit from the realisation of a capital asset or another capital gain" or "a payment or transaction that represents a distribution of a capital gain". These gains are not taxable distributions.

8.74 The amount of any capital gain is reduced under s HC 15(5)(b) by any capital loss that the trustee incurs in the income year in which the capital gain was derived. For example, 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 include for the year.

8.75 The capital gains included 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 has not been converted into money or money's worth, is not realised. In this context, a loss that has accrued, but has not been realised, is not incurred.

8.76 Under s HC 15(5C) and (5D), the source of a capital gain or loss is determined under s YD 4 (classes of income treated as having a New Zealand source).

8.77 Section HC 15(5) excludes certain capital gains of a foreign trust from distributions that are not taxable distributions. This means they cannot be distributed by a foreign trust tax-free.

8.78 A capital gain does not include a gain that is required to be included 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 the purpose of disposing of it. In the absence of s CB 6, such an amount might be regarded as a capital amount. As it is included in the person's income under s CB 6, it does not give rise to a capital gain for the purposes of the definition of taxable distribution.

8.79 In addition, some gains a trustee derives from a transaction (or a series of transactions) with an associated person are not capital gains for the purposes of the definition of taxable distribution.

8.80 A capital gain does not include an amount derived by a trustee with an associated person where a controlled foreign company is the settlor and no person is treated as a settlor under s HC 28(3) or (4) (s HC 15(5)(ac)). A person is treated as a settlor under these provisions if they have a control interest of 10% or more.

8.81 A capital gain also does not include an amount resulting from a transaction between a trustee and an associated person who is not a natural person or corporate trustee. This applies only if the gain is greater than that the trustee would derive from a transaction at market value.

8.82 Under s HC 15(5B), these gains with associated persons are treated as income of the trustee for the purposes of the ordering rules in s HC 16. This means they must be distributed earlier than other capital gains to prevent deferral of taxation.

Corpus

8.83 In determining whether a distribution is a taxable distribution, it is also important to understand the meaning of "corpus". A distribution is not a taxable distribution to the extent it consists of corpus.

8.84 Corpus is defined in s HC 4. Subject to the exclusions discussed from [8.89], corpus means an amount 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 (see Part 2 (Settlors)). The market value is measured at the date of the settlement. Where the settlement is denominated in a foreign currency, the market value is the value in New Zealand dollars on the date of settlement. Therefore, a change in the value of property settled on a trust does not change the value of the corpus of the trust.

8.85 Where a trustee treats a trust with multiple settlements (as permitted by s HC 3) as a single trust, the value of the property is the sum of the market value of the property determined at the time of settlement of the property (s HC 4(1B)).

8.86 Corpus requires a settlement of property. A settlement of property is not the same as a transfer of value. Some transfers of value do not result in the trust receiving property. One example is the provision of services for less than market value, even though there is a transfer of value and a settlement on the trust. Another example is the provision of an interest-free loan to a trust. Again, although there is a transfer of value and a settlement, no property is settled on the trust. Although the trust as borrower enjoys an economic benefit from being able to enjoy the use of the loan principal for the term of the loan, this is not a form of property. This differs from the position accepted in argument by the Commissioner in *Case Y25* (2008) 23 NZTC 13,270.

8.87 Whether a settlement will give rise to corpus has implications for the value of corpus held by a trust. This is relevant in determining whether a distribution from a foreign or non-complying trust is a taxable distribution.

8.88 The three exclusions from the general definition of corpus are discussed next.

Property settlement by another trust

8.89 Firstly, under s HC 4(3), 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.

8.90 This exclusion prevents 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.

8.91 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 does not apply if the distribution from the other trust was of an amount of corpus of the other trust or a capital gain if the other trust was a foreign trust. In determining whether this exclusion applies, the ordering rules apply to determine the character of the amount distributed.

8.92 There does not have to be a resident beneficiary at the time of the property settlement 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

8.93 Secondly, under s HC 4(4), 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 for their business. The difference between the market value of the goods and the price paid is a transfer of value and a settlement.

8.94 This exclusion ensures 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

8.95 Thirdly, s HC 4(5) provides 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).

8.96 This exclusion has limited application. If an amount is income of a person, the settlement of that amount on a trust does not prevent it from being their income. A person cannot avoid assessment of income that they derive by assigning it to another person (*Hadlee and Sydney Bridge Nominees Ltd v CIR* (1989) 11 NZTC 6,155 (HC)). The same applies to a settlement of that income.

Consequences of excluded property settlements

8.97 As noted in Part 7 (Trustee income), a property settlement a trust receives that is excluded from corpus under s HC 4(3) to (5) is treated as trustee income under s HC 7(3). As noted at [8.10], the settlement is also a distribution as defined in s HC 14.

8.98 The exclusion from the definition of corpus in s HC 4(3) is discussed further from [8.153] in relation to resettlements.

Taxation of taxable distributions

8.99 Taxable distributions derived by a beneficiary from a non-complying trust have a special tax treatment.

8.100 Section HC 19 provides that such a taxable distribution:

- is excluded income of the person under s CX 59;
- may be reduced by tax losses calculated under s HC 22; and
- is taxed at the non-complying trust rate set out in s HC 34(1) under s BF 1(b).

8.101 Under s HC 34(2), the tax is payable at the due date for the beneficiary's terminal tax for a tax year under s RA 13. If the beneficiary has a 31 March balance date but does not have an agent, this will be 7 February in the following year.

8.102 If the distribution is a foreign-sourced amount that is derived by a non-resident beneficiary, then no tax is payable. Section BD 1(3) in the core provisions removes non-residents' foreign-sourced income (as defined in s BD 1(4)) from having the status as excluded income. Section BD 1(5) then excludes non-residents' foreign-sourced income from a person's assessable income.

8.103 Section CA 2(3) confirms that excluded income under s CX 59 does not include non-resident's foreign-sourced income. Consequently, only taxable distributions that remain as excluded income after consideration of source and residency rules are taxable under s BF 1(b).

8.104 The result is that all taxable distributions from non-complying trusts are taxed at the non-complying trust rate to New Zealand resident beneficiaries but only New Zealand-sourced taxable distributions are taxed at that rate to non-resident beneficiaries.

8.105 If a controlled foreign company (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 non-complying trust tax rate.

8.106 A different approach is adopted for taxable distributions from foreign trusts as these distributions are included in the assessable income of the beneficiary in the ordinary way. A taxable distribution to which s HC 18 applies is income of the beneficiary recipient under s CV 13(c). However, s BD 1(5)(c) operates to remove from assessable income any taxable distributions derived by non-resident beneficiaries that are foreign-sourced amounts under s BD 1(4).

8.107 A "foreign-sourced amount" is defined in s YA 1 as meaning an amount of income that is not treated as having a New Zealand source under ss YD 4 and YZ 1 (s YZ 1 is a terminating provision dealing with source rules for interest).

8.108 Section YD 4(13) directs that income a beneficiary derives from a trust has a New Zealand source to the same extent as the income of the trust has. The section applies to the extent that a taxable distribution is treated under the ordering rules as income accumulated by the trustee in a prior year.

8.109 Where the taxable distribution consists, under the ordering rules, of a capital gain, s YD 4(18) applies. The gain is treated as having a New Zealand source by reference to the source of the actual gain being distributed, rather than by reference to the proportion of all capital gains made by the trust that are New Zealand sourced.

8.110 If a New Zealand resident beneficiary (in their capacity as a beneficiary) derives a taxable distribution, they may be allowed a tax credit under s LJ 6 for any foreign tax paid. To qualify for the tax credit, the foreign tax must be of substantially the same nature as NRWT (ie a withholding tax on a distribution to a non-resident). It does not extend to underlying tax paid by a trustee on accumulated foreign-sourced amounts subsequently distributed.

Section GB 22 – anti-avoidance

8.111 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 of the rules relating to beneficiary income and taxable distributions. This provision was discussed in Part 5 (Beneficiary income).

8.112 The Commissioner may also consider the application of s BG 1 to arrangements that have a more than merely incidental purpose or effect of tax avoidance. For example, s BG 1 might apply to an arrangement that involves a loan to a beneficiary of an amount that would have resulted in a taxable distribution taxed at the non-complying trust tax rate if the amount had been distributed to the beneficiary. Section BG 1 does not apply to all such arrangements. In determining whether s BG 1 applies, relevant factors include (but are not limited to) the relationship between the trustee and the beneficiary, the term of the loan, the interest and repayment terms, the

history of payments made on the loan, and the commercial reality of the beneficiary making payments.

Ordering rules

Introduction

8.113 Because some distributions are taxable and some are not, opportunities could arise for avoiding or deferring tax on income accumulated in trusts by distributing otherwise 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. These rules determine the order in which amounts are treated as having been distributed from such trusts.

8.114 The rules override the treatment of the distributions that would otherwise apply based on the terms of the trust 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, so determine whether it is a taxable distribution or not. As noted earlier, it is necessary to interpret the definition of taxable distribution and the ordering rules together.

8.115 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 rules are discussed from [8.143].

8.116 The rules treat a distribution as being made up of the following elements in the following order (s HC 16(2)):

- income derived by the trustee that is beneficiary income of the beneficiary in the previous income year;
- income derived by the trustee in the current income year;
- income derived by the trustee in an earlier income year other than beneficiary income;
- a capital gain derived by the trustee in the current income year that is not income under s HC 15(5B);
- a capital gain derived by the trustee in an earlier income year; and
- the corpus of the trust.

8.117 The ordering rules apply on an end-of-year basis. That is, a distribution is not characterised at the time at which it is made. Rather, distributions are characterised at the end of the income year in which they are made by reference to the total

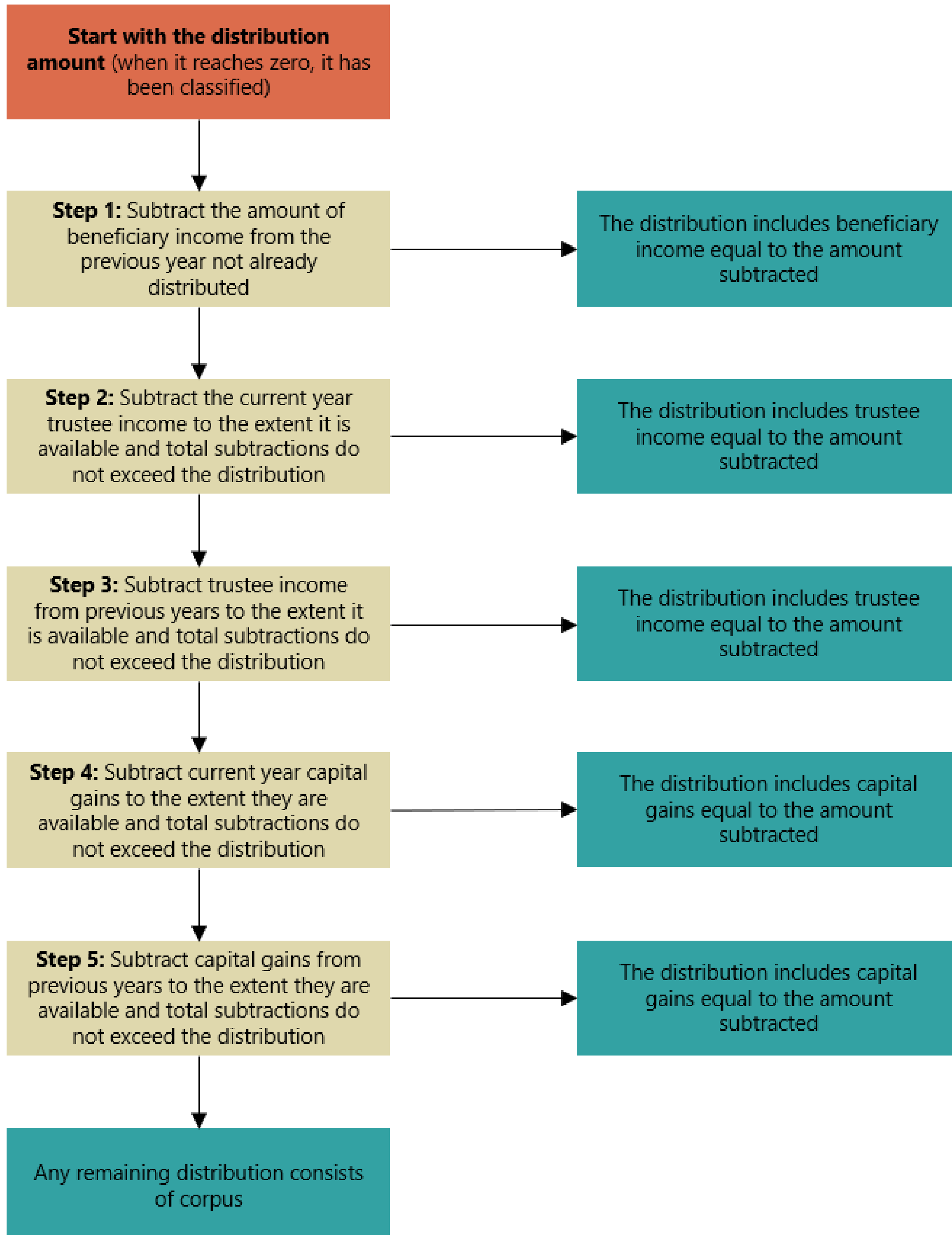
income and capital gains derived by the trustee in that income year (and previous income years). The ordering rules are applied individually to each distribution made by the trustee in the order in which the distributions are made (subject to potential reordering under s HC 16(5), as discussed from [8.133]).

8.118 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 (s HC 16(3)(a)). This means the order in which the distributions are made can be significant.

8.119 For each distribution, the elements must be applied in the order in s HC 16(2). 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 (s HC 16(3)(b)).

8.120 Figure | Hoahoa 3 summarises the steps for classifying the distribution amount subject to deductions, capital losses and the reordering rule. Each of the elements is further explained following Figure | Hoahoa 3.

Figure | Hoahoa 3: Classifying the distribution amount (subject to deductions, capital losses and the reordering rule)



First element – beneficiary income from the previous year

8.121 The first element a distribution consists of is an amount of income derived by the trustee that is beneficiary income of the beneficiary from the prior year (s HC 16(2)(aa)).

8.122 This applies where an amount has been treated as beneficiary income in a previous year under s HC 6(1B) but paid in the current year. Section HC 6(1B) allows the trustee an extended period to pay beneficiary income. See Example | Tauira 23.

Example | Tauira 23: Beneficiary income from prior year is first element

The trustee of a non-complying or foreign trust derived $100 of income in the year ended 31 March 2023 and allocated it as beneficiary income. A distribution of $150 is made two months after the end of the trust's balance date. While the distribution is made in the 2024 income year, the first $100 will be treated as beneficiary income from the previous year under ss HC 6(3) and HC 16(2)(aa). The trustee allocated all the income in the current year as beneficiary income and does not have any accumulated trustee income or capital gains so the remaining $50 is corpus.

Second element – current year trustee income

8.123 The second element a distribution consists 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)).

8.124 An amount of income derived by a trustee in an income year is determined after subtracting any deduction that is included in the calculation of net or taxable income for the corresponding income year (s HC 16(4)(a)).

8.125 "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. Income under part C may be exempt to the trustee. For example, foreign investment fund income derived by a resident trustee of a foreign trust is treated as exempt under ss HC 26 and CW 54. If it is subsequently distributed to a resident beneficiary, it would comprise a taxable distribution under the ordering rules.

8.126 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 (as shown in Example | Tauira 24).

Example | Tauira 24: Change to derivation of beneficiary income

> During an income year, the trustee of a non-complying trust derives $100 of income and a $100 capital gain. The trustee has discretion under the trust to distribute income or capital to any of the beneficiaries of the trust. The trustee makes two distributions.
>
> On 1 February, the trustee pays the $100 capital gain to a non-resident beneficiary. On 1 March, the trustee pays the $100 of income to a resident beneficiary. In the absence of the ordering rules, the $100 of income is beneficiary income of the resident beneficiary because it is income that is paid to a beneficiary. The $100 capital gain could not be beneficiary income because it is not "income" derived by the trustee.
>
> However, the result is different under the ordering rules, despite the trustee paying the $100 capital gain first and the $100 of income second. Applying the ordering rules, when the trustee makes the first payment, the distribution is treated as consisting of the $100 of income derived by the trustee (because income comes before a capital gain in the ordering rules). Because the payment is treated as consisting of the trustee's current year income and is paid to a beneficiary, it is 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 which beneficiary has derived beneficiary income.

8.127 In the case of contemporaneous distributions, the trustee can generally decide how current year income is apportioned between distributions. However, the total current year income treated as being included in the distributions cannot exceed the current year's income (see Example | Tauira 25).

Example | Tauira 25: 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 two years earlier that has not yet been treated under s HC 16 as being included in a distribution. Given that the distributions are contemporaneous, the trustee can effectively decide how the current year income will be divided between the beneficiaries.

The trustee can 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 is 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 is taxed at the beneficiaries' marginal tax rates, and the taxable distribution is taxed at 45%.

Third element – trustee income derived in an earlier income year

8.128 The third element that a distribution consists 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)). An amount of income derived by a trustee in an income year is determined after subtracting any deduction that is included in the calculation of net or taxable income for the corresponding income year (s HC 16(4)(a)) (see Example | Tauira 26).

Example | Tauira 26: Accumulated income available for distribution

The trustee of a non-complying or foreign trust derived $100 of income in the year ended 31 March 2023. No allocations of beneficiary income were made. A distribution of $60 was made as current year trustee income under s HC 16(2)(a). As a result, $40 is available to be treated, under s HC 16(2)(b), as prior year trustee income in future distributions.

Fourth element – current year's capital gains

8.129 The fourth element that a distribution consists of is a capital gain that the trustee derives in the income year and is not income under s HC 15(5B) (s HC 16(2)(c)). Section HC 15(5B) treats certain gains as income of the trustee for the purpose of the ordering rules and results in those gains being distributed earlier.

8.130 The concept of a capital gain is considered from [8.72] in the context of s HC 15 and the definition of taxable distribution. The amount is determined after subtracting any capital loss that the trustee incurs in the income year (s HC 16(4)(b)).

Fifth element – previous years' capital gains

8.131 The fifth element that a distribution consists of is a capital gain that the trustee derived in an earlier income year (s HC 16(2)(d)) rather than in the current year in s HC 16(2)(c). It is also calculated after subtracting the amount of any capital loss that the trustee incurs in the income year (s HC 16(4)(b)).

Sixth element – corpus

8.132 The sixth element that a distribution consists of is the corpus of the trust (s HC 16(2)(e)). Corpus is discussed from [8.83]. 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

8.133 Section HC 16(5) allows the order of amounts distributed to be amended in certain situations.

8.134 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 a distribution currently being considered. Whether an amount is available depends 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 foreign-sourced income to non-resident beneficiaries (who as non-residents are not liable to tax on the income if it was of foreign-sourced amounts) and capital gains to resident beneficiaries. The s HC 16(2) ordering rules do not prevent the streaming of income and capital gains in this manner if the distribution to the non-resident was made before or contemporaneously with the distribution to the resident.

8.135 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 apply so that, when determining the elements of a distribution to a beneficiary (beneficiary A), amounts of income or capital gain previously distributed to another beneficiary (beneficiary B) must be ignored. This results in the amount of income or capital gain still being available to be included in determining the elements of a distribution to beneficiary A.

8.136 If s HC 16(5) applied in Example | Tauira 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.

8.137 Section HC 16(5) applies:

- if some or all of a distribution to beneficiary A is not treated as beneficiary income or a taxable distribution, because of a previous distribution to beneficiary B of income and capital gains; **unless**
- the distribution to beneficiary B:
  - is a genuine transaction entered into and carried out in good faith; and
  - it is not a settlement.

Effect requirement

8.138 If the treatment of the distribution to beneficiary B has no effect on whether the distribution to beneficiary A is a taxable distribution (eg if both distributions are of current year income), then s HC 16(5) does not apply and there is no change to the ordering under s HC 16(2). The important consideration is the effect of the treatment of the earlier 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

8.139 Section HC 16(5) applies where the distribution to beneficiary B is not a genuine transaction entered into and carried out in good faith.

8.140 This requirement was reworded with the introduction of the ITA 2007. The expression of the current requirement replaced an earlier expression that 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)).

Where the distribution is a settlement

8.141 Section HC 16(5) also applies where the distribution is a settlement (see Example | Tauira 27).

Example | Tauira 27: Reordering where there is a settlement

The trustee of a foreign trust settles all 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) applies as the distribution is a settlement. It treats 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 a genuine transaction.

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

8.142 Section HC 16(5) applies only to the extent necessary to determine the elements of the distribution to beneficiary A (as identified and discussed at [8.135] to [8.137]). This means the treatment of the distribution to beneficiary B is not necessarily modified completely. This is shown in Example | Tauira 28.

Example | Tauira 28: 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 purports to distribute $10,000 to Non-stick Ltd, a beneficiary of the trust that would not pay tax on this amount because it is a trustee of a registered charity. This is followed by an actual 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 not supported by a resolution or crediting an amount to Non-stick Ltd's current account and is not genuine.

Applying the ordering rules under s HC 16(2), 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 are 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.

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 is treated as included in the distribution to Cast Iron Ltd. This leaves $2,000 of the capital gain amount, which is still treated as being included in the distribution to Non-stick Ltd. The remainder of the distribution to Non-stick Ltd ($8,000) is treated as being made up of corpus. Therefore, the result is that the $8,000 distribution to Cast Iron Ltd is treated as being a distribution of a capital gain. This is a taxable distribution. The distribution to Non-stick Ltd is treated as including $2,000 of capital gain and $8,000 of corpus.

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

8.143 Section HC 16(6) contains three exceptions to the ordering rules: distribution by the trustee of a complying trust (discussed from [8.144], from a non-discretionary trust (from [8.147]) and where a foreign trust becomes a complying trust (from [8.151]). If any of these exceptions applies, the distributions are treated as consisting of amounts that reflect the terms of the trust or the exercise of the trustee's discretion.

Distribution by the trustee of a complying trust

8.144 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 income will have been taxed to the beneficiary as beneficiary income or to the trustee as trustee income, so it is not necessary to apply the ordering rules to limit opportunities for manipulation of distributions.

8.145 This is consistent with s HC 16(1), which states s HC 16 applies only when a distribution is made by a trustee of a non-complying trust or a foreign trust.

8.146 The overriding exclusion from the ordering rules for distributions from complying trusts that are treated as exempt (ie all distributions except beneficiary income) means distributions made by dual status trusts are not subject to the ordering rules.

Distribution from a non-discretionary trust

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

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

8.148 A non-discretionary trust is defined in s HC 16(8) and 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.

8.149 In these circumstances, less scope exists for distributions to be manipulated deliberately to avoid New Zealand income tax. This is because 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
- trusts are of a type where it is unlikely the terms of a trust deed would have been structured with a view towards avoiding New Zealand income tax.

8.150 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 this exception. If this were not the case, it would be possible to create or use non-discretionary trusts established on or before 17 December 1987 to avoid the ordering rules.

Distribution where a foreign trust becomes a complying trust

8.151 Section HC 16(6)(c) relates to trusts that were foreign trusts before a settlor of the trust became resident in New Zealand. The ordering rules do not apply to a distribution from such a trust if it was settled by a natural person and an election is made under s HC 30(2). Elections can be made by the settlor, a trustee or a beneficiary.

8.152 This is consistent with the fact the ordering rules do not apply to distributions made from complying trusts, which is the effect of an election. Elections are discussed in Part 10 (Transitional issues on becoming resident).

Resettlements

8.153 A resettlement occurs when the trustee of an existing trust makes a settlement of property on a new trust.

8.154 A distinction should be made between a resettlement that:

- is made on behalf of a beneficiary that coincides with the trustee transferring an absolute interest in the property to the beneficiary; and
- does not coincide with the trustee transferring an absolute interest in the property to the beneficiary, but which may give a beneficiary an interest in the property as a beneficiary of the new trust.

Resettlement made on behalf of a beneficiary

8.155 The first situation involves a:

- payment made by the trustee to the beneficiary for the purposes of the definitions of beneficiary income and distribution; and
- settlement by the beneficiary on the new trust.

8.156 A payment exists because the trustee has transferred an absolute interest in the property to the beneficiary by dealing with the amount in their interest or on their behalf (see the definition of pay in s YA 1). Having transferred an absolute interest in the property to the beneficiary, the trustee is a bare trustee in relation to the property. This means that s YB 21 (transparency of nominees) can apply to the trustee. Because the trustee makes the settlement on behalf of and as nominee for the beneficiary, the beneficiary is treated as the settlor of the trust under s YB 21(1).

8.157 The payment may be treated as beneficiary income or a taxable distribution to the beneficiary. This depends on the type of trust, the operation of the ordering rules, and the available income and capital gains of the existing trust.

8.158 For the trustee of the new trust, the property settled by the beneficiary is normally corpus, subject to any of the exclusions in s HC 4(3) to (5) applying.

Resettlement not made on behalf of a beneficiary

8.159 This section discusses the tax treatment of resettlements that do not coincide with the trustee transferring an absolute interest in the property to a beneficiary.

Corpus

8.160 The tax treatment of this type of resettlement largely depends on whether the resettlement is treated as corpus of the recipient trust.

8.161 The definition of corpus was discussed from [8.83]. In the context of a resettlement, it means an amount that is equal to the market value of a settlement of property by the existing trust on the recipient trust. If a property settlement from one trust to another is corpus (ie it is not excluded under s HC 4(3)), then the settlement does not give rise to income for the trustee of the recipient trust. It is also not a distribution under s HC 14.

8.162 A property settlement is excluded from the corpus of the recipient trust:

- to the extent to which, if the property were distributed to a beneficiary of the existing trust and the beneficiary was resident in New Zealand, the distribution would be beneficiary income or a taxable distribution to that beneficiary (s HC 4(3));
- if the settlor is allowed a deduction for the settlement (s HC 4(4)); or
- if, but for the fact of the settlement, it would be income of the settlor (or would be income if the settlor was resident in New Zealand at the time of settlement) (s HC 4(5)).

8.163 If a property settlement from the existing trust is excluded from corpus of the recipient trust, then the settlement is:

- trustee income under s HC 7(3); and
- a distribution under s HC 14.

Trustee income

8.164 As covered in Part 7 (Trustee income), s HC 7(3) extends trustee income to include the market value of any property settlement a trust receives that is excluded from corpus under s HC 4(3) to (5). The amount is reduced by the market value that the trustee treats as beneficiary income or a taxable distribution. Section CV 13(b) includes such amounts in the income of the trustee.

8.165 If the resettlement is made by a non-complying trust, the income is excluded income for the recipient trustee. However, the income is taxed to the trustee under s BF 1(b) at the non-complying trust tax rate. Therefore, the treatment of the settlement as trustee income and a distribution does not result in double taxation. However, as discussed at [8.175] it is possible for beneficiaries of the recipient trust to be taxed on subsequent distributions from the recipient trustee.

8.166 If the resettlement is made by a complying or foreign trust, the income may be assessable income for the recipient trustee and taxed at the trustee tax rate.

8.167 A resettlement of property that is excluded from corpus under s HC 4(3) to (5) is an amount of income that the recipient trustee derives or has derived for the purposes of the ordering rules in s HC 16(2)(a) and (b).

8.168 Note that the settlement amount is treated as income for the purposes of the ordering rules, even if the amount was a capital gain in the hands of the existing trust. On being resettled on the recipient trust, the amount, which is excluded from corpus under s HC 4(3), is recharacterised as trustee income and income under ss HC 7(3) and CV 13(b), respectively.

Distribution

8.169 A resettlement of property from an existing trust that is excluded from corpus of the recipient trust under s HC 4(3) is also a distribution under s HC 14(2)(a).

8.170 Section HC 14(1) provides that a trustee makes a distribution when the trustee transfers value to a person because the person is a beneficiary of the trust. This includes a situation where one trust (the existing trust) settles property on another trust (the recipient trust). In this situation, the recipient trust is a beneficiary of the existing trust.

8.171 Section HC 14(2)(a) provides that a resettlement is a distribution only if the amount or the property settled would have been beneficiary income or a taxable distribution to a beneficiary of the existing trust had it been distributed at the time to a beneficiary resident in New Zealand. These are the same circumstances as described under s HC 4(3).

Subsequent distributions by the recipient trustee

8.172 The following paragraphs discuss the tax implications of a subsequent distribution by the recipient trustee of an amount settled on the recipient trustee that was excluded from corpus under s HC 4(3) to (5).

8.173 As noted at [8.164], the market value of the property settled is treated as trustee income of the recipient trustee reduced by the amount of the market value that the trustee treats as beneficiary income or a taxable distribution.

8.174 If the recipient trust is a complying trust, then a subsequent distribution by the recipient trustee of any trustee income from the resettlement to a beneficiary of the recipient trust is exempt income of the beneficiary under s HC 20.

8.175 A subsequent distribution is a taxable distribution if the recipient trust is a foreign or non-complying trust. This is because the resettlement amount is income derived by

the trustee of the recipient trust that is treated as not being beneficiary income. This would be a taxable distribution under s HC 15 for a foreign or non-complying trust. This means the amount resettled could be taxed twice as is the case when a trustee of a foreign or non-complying trust accumulates income:

- once to the trustee of the recipient trust as assessable income (if the existing trust is a complying or foreign trust) or as a taxable distribution at the non-complying trust rate (if the existing trust is a non-complying trust); and
- again as a distribution to the beneficiary of the recipient trust at the beneficiary's marginal tax rate (if the recipient trust is a foreign trust) or at the non-complying trust rate (if the recipient trust is a non-complying trust).

Part 9: Special cases

Introduction

9.1 The general tax treatment discussed in this statement applies to most trusts, including the standard family or trading trust structures often used in New Zealand. However, different tax rules apply to:

- charitable trusts (from [9.2]);
- estates (from [9.24]);
- community trusts (from [9.41]);
- superannuation funds (from [9.45]);
- lines trusts (from [9.49]);
- licensing trusts (from [9.51]);
- bare trusts (from [9.53]);
- unit trusts (from [9.55]);
- Māori authorities (from [9.57]);
- foreign investment funds (from [9.59]).

Charitable trusts

9.2 Section HC 13 defines a charitable trust, for the purposes of the trust rules, as a trust for which:

- all income derived or accumulated by the trustee in the current or any earlier income year is held for charitable purposes; and
- any income derived by the trustee in the current year is exempt income under s CW 41(1) or s CW 42(1).

9.3 For the exemptions to apply, the trust must be a tax charity.

Charitable purposes

9.4 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.

9.5 "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:

- trust will be charitable for the purposes of the ITA 2007 if it meets the public benefit requirement apart from the fact the beneficiaries are related by blood; and
- 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.

9.6 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.

9.7 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 NZTC 21-088 the Supreme Court said charitable purposes must be recognised on a case-by-case basis by analogy with previous common law authorities. This was followed in *A-G v Family First New Zealand* [2022] NZSC 80.

9.8 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 (eg 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)).

Exemptions under ss CW 41 and CW 42

9.9 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.

9.10 A "tax charity" is defined in s YA 1 by reference to s CW 41(5). A trustee of a trust is a tax charity if it is registered as a charitable entity under the Charities Act 2005 (s CW 41(5)(a)). Under s 13(1)(a) of the Charities Act, a trustee qualifies for registration if an amount of income is derived in trust for charitable purposes.

9.11 In addition, a tax charity means a trustee that is non-resident, carrying out the trust's charitable purposes outside New Zealand and the Commissioner has approved the trustee as a tax charity in circumstances where registration as a charitable entity under the Charities Act 2005 is unavailable (s CW 41(5)(c)).

9.12 Under s CW 41, an amount of income derived by a trustee of a trust for charitable purposes is 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.

9.13 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 the:

- the entity is registered as a charitable entity under the Charities Act 2005 at the time the income is derived;
- the trust carries out its charitable purposes in New Zealand;
- the trustee of the trust is a tax charity; and
- no person with some control over the business can direct or divert an amount derived from the business to the benefit or advantage of a person other than the trust except for a purpose of the trust, and if the trust is carrying on the business for another trust, a person other than the operating entity cannot benefit except for a purpose of that entity.

9.14 Under s CW 42(3), a trustee is treated as carrying on a business if they acquire a revenue-producing asset from a person and that person retains or reserves an interest in the asset or the asset will revert to that person.

9.15 Under s CW 42(5), 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:

- 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
- that ability or influence arises because they are:
  - 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;
  - a director or shareholder of the company that is carrying on the business; or
  - associated with any relevant trustee, settlor, director or shareholder.

9.16 This requirement is 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 occurs.

9.17 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 the trust uses 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)).

9.18 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:

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

9.19 A relevant benefit or advantage may or may not be convertible to money and includes:

- deriving an amount that would be income under the ITA 2007; or
- retaining or reserving an interest in an asset disposed of to a trust or where the asset disposed of will revert to them.

9.20 However, a relevant benefit or advantage does not arise merely because a person earns interest on money lent at current commercial rates (s CW 42(8)).

9.21 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)). Where the charitable purposes are not limited to New Zealand, only the income apportioned to New Zealand is exempt. For further discussion about how the s CW 42 exemption applies, see **Charities: Business income exemption – IRRUIP17**.

Distributions

9.22 While many charitable trusts will not have beneficiaries and will instead use funds for charitable purposes, the definition of charitable purpose for tax purposes is broad enough to include trusts that have beneficiaries. Trust law determines the tax treatment of distributions from charitable trusts. Distributions from a charitable trust that is a complying trust, of amounts that are not beneficiary income, are 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.

Settlor liability

9.23 A settlor can be 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.

Estates

Estates are not trusts but some trust rules apply

9.24 The mere fact a person has died and an executor or administrator has been appointed to manage their estate does not give rise to a trust relationship. Trustees and executors/administrators have different capacities (*Re Hayes* [1971] 1 WLR 758 (Ch)). However, it will often be the case that a trust is created by a will (referred to as a testamentary trust). This can occur expressly by way of a statement in a will that specific property of the deceased will be held on trust for a named beneficiary. This could also occur where property is left for a minor beneficiary that needs to be held until the beneficiary is of age.

9.25 When a trust arises, particularly in a foreign context, is discussed in IS 19/04. IS 19/04 also discusses whether a New Zealand resident who receives money or property on the death of someone overseas has beneficiary income or a taxable distribution from a foreign trust.

9.26 Under s 43 of the TAA, an executor or administrator is responsible for filing the same returns a deceased taxpayer was required to furnish had they remained alive. In the year a person dies, any return will cover the period from the beginning of the income year in which the taxpayer died until the date of death.

9.27 Income derived by the taxpayer's estate after their death is accounted for by the estate in its IR6 return. Despite an estate (until assent) not being a trust, "trustee" is defined in s YA 1 as including an executor and administrator (as noted in Part 3 (Trustees and beneficiaries)). For clarity, where trustee is used in this section on estates, it means an executor or administrator. The trust rules also contain specific rules that apply to estates for administrative convenience.

9.28 Section HC 8(2) provides that an amount received in an income year by the trustee of an estate for the period after death is treated under s CV 12 as assessable income derived by the trustee during that income year.

9.29 However, this does not apply to reportable income received up to 28 days after a person's date of death (s HC 8(1B)). This income can be included in the final return for the deceased person and is not income derived by the trustee. It is particularly relevant to payments by the Ministry of Social Development.

9.30 As a result, a need exists to account correctly for different sources of income when derived. The trustee is required to register the estate as a new taxpayer and apply for

an IRD number in the name of the estate using **IRD number application: resident non-individual – IR596**.

9.31 Section HC 8(2) 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. Some doctors, directors and barristers may fall into this category (for further details, see **IS 16/06: Income tax – timing – when is income from professional services derived?**

9.32 Section HC 8(2) applies only where the amount received by the trustee of the estate is not income derived by the deceased person during their lifetime. Any income derived by the deceased during their lifetime should be returned on behalf of the deceased in a return under s 43(1) of the TAA. Section HC 8(2) also applies only if the amount the trustee received 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.

9.33 The effect of s HC 8(2) is that the amount the trustee of the estate receives is deemed to be income derived by the trustee. Because the amount is treated as income derived by the trustee and not trustee income, it can be vested absolutely in interest in a beneficiary of the estate or can be paid to a beneficiary of the estate and become beneficiary income where an interim distribution of the estate occurs. If there is no such vesting or payment, the income is taxed as trustee income.

9.34 The trustee of the estate is liable for income tax owed by the deceased as well as for any tax liability as trustee of the estate. However, 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 under s 177C(2)(c) of the TAA if an estate has been distributed.

9.35 A final tax return must be prepared for the period up to the date of distribution when the estate is wound up. The trustee of the estate 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.

9.36 Subject to exceptions for close relatives, transfers of property following death are treated as disposals at market value (under subpart FC). There is a transfer from the deceased to the estate and again when the estate is distributed.

Deduction of irrecoverable book debts

9.37 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 was earlier included in the deceased's assessable income or in the assessable income of the trustee of the deceased's estate.

9.38 In these circumstances, the amount written off is allowed as a deduction in this order:

- First, it is set against assessable income derived as trustee income during that income year.
- 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.
- 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.

9.39 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.

9.40 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

9.41 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 a trustee of a community trust is exempt under s CW 52.

9.42 Distributions from community trusts that are beneficiary income are taxed in the ordinary way under ss HC 17 and CV 13. Other distributions from community trusts are also taxable to recipients 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.

9.43 However, distributions from community trusts are not taxable to the extent the amounts represent:

- corpus of the trust (s HC 21(2)(b)); or
- a capital gain of the trust (s HC 21(2)(c)).

9.44 Contrary to the usual position, trustees of community trusts are not liable for tax as agents for recipients of distributions from community trusts under ss HC 32(3) and HD 12(1). Consequently, the obligation lies on the recipient of the distribution to include such income in a return and pay tax on it.

Superannuation funds

9.45 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 and if the retirement scheme is a trust, the trustees of the retirement scheme.

9.46 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)). However, all distributions to members of a superannuation fund are exempt income for the beneficiaries (ss HC 20 and CW 53).

9.47 Under s HC 24(5), the general rules for calculating trustee income are modified by ss CX 40 and DV 1 to DV 4. Under s CX 40, amounts derived from investments in life insurance policies entered into in New Zealand are 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.

9.48 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

9.49 A "lines trust" is defined in s YA 1 to mean a trustee of a trust that:

- has had shares allocated, transferred or vested in it, being shares in:
  - an energy company as defined in s 2(1) of the Energy Companies Act 1992 under an approved establishment plan under that Act;
  - a company under s 76 of the Energy Companies Act 1992; or
  - a company that has had assets and liabilities of the Crown transferred to it under s 16 of the Southland Electricity Act 1993; and
- continues to hold those shares.

9.50 There are no specific rules in the ITA 2007 for the taxation of lines trusts. 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 from [9.2]).

Licensing trusts

9.51 A "licensing trust" is included in para (a) of the definition of "company" in s YA 1 as it is a body corporate under ss 302 and 303 of the Sale and Supply of Alcohol Act 2012. This means a licensing trust has a legal existence separate from its members. A licensing trust may convert to be a community trust under ss 351 to 358 of the Sale and Supply of Alcohol Act 2012 but if it does, its status as a body corporate is preserved under ss 359 and 360 of that Act, so it will continue to be treated as a company under the ITA 2007.

9.52 Consequently, both licensing trusts and community trusts regulated by the Sale and Supply of Alcohol Act 2012 are not taxed as trusts under the trust rules.

Bare trusts

9.53 "Bare trust" is not a defined term in the ITA 2007. Under common law, a bare trust is a trust where the trustee has no obligations or duties to perform other than to maintain or transfer the property held by the trustee to, or as directed by, the beneficiary. The duties of a bare trustee are passive in the sense that a bare trustee must comply with the directions of the beneficiary and has no independent power, discretion or responsibility in connection with the trust property (*Estate of Frank Hillyer King v CIR* [2007] NZCA 474 and *Herdegen v FCT* (1988) 20 ATR 24 (FCA)).

9.54 Under s YB 21, where a person holds something or does something as a bare trustee for another person, the bare trustee is ignored and the other person is treated as holding or doing that thing for tax purposes.

Unit trusts

9.55 A "unit trust" is defined in s YA 1, subject to several exclusions, 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;

9.56 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, which have their own tax regime in subpart HM.

Māori authorities

9.57 Section HF 2 sets out the persons who are eligible to become a Māori authority by making an election under s HF 11. Under s HF 2(3), the trusts eligible to make an election to become a Māori authority are the:

- trustees of a trust established by an order made under Te Ture Whenua Māori Act 1993;
- trustees of a trust who own land that is subject to Te Ture Whenua Māori Act 1993;
- 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 Māori Fisheries Act 2004;
- 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 Māori Fisheries Act;
- 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
- the Māori Trustee in their capacity as an agent for the owner of land that is subject to Te Ture Whenua Māori Act 1993.

9.58 Section HC 1(2)(c) excludes Māori authorities from the trust rules. In addition, under s HC 35(4), the minor beneficiary rules do not apply to a distribution from a Māori authority. The ITA 2007 contains specific rules (mostly in subpart HF) relating to the tax treatment of Māori authorities and distributions from Māori authorities. Distributions from a Māori authority are taxed currently at a rate of 17.5%.

Foreign investment funds

9.59 A foreign investment fund (FIF) is defined in s EX 28 as:

- a foreign company;
- a foreign superannuation scheme;
- an insurer under a life insurance policy that is offered or entered into outside New Zealand; or
- an entity described in sch 25, part A (no entities are currently listed).

9.60 A foreign company includes a foreign unit trust. This is essentially a unit trust that is non-resident.

9.61 A "foreign superannuation scheme" is defined in s YA 1 as a superannuation scheme constituted outside New Zealand. A "superannuation scheme" is also defined in

s YA 1 as including a trust established for the purposes of providing retirement benefits to members or beneficiaries. Therefore, trusts that are constituted or administered outside New Zealand have the potential to fall within the definition of a FIF.

9.62 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 **Guide to foreign investment funds – IR461**.

9.63 Foreign superannuation schemes that are not taxed as FIFs may be taxed under the foreign superannuation scheme rules in s CF 3.

Part 10: Transitional issues on becoming resident

Overview

10.1 When a natural person immigrates to New Zealand or a returning New Zealander becomes resident again, there are tax implications when that person is a settlor of a foreign trust. This part explains those implications. It also explains the tax implications for settlors, trustees and beneficiaries when they become New Zealand resident. Whether a person becomes a transitional resident is a relevant consideration.

Transitional resident status

10.2 A transitional resident is a natural person who is resident after being non-resident for at least 10 continuous years and who has not been a transitional resident before. As a result, a transitional resident can be a person who has never been resident in New Zealand or a former New Zealand resident.

10.3 Transitional residents are exempt from tax under ss HR 8 and CW 27 on foreign-sourced amounts (other than income from employment and services) for a period:

- beginning on the earlier of the day they became a New Zealand tax resident through either having a permanent place of abode or having been personally present for more than 183 days; and
- ending at the earliest of:
  - the day they nominate to cease being a transitional resident under s HR 8(4);
  - the day before they stop being a New Zealand resident;
  - the end of the 48th month after the month in which they acquired a permanent place of abode; or
  - the end of the 48th month after the last day on which they satisfied the 183-day test.

10.4 The consequence of these rules is that the period a person is a transitional resident will frequently exceed 48 months and may extend to 60 months.

10.5 If a person elects to stop being a transitional resident under s HR 8(4), the election 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, civil union partner or de facto partner (if also a transitional resident) are treated as having made an application under s HR 8(4) (see Example | Tauira 29).

Example | Tauira 29: Calculation of transitional residency period

> Motoko moves to New Zealand from Japan on 1 January 2022. She has never been resident in New Zealand before.
>
> She becomes a resident on 2 July 2022 due to having been personally present in New Zealand for more than 183 days. Her residence is deemed to have started on 1 January 2022, which is the first of the 183 days. This is earlier than when she would be considered to have a permanent place of abode.
>
> Motoko's last day as a transitional resident will be on 31 July 2026 unless, on an earlier date, she applies for Working for Families tax credits, decides not to be a transitional resident or becomes non-resident again.

10.6 A transitional resident does not include a trustee in that capacity.

10.7 Further details about transitional residents are in IS 16/03 at page 26.

Change in settlor's residence affects foreign trust status

10.8 A trust settled by a non-resident before immigrating to New Zealand is a foreign trust under s HC 11 if at a moment in time no settlor is resident in New Zealand. As noted at [8.44], a moment in time is an event such as a settlor becoming resident or a distribution.

10.9 If a transitional resident establishes a trust, they will not be a foreign trust. This is because s HC 11 cannot be satisfied as a transitional resident is resident in New Zealand. Moreover, s HC 30(1)(b) cannot apply to treat distributions as being from a foreign trust as the trust does not exist immediately before the settlor becomes a resident. The trust will either be a complying or non-complying trust.

10.10 Once a settlor with a pre-migration trust becomes resident, or stops being a transitional resident and continues to be a resident, the trust has a year to make an election to be a complying trust. The election must be made before making a distribution, and tax must be paid on worldwide trustee income after the election date. The advantage of a trust becoming a complying trust is that distributions of accumulated income to beneficiaries after the election are not taxable.

10.11 Distributions of trustee income derived before the date of election, or the election expiry date if there is no election, are treated as coming from a foreign trust even though s HC 11 is not satisfied. If there are no resident trustees, trustee income and non-resident beneficiary income are taxed only if they have a New Zealand source.

10.12 If an election is not made before the election expiry date, the foreign trust becomes a non-complying trust. However, it is possible to make a retrospective election so

distributions from the trust can be treated as coming from a complying trust from the effective date. If the obligations of a trustee relating to trustee income have not been met, it is also possible to make a voluntary disclosure so future distributions can be treated as coming from a complying trust.

Election for a foreign trust to be a complying trust

10.13 A foreign trust that is not a dual status trust will not meet the requirements to be a complying trust under s HC 10(1)(a). This is because the worldwide income of the trustee will not have always been subject to tax in New Zealand. However, s HC 10(ab)(i) allows a person to convert a foreign trust into a complying trust if an election is made under ss HC 30 and HC 33 before the election expiry date and before a distribution.

10.14 If an election is not made in time, s HC 10(1)(ab)(ii) allows a retrospective election to be made so the trust can be a complying trust. Similarly, if tax obligations relating to the trustee's income tax liability have not been complied with, s HC 10(1)(ac) allows a voluntary disclosure to be made so distributions can be treated as coming from a complying trust.

10.15 If the trust has dual status as both a complying and a foreign trust immediately before the settlor becomes resident in New Zealand, it will not be treated as meeting the requirements of s HC 30(1)(b) such that s HC 30 will not apply. The Commissioner considers that the provision applies to a trust that is a foreign trust only and not also a complying trust. Consequently, a dual status trust will lose its status as a foreign trust on the day the settlor becomes resident and continue as a complying trust for so long as it meets the requirements of s HC 10(1). If the status of complying trust is subsequently lost, the trust would not then be able to rely on s HC 30 as the prerequisite condition of s HC 30(1)(b) would never have been satisfied. However, it could make an election under s HC 33 to maintain that status.

Election in time by a foreign trust to become a complying trust

10.16 Where a non-resident settles a foreign trust and immigrates or returns to New Zealand, an election can be made for the foreign trust to become a complying trust. This means distributions to beneficiaries of trustee income derived after the date of the election can be made tax free.

10.17 Section HC 10(1)(ab)(i) provides that a trust can be a complying trust if the requirements of ss HC 10(2) and HC 30(2) are met.

10.18 Under s HC 10(2), a foreign trust may become a complying trust to the extent set out in s HC 30 if an election is made under s HC 30(2) before the:

- time of distribution; and
- election expiry date given by s HC 30(5).

10.19 The requirements of s HC 10(1)(a) must also be met for trustee income derived after the date of the election. This essentially means New Zealand tax must be paid on the trustee's worldwide income and the tax obligations relating to trustee income must be satisfied.

10.20 Section HC 30(5) provides that the election expiry date is the day that is the first anniversary of the transition date. The transition date is set out in s HC 30(1)(a) in relation to a natural person. It is the day the natural person:

- becomes resident in New Zealand and is not a transitional resident; or
- stops being a transitional resident and continues to be a New Zealand resident.

10.21 Example | Tauira 30 illustrates the different times when a person ceases to be a transitional resident and when the election expiry date ends.

Example | Tauira 30: Transitional resident and election expiry dates

> Chris settles a trust while a non-resident and becomes a transitional resident on 31 March 2019. His last day as a transitional resident is on 31 March 2023. As he continues to be a New Zealand resident the following day, his transition date is 1 April 2023. The election expiry date is 1 April 2024. If an election is made before this date, distributions consisting of amounts derived after the date of election are treated as coming from a complying trust if the income tax liability relating to trustee income is satisfied.

10.22 The election under s HC 30(2) can be made by a settlor, trustee or beneficiary of the trust choosing to satisfy the income tax liability of the trustee under s HC 33(1). It does not need to be made by the trustee. Under s HC 33(4), the person making the election must advise the Commissioner of the election before the election expiry date. This is done using form **Election to pay income tax on trustee income - IR463**.

10.23 The liability of a trustee to satisfy their tax obligations on trustee income is not removed because a settlor or beneficiary has made an election under s HC 33. For example, if a settlor makes the election, a non-resident trustee of the trust will also remain liable for tax on New Zealand–sourced income (or worldwide income if the settlor continues to make settlements on the trust after becoming resident). The Commissioner is not constrained from pursuing any of the liable parties jointly or severally when assessing or collecting that tax. However, because the settlor has made the election, the Commissioner will pursue the trustee only if the settlor fails to satisfy the liability of the trustee. The Commissioner will not use these powers to collect more than 100% of tax due.

10.24 Under s HC 33(3)(a), the election takes effect on or after the election date. The person making the election, which can be the settlor, trustee or beneficiary, must satisfy the tax obligations of the trustee relating to the income tax liability of the trustee (s HC 33(2)). However, the person is not required to satisfy the income tax liability of the beneficiary that the trustee must satisfy as agent under s HC 32.

10.25 From the election date, the tax obligations of the trustee are determined under s HC 33(1C) on the basis that both the trustee and settlor are New Zealand residents. This means New Zealand tax is paid on worldwide income. For example, a non-resident trustee no longer derives non-resident passive income under s RF 2 and has non-resident withholding tax deducted. The trustee should request the payer of passive income, such as New Zealand interest, to deduct resident withholding tax instead.

10.26 The tax treatment of distributions is given by s HC 30(3). This section requires that the trust is treated as a foreign trust for distributions that:

- consist of an amount derived by the trustee before the date of the election; and
- do not give rise after the transition date to an income tax liability that is paid before the distribution is made (s HC 30(3)(a)).

10.27 The trust is treated as a complying trust for distributions that consist of an amount derived by the trustee:

- before the date of the election and give rise on or after the transition date to an income tax liability that is paid before the distribution is made; or
- on or after the date of the election, if the requirements of s HC 10(1)(a) are met (s HC 30(30(b)).

10.28 The trust is treated as a non-complying trust to the extent that a distribution consists of any other amount.

10.29 Section HC 30(6) sets out two methods for calculating income derived in the part of the income year before the election is made or before the election expiry date if no election is made. One method is to use the amount actually derived in that period. The other method is to apportion income derived in the year of election on a daily basis between the period before the election date or election expiry date and the rest of the year. The apportionment method is shown in Example | Tauira 31.

Example | Tauira 31: Calculating income derived before the date of the election

Kiri makes an election on 1 July for the foreign trust she settled overseas to be a complying trust. Kiri decides to use the apportionment method. The amount of trustee income derived in the period from 1 April to 30 June for the purposes of

s HC 30(3) will the amount of trustee income derived in the year of election multiplied by 91/365.

10.30 No methods are prescribed for calculating the income derived in the period after the election is made or has expired, but the Commissioner will accept either of the same two methods for this or any other reasonable method of apportionment.

10.31 Example | Tauira 32 demonstrates a settlor of a foreign trust making an election in time and the trustee's obligations being satisfied.

Example | Tauira 32: Election made and trustee's obligations satisfied

Facts

Sarah settles $100,000 on trust on 1 April 2017 when she is resident in South Africa. The trustees are all resident in South Africa. Two members of Sarah's family (Emily and Chloe) are beneficiaries of the trust. The trustees have discretion to pay income or capital to Emily and Chloe. No further settlements are made on the trust after 1 April 2017.

Sarah, Emily and Chloe become resident in New Zealand on 1 May 2017 and are transitional residents until the end of 31 May 2021. None has previously been resident in New Zealand.

On 1 November 2021, Sarah elects under ss HC 30(2) and HC 33(1) to pay tax on the trustee income of the trust. All the income the trustees derive is from outside New Zealand. The amounts the trustees derived and accumulated are shown in the following table.

Income year	Income	Capital gains
2018	$1,000	Nil
2019	$10,000	$5,000
2020	$11,000	$5,000
2021	$13,000	$2,000
2022	$8,000	$3,000
2023	$10,000	$3,000

Sarah pays tax on the trustee income derived between 1 November 2021 (the date of election) and 1 April 2023. On 1 April 2023, the trustees make distributions to Emily of $53,000 and to Chloe of $30,000. Emily and Chloe are still resident in New Zealand on 1 April 2023.

Tax consequences

Entitlement to make election

Sarah is entitled to make an election under ss HC 30(2) and HC 33(1). This is because she is the settlor of the trust and a natural person who stopped being a transitional resident and continued to be a New Zealand resident, and the trust would be a foreign trust immediately before Sarah ceased to be a transitional resident and continued to be a resident on 1 June 2021.

Emily and Chloe, as beneficiaries of the trust and the trustees in South Africa, could also have made the election.

The election had to be made within one year of the day on which the settlor ceased being a transitional resident and continued to be a New Zealand resident. Sarah stopped being a transitional resident and continued as a resident on 1 June 2021. The election could have been made at any time before 1 June 2022. Therefore, Sarah's election on 1 November 2021 was within time.

Trustee income

The trustee income was not liable to New Zealand tax before 1 June 2021 because all the income was derived outside New Zealand by non-residents and no settlor of the trust was a New Zealand resident who was not a transitional resident (ss BD 1(4) and HC 25(2)(a)).

If no election had been made, the income derived by the trustees after Sarah ceased to be a transitional resident and continued resident would have continued to be not liable for New Zealand tax. This is because all the income would have been derived by non-resident trustees from foreign-sourced amounts and Sarah was not resident in New Zealand at the time of settlement (s HC 25(4)).

However, due to the election, the trustee's tax obligations are determined on the basis that both the trustee and settlor are resident in New Zealand from the date the election applies, which is 1 November 2021 (s HC 33(1C)). Sarah is liable to meet the income tax liability of the trustees beginning on the date of her election under s HC 33(1).

The exclusion for non-resident trustees in s HC 25(4) does not affect Sarah's liability (or the requirements for a complying trust) (s HC 25(5)). However, Sarah is not liable as agent for the trustees for tax on trustee income. This is because Sarah 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 Sarah is liable to pay tax on the trustee income beginning on the date of election.

Sarah chooses to make a time-based apportionment under s HC 30(6) for trustee income derived before the election in the 2022 income year. The amount derived in this period is:

$$\$8,000 \times (214 \div 365) = \$4,690$$

Sarah is also liable to tax on trustee income derived in all subsequent income years. However, the $10,000 derived by the trustees in the 2023 income year is distributed to Emily as beneficiary income so there is no trustee income in that year.

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(1). The ordering rules in s HC 16(2) do not apply to the distributions to Emily and Chloe as Sarah is a natural person and an election has been made under s HC 30(2). The distributions are instead deemed to reflect the terms of the exercise of the trustees' discretion.

If it is assumed that the trustees exercise their discretion to pay income to Emily and capital to Chloe, the treatment of the distributions is as follows:

(a) *$53,000 distribution to Emily*

The trustees exercise their discretion to distribute income derived in the 2018 to 2023 income years.

The $10,000 derived in the 2023 income year is assessable as beneficiary income (ss HC 17(1) and CV 13(a)).

The $35,000 of income derived in the 2018 to 2021 income years and the portion of income derived in the 2022 income year before the election (ie $8,000 x (214 ÷ 365) = $4,690) are assessable as a taxable distribution of $39,690 from a foreign trust (ss HC 30(3)(a) and HC 15(4)).

The taxable distribution is taxed at Emily's marginal rates.

The remaining portion of income derived in the 2022 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), HC 20 and CW 53).

(b) *$30,000 distribution to Chloe*

The trustees exercise their discretion to distribute capital to Chloe. The distribution is of the $18,000 of capital gains derived by the trustees in the 2019 to 2023 income years and $12,000 of corpus.

Capital gains of $12,000 derived in the 2019 to 2021 income years and the portion of capital gains derived in the 2022 income year before the election are not assessable (ie $3,000 x (214 ÷ 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 2022 income year after the election, $1,241, and capital gains of $3,000 in the 2023 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), HC 20 and CW 53).

The distribution of corpus is not assessable.

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

Effect of not making a s HC 30 election

10.32 If an election is not made by the election expiry date, s HC 30(4) treats the trust as a foreign trust to the extent that a distribution consists of an amount derived by the trustee before the election expiry date and that amount does not give rise to an income tax liability on or after the transition date that is paid before the distribution is made.

10.33 The trust is treated as a non-complying trust to the extent to which the distribution consists of an amount derived by the trustee that gives rise on or after the transition date to an income tax liability that is not satisfied before the distribution is made (see Example | Tauira 33).

Example | Tauira 33: No election to pay tax on trustee income

Facts

The facts are the same as in Example | Tauira 32 except that no election is made to pay tax on trustee income before the election expiry date.

Tax consequences

Trustee income

Because no election has been made, the trustee income is not liable for tax after Sarah stops being a transitional resident and continues as a resident as explained in Example | Tauira 32. Sarah is not liable as agent for the trustees (for the reasons set out in Example | Tauira 32 under the heading "trustee income" that explain she was not resident when the settlement was made).

Distributions

The trust is basically treated as a foreign trust for any distribution of amounts derived before the election expiry date. It is treated as a non-complying trust where the distribution is of amounts derived by the trustee that gives rise to an income tax liability after the transition date (s HC 30(4)). The ordering rules in s HC 16 apply to determine the different elements of the distribution.

The distributions to Emily and Chloe are made on the same date of 1 April 2023 as in Example | Tauira 32. As no election was made, the ordering rules in s HC 16(2) override the trustee's resolutions.

(a) $53,000 distribution to Emily

The $10,000 derived in the 2023 income year is assessable as beneficiary income. Although the amount was paid on 1 April 2023 and the 2023 income year ended on 31 March 2023, it was still within the extended period available under s HC 6(1B) in which beneficiary income can be allocated.

The $43,000 from the income derived before the election expiry date on 1 June 2022 is assessable as a taxable distribution from a foreign trust at Emily's marginal rates (ss HC 30(4)(a), HC 15(4) and HC 16(2)(b)).

(b) $30,000 distribution to Chloe

The capital gains derived in the 2019 to 2023 income years of $18,000 are not assessable. They are amounts derived before the election expiry date of 1 June 2022 and do not give rise to an income tax liability (ss HC 30(4)(a) and HC 15(4)).

The distribution of corpus of $10,000 is also not assessable.

Late elections

10.34 If no election is made under s HC 30(2) before the election expiry date, it is still possible to convert a foreign trust to a complying trust by making an election using different provisions.

10.35 Under s HC 10(1)(ab)(ii), a foreign trust that would otherwise be a non-complying trust due to an election not being made before the election expiry date can become a complying trust. For this to apply, a person must make an election under s HC 33(1) to choose to satisfy the income tax liability of a trustee. This person can be a settlor, trustee or beneficiary. In addition, the trustee's income tax liability must be satisfied for all income years beginning on or after the date on which the election applies to the trust and before the time of distribution.

10.36 Under s HC 33(3)(b), the person making the election can choose it to apply from the:

- date of the election (the electing date);
- beginning of the income year that includes the electing date (the electing year); or
- the beginning of the income year that is four years or less before the beginning of the electing year.

10.37 If a trustee is required to file a return of income for an income year, the person must notify the Commissioner of the election within the time allowed for filing a return of income for the year. For a trust with a balance date of 31 March and no agent, this is 7 July.

10.38 The election may require the Commissioner to make an assessment or reassessment. If this is the case, the person making the election must provide the Commissioner with the information required under s 113F of the TAA to make a correct assessment of an affected year.

10.39 Where the election results in an increase in the assessed income tax liability of the trustee for an income year before the electing year, the person and trustee may not be liable for a penalty under part 9 of the TAA. This applies if the Commissioner accepts that the trustee's tax position for each income year beginning on or after the effective date and before the electing year is not:

- an unacceptable position under s 141B of the TAA;
- an abusive tax position under s 141D of the TAA; or
- a tax position that causes the trustee to be liable to pay a shortfall penalty for evasion of a similar act under s 141E of the TAA.

10.40 The effect on distributions of an election is determined by s HC 33(5) rather than s HC 30(3). The latter section applies in the case of an election made by the election expiry date.

10.41 Firstly, a distribution made before the beginning of the electing year has the tax consequences that it would have in the absence of an election. These are determined by s HC 30(4).

10.42 Secondly, a distribution made **after** the beginning of the electing year for an amount derived by a trustee **before** the effective date is treated as being a distribution by a trust having the status, of foreign trust, non-complying trust or complying trust, that the distributing trust has when the amount is derived.

10.43 Thirdly, a distribution made **after** the beginning of the electing year from an amount derived on or **after** the effective date is treated as being made by the trustee of a complying trust if the requirement to pay tax on worldwide income is met for trustee income derived on or after the effective date. A distribution is otherwise treated as coming from a non-complying trust.

10.44 Where the trustee derives an amount in an income year that includes the effective date, it can be apportioned on a daily basis or the actual amount derived before the effective date can be used (s HC 33(5)(d)).

10.45 These scenarios are summarised in Table | Tūtohi 1.

Table | Tūtohi 1: Distributions following late elections

Timing	Scenario 1	Scenario 2	Scenario 3
When amount derived by trustee	Before start of electing year	Before effective date of election	After effective date of election
When amount distributed by trustee	Before start of electing year	After start of electing year	After start of electing year
Tax treatment of distribution	As if no election made	As from a trust having the same status as when amount derived	From a complying trust if s HC 10(1)(a) met otherwise from a non-complying trust

10.46 Example | Tauira 34 involves a settlor of a foreign trust who migrates to New Zealand and does not make an election before the election expiry date but afterwards makes a late election.

Example | Tauira 34: Inbound migrating settlor

A settlor of a foreign trust, which was settled in 2004, migrates to New Zealand in 2009 and continues to be a New Zealand resident on 1 October 2013 (after ceasing to be a transitional resident). This is the transition date. All beneficiaries of the trust also migrate to New Zealand and continue to be New Zealand residents from the same date after ceasing to be transitional residents. The trustee is not resident in New Zealand.

The trust has both New Zealand–sourced rental income and foreign-sourced income. No s HC 33 election is made before the election expiry date on 1 October 2014. The trustee pays tax on New Zealand–sourced rental income but is not required to pay tax on the foreign-sourced income as no settlements have been made on the trust after becoming resident (second exception in s HC 25(4)). The balance date of the trust is 31 March.

A distribution (not being beneficiary income) of $1 million is made on 30 June 2016 to the New Zealand resident beneficiaries. No New Zealand tax is paid on this distribution by the trustee as agent for the beneficiaries.

The trustee wishes to make a distribution on 30 June 2021 and has learned that amendments made to the trust rules affect the taxation of distributions. As a result of this enquiry, the trustee learns that a s HC 33 election may be made to pay tax on worldwide trustee income retrospectively.

The trustee makes a s HC 33 election on 5 April 2021 to apply from the beginning of 1 April 2017. This is the beginning of the fourth income year before the income year beginning 1 April 2021. The trustee notifies the Commissioner of the election and provides the information required to reassess back years. The reassessments result in more tax being payable but no penalty results as the Commissioner accepts that the circumstances in s HC 33(6) do not apply.

Tax effect on distribution made on 30 June 2016

The tax consequences of distributions made before the electing year (ie before the beginning of 1 April 2021) are those that would have been in the absence of an election (s HC 33(5)(a)). These are determined under s HC 30(4) as it applied then. According to s HC 30(4), the trust is treated as:

- a foreign trust to the extent the distribution consists of an amount derived by the trustee before the election expiry date of 1 October 2014; and

- a non-complying trust to the extent that the distribution consists of an amount derived by the trustee on or after the election expiry date.

This analysis reveals that the distribution of $1 million comprised:

- $400,000 from trustee income derived before 1 October 2014 (a taxable distribution from a foreign trust);
- $250,000 from trustee income derived on or after 1 October 2014 (a taxable distribution from a non-complying trust);
- $300,000 from a capital gain derived before 1 October 2014 (a distribution of a capital gain from a foreign trust); and
- $50,000 from a capital gain derived on or after 1 October 2014 (a taxable distribution from a non-complying trust).

In summary, this distribution is treated as:

- $400,000 – as a taxable distribution from a foreign trust;
- $300,000 – as a taxable distribution from a non-complying trust; and
- $300,000 – as a distribution of a capital gain from a foreign trust.

For the taxable distribution of $400,000, the beneficiary is liable for tax at the beneficiary's marginal rate for the year ending 31 March 2017, along with any penalty and interest assessed for the late payment of that tax. For the taxable distribution of $300,000, the beneficiary is liable for tax at the 45% rate imposed on a taxable distribution from a non-complying trust, along with any penalty and interest assessed for the late payment of that tax. No tax is payable on the distribution of the capital gain from a foreign trust.

Proposed distribution on 30 June 2021

Because the trustee made a s HC 33 election with effect from 1 April 2017, the proposed distribution can be treated as a distribution from a complying trust to the extent the distribution is from income derived on or after 1 April 2017. However, this is dependent on the trustee satisfying the tax obligations of the trust **before** the date of the distribution at 30 June 2021 (s HC 33(5)(c)(i)) on the basis that both the settlor and trustee are treated as residents (s HC 33(1C)).

The proposed distribution is $1.5 million and the analysis of the source of that distribution shows:

- $450,000 is to be made from trustee income derived before 1 April 2017 (taxable distribution from a non-complying trust as the trustee derived non-resident foreign-sourced income); and
- $1.05 million is to be made from trustee income derived on or after 1 April 2017 (distribution from a complying trust).

This means the trustee is liable to pay tax at 45% on the taxable distribution of $450,000 (distributed from trustee income derived before 1 April 2017) as agent for the beneficiary but the distribution of $1.05 million is exempt income of the beneficiary.

This treatment in s HC 33(5)(b) for trustee income derived after 30 September 2014 and before 1 April 2017, and the treatment in s HC 33(5)(c) for trustee income derived from 1 April 2017 overrides the effect of s HC 30(4) for those periods.

These amendments also apply in the case of multiple non-resident settlors if only one of those settlors becomes a New Zealand resident. This is because the settlor regime taxes worldwide trustee income if at least one of those settlors is resident in New Zealand (s HC 25) subject to the exceptions.

Tax shortfall voluntarily disclosed

10.47 If an incorrect tax position is taken in relation to trustee income when no election is made under s HC 30(2), a voluntary disclosure can be made. This allows the trustee to correct past tax positions. Subject to the income tax liability and any shortfall penalty being satisfied before the distribution is made, it can be treated as coming from a complying trust.

10.48 Section HC 10(1)(ac) provides that a trust can become a complying trust if the requirements of s HC 30(4)(ab) are met. The requirements are met if a distribution consists of an amount derived by a trustee that gives rise on or after the transition date to an income tax liability that meets the requirements of s HC 30(4B) or s HC 10(1)(ab) (which deals with late elections). The transition date was explained at [10.20]. An income tax liability meets the requirements of s HC 30(4B) if:

- the liability is satisfied before the distribution is made; and
- the liability gives rise to a tax shortfall for the trustee for an income year ending before the distribution is made; and
- any shortfall penalty is satisfied before the distribution is made.

10.49 A "tax shortfall" is defined in s 3 of the TAA as broadly the difference between the tax effect of a tax position for a return period and the correct tax position. Shortfall penalties range from 20% of the tax shortfall to 150% depending on how the shortfall arose. However, to encourage voluntary compliance, penalties can be reduced by 75% to 100% under s 141G(3) of the TAA if the shortfall is voluntarily disclosed to the Commissioner before an audit starts.

10.50 Example | Tauira 35 shows the effect of a settlor making a voluntary disclosure.

Example | Tauira 35: Making a voluntary disclosure

A settlor of a foreign trust becomes resident in New Zealand on 1 April 2020. They are not eligible to be a transitional resident as they became resident within 10 years of becoming non-resident. No election is made before the election expiry date on 1 April 2021. The trust has a non-resident trustee who derives foreign-sourced income and New Zealand rental income.

The settlor makes a settlement on the trust on 1 June 2020. This means the second exception in s HC 25(4) no longer applies and the foreign-sourced amounts are assessable income along with the rental income. However, the non-resident trustee does not appreciate this and does not include it in their income tax return (IR6) for the 2021 and 2022 income years.

For Christmas 2022, the trustee proposes to make a distribution to the New Zealand resident beneficiaries. The trustee learns from a tax advisor that the foreign-sourced amounts were taxable but if a voluntary disclosure is made and the liability is satisfied (including any shortfall penalty) before the distribution it can be treated as coming from a complying trust and will be exempt income for the beneficiaries.

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

10.51 When a trust is established overseas, trustee income may not be subject to New Zealand tax. However, this changes 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. It is then necessary to establish, at the date of change, the cost of trading stock and depreciable assets the trust owns. It is also necessary to establish a value for financial arrangements that come into the tax base.

Valuation rules for when trusts come into the tax base

10.52 Section HC 31(1) applies 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". Non-resident passive income is defined in s RF 2 and includes interest and dividends.

10.53 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 became resident in New Zealand and an election was made under ss HC 30(2) and HC 33 to pay tax on trustee income.

10.54 In addition, s HC 31 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 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 becomes resident in New Zealand and an election is made to pay tax on trustee income, both the New Zealand and foreign business profits would be liable to income tax. Section HC 31 would then apply to the assets and financial arrangements used to earn the foreign-sourced business profits.

10.55 Section HC 31(1B) provides that s HC 31 does not apply to charitable trusts that fail to meet the requirements for deriving exempt income under s CW 41 or s CW 42. Instead, 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.

Cost of premises, plant, machinery, equipment and trading stock

10.56 Section HC 31(3) sets out the methods for determining the cost of premises, plant, machinery, equipment and trading stock on the change date. For premises, plant, machinery and equipment, the determination of cost forms the basis for any depreciation losses that are deductible from trustee income. For trading stock, the determination of cost establishes the opening value.

10.57 Either of two methods may be used. These methods can be described as the item's book value or New Zealand tax value. Under s HC 31(2), the person liable for income tax on trustee income chooses the method and should indicate the method taken in

the trust's income tax return. The person liable could be the settlor, trustee or beneficiary in the case of an election.

Book value method

10.58 The book value method treats the cost of an asset as the historical cost of the asset less accumulated depreciation. Alternatively, the cost can be the value used by the trustee for income tax purposes in a country (or territory) in which the trustee income has been liable to income tax. In either case, it cannot be more than market value.

10.59 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.

New Zealand tax value method

10.60 Under the New Zealand tax value 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 method is calculated in two steps:

10.61 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.

10.62 The second step is to deduct from the original value 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.

10.63 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.

10.64 Under the New Zealand tax value method, it is assumed the trustee income was always liable to New Zealand income tax. This does not, however, include an assumption that assets are in New Zealand and that any special rates of depreciation historically available in New Zealand are applicable. If, for example, assets were used to carry on a business in Hong Kong, the depreciation is calculated by assuming the trustee income derived from the Hong Kong business was always liable to New Zealand income tax and depreciation was allowed based on the assets being in Hong Kong.

Financial arrangements

10.65 Subsections (4) and (5) of s HC 31 set out a method for calculating the consideration for a financial arrangement on the change date. Common financial arrangements include loans and bank deposits. The amount determined is used to calculate the base price adjustment when the arrangement matures, is remitted, is sold or is otherwise transferred. The intention is to ensure income or expenses that would have been notionally accrued on 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 becoming liable to income tax.

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

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

10.67 In the formula:

- **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.

10.68 The consideration calculated is included in the formula in s EW 31 when calculating the base price adjustment for the financial arrangement.

Impact of transitional residence

Distributions from foreign trusts and non-complying trusts

10.69 Transitional residents are treated the same as non-residents under s HR 8(1)(a) when they derive foreign-sourced amounts with two exceptions. Income from foreign-sourced amounts is exempt under s CW 27 unless it is employment income or income from a supply of services. Consequently, a transitional resident who derives a foreign-sourced amount as either beneficiary income or a taxable distribution from either a foreign or non-complying trust is treated as deriving exempt income that is excluded from assessable income under s BD 1(5).

10.70 Beneficiary income retains the character it had when derived by the trustee because the trust provisions, such as s HC 5, are structured to retain the dual derivation of such income by both the trustee and the beneficiary as discussed in Part 5 (Beneficiary income).

10.71 Although taxable distributions are a construct of the trust tax regime, it is implicit from both the ordering rules in s HC 16 and s YD 4(13) and (18) that the source of the income or capital gains in the hands of the trustee that are subsequently included in such distributions remains relevant in characterising them for tax purposes. For more detail on the relevance of source and residency for the tax treatment to non-residents, see Part 8 (Distributions from trusts).

10.72 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 as under s YD 4(13) and (18). The ordering rules in s HC 16 determine the character of the taxable distribution. This means taxable distributions are not exempt to transitional residents under s CW 27 as foreign-sourced amounts to the extent they comprise accumulated income and associated party capital gain amounts sourced from New Zealand. A transitional resident who derives New Zealand–sourced taxable distributions from foreign trusts must include this in their assessable income.

10.73 New Zealand–sourced income included in taxable distributions to transitional residents from non-complying trusts is excluded income but is taxable to the transitional resident at the non-complying trust rate.

Distributions from complying trusts

10.74 Beneficiary income retains its underlying character (see Part 5 (Beneficiary income)). Consequently, a transitional resident receiving beneficiary income from a complying trust is taxed on New Zealand–sourced income within that distribution, but not on foreign-sourced amounts.

Taxation of foreign-sourced trustee income when the immigrating settlor is a transitional resident

10.75 The tax treatment of foreign-sourced amounts derived by a non-resident trustee is determined under s HC 25 (foreign-sourced amounts: non-resident trustees). Section HC 25 does not make non-resident trustees liable for tax on foreign-sourced amounts while the immigrating settlor is a transitional resident, but does in the income year any settlor ceases to be a transitional resident and continues to be a New Zealand resident.

10.76 One exception is where a trustee is always non-resident in an income year and the only settlements on the trust were made when the settlor was non-resident (s HC 25(4)). If a transitional resident makes further settlements, the exception does not apply after the person becomes resident. The exception does not apply because a settlement has been made by a New Zealand resident. This means that from the income year in which the settlor ceases to be a transitional resident, any foreign-sourced amounts are taxable where the trustee is non-resident.

10.77 Section HC 26, in conjunction with s CW 54, treats foreign-sourced amounts derived by resident trustees as exempt where the immigrating settlor is a transitional resident (and the trustees comply with certain registration and disclosure requirements) but not in the income year the settlor ceases to be a transitional resident.

10.78 New Zealand–sourced income of a trustee of a foreign or non-complying trust is always taxable irrespective of the status of the settlor.

Liability of settlor while a transitional resident

10.79 In general, a settlor who is resident in New Zealand is liable as agent of the trustee for income tax payable by the trustee. No liability exists if a trustee is resident at all times in an income year (s HC 29(3)).

10.80 Where a settlor who is a natural person makes no settlements on a foreign trust after they become resident and they had not previously been resident in New Zealand after 17 December 1987, they are also not liable under s HC 29(5) for the tax on trustee income of that trust. However, this exclusion does not apply if they make an election under s HC 33.

10.81 If a settlor makes further settlements on a foreign trust with non-resident trustees while they are a transitional resident, they are 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 are liable for tax on the foreign-sourced amounts of the trustee through the combination of ss HC 25(2) and HC 29(1).

Agency liability in respect of non-complying trusts

10.82 Where immigrants to New Zealand and returning New Zealanders who have been absent for more than 10 years settle a trust before 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(5). However, agency liability is 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 interest at a market rate on it. Also, returning

New Zealanders will have an agency liability if they had previously been resident in New Zealand after 17 December 1987.

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

Beneficiary income

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

Taxable distributions

10.84 Newly-resident beneficiaries who are not or who have ceased to be transitional residents are taxed on taxable distributions from foreign trusts at their marginal rates and from non-complying trusts at the non-complying trust rate.

New Zealanders returning within five years

10.85 If a person ceases to be resident and then returns to New Zealand within five years and resumes tax residency, they are taxed on all beneficiary income and taxable distributions they derived from foreign and non-complying trusts over the period of absence. The intention of s HC 23 is to prevent such beneficiaries from changing residence to defeat the trust rules.

10.86 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.

10.87 Any beneficiary income taxable under s HC 23 may be accompanied by relevant foreign tax credits or NRWT. 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

10.88 If a trustee migrates to New Zealand and becomes resident, that alone does not necessarily result in the trust being taxable. Liability on foreign-sourced amounts is determined by the residence of the settlor and beneficiaries. If the settlor is non-

resident and no beneficiaries are resident, the trustee has no liability for New Zealand tax in that capacity.

10.89 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 (Compliance).

10.90 A trustee will be a transitional resident under s HR 8 only in their personal capacity as a natural person, which excludes their status as a trustee. Section CW 27 does not apply to exempt foreign-sourced amounts from tax that a transitional resident derives as a trustee.

Part 11: Transitional issues on becoming non-resident

Impact of settlor leaving New Zealand

11.1 If all the settlors of a complying trust leave New Zealand, ss HC 26(1) and CW 54 result in foreign-sourced amounts derived by a resident trustee being exempt income in the income year following the departure of the last of the settlors. If the trustee is non-resident and s HC 25(2) applied to treat foreign-sourced amounts as assessable income due to a settlor being resident, the amounts become non-residents' foreign-sourced income. In both cases, the amounts are not assessable income under s BD 1(5). If the trustee does not pay tax on worldwide income, the trust ceases to be a complying trust at the time it next makes a distribution because it does not meet the requirements of s HC 10(1)(a)(i).

11.2 If complying trust status is lost, the trust becomes a non-complying trust and subject to the ordering rules in s HC 16 (discussed in Part 8 (Distribution from trusts)). Taxable distributions derived by any New Zealand resident beneficiaries attract tax at the non-complying trust rate. New Zealand-sourced taxable distributions to non-resident beneficiaries are also subject to tax at the same rate.

11.3 It is possible for an election to be made to maintain or gain complying trust status. This allows distributions made to beneficiaries to be exempt because tax has been paid at the trustee level. In some circumstances, an election can be deemed to have been made.

Election to remain a complying trust

11.4 Under s HC 10(1)(ab)(ii), a trust that would otherwise become a non-complying trust can continue to be a complying trust. A person must:

- make an election under s HC 33(1); and
- for all income years beginning on or after the date on which the election applies to the trust and before the time of distribution, satisfy the trustee's tax obligations relating to the trustee's income tax liability for the trustee income.

11.5 The election works in the same way as a late election described in Part 10 (Transitional issues on becoming resident). The person who makes the election can be a settlor, trustee or beneficiary. The person making the election can choose for it to apply from the:

- date of the election (the electing date);
- beginning of the income year that includes the electing date (the electing year); or
- beginning of the income year that is four years or less before the beginning of the electing year.

11.6 If a trustee is required to file a return of income for an income year, the person must notify the Commissioner of the election within the time allowed for filing a return of income for the year. The election is made on form IR463.

11.7 The election may require the Commissioner to make an assessment or reassessment in a year or years before the year in which the election is made. If this is the case, the person making the election must provide the Commissioner with the information required to determine the correct assessment under s 113F of the TAA.

11.8 Where the election results in an increase in the assessed income tax liability of the trustee for an income year before the electing year, the person and trustee are not liable for a penalty under part 9 of the TAA if the Commissioner accepts that the trustee's tax position for each income year beginning on or after the effective date and before the electing year is not any of:

- an unacceptable tax position under s 141B of the TAA;
- an abusive tax position under s 141D of the TAA; and
- a tax position that causes the trustee to be liable to pay a shortfall penalty for evasion of a similar act under s 141E of the TAA.

11.9 The effect of an election on distributions is determined by s HC 33(5).

11.10 Firstly, a distribution made before the beginning of the electing year has the tax consequences that it would have in the absence of an election.

11.11 Secondly, a distribution made after the beginning of the electing year for an amount derived by a trustee before the effective date is treated as being a distribution by a trust having the same status that the trust had when the amount was derived. The status could be that of a foreign trust, non-complying trust or complying trust.

11.12 Thirdly, a distribution made after the beginning of the electing year from an amount derived on or after the effective date is treated as being made by the trustee as trustee of a complying trust if the requirements of s HC 10(1)(ab) are met for trustee income derived on or after the effective date. These requirements are essentially that

the obligations to pay tax on the worldwide income of the trustee from the date the election applies have been met. A distribution is otherwise treated as coming from a non-complying trust.

11.13 Section HC 30(6) sets out two methods for calculating income derived in the part of the income year before the election is made or before the election expiry date if no election is made. One method uses the amount derived in the part-year. The other method apportions income derived in the year of election on a daily basis between the period before the election date or election expiry date and the rest of the year. No method is prescribed for calculating the income derived in the 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 or any other reasonable method of apportionment.

Deemed election to remain a complying trust

11.14 In some circumstances, the trustee may not be aware that the settlor or settlors have become non-resident. Section HC 33(1B) provides for a deemed election by a trustee. If the trustee pays tax on worldwide income and notifies the Commissioner that it is a complying trust, the trust can maintain that status.

11.15 The section applies if:

- the trust is a complying trust under s HC 10(1)(a) from when a settlement was first made until it failed to meet the requirements of s HC 10(1)(a)(i) by, for example, the trustee deriving non-residents' foreign-sourced income after the settlor becomes non-resident (the non-complying year); and
- the trustee meets the tax obligations relating to the income tax liability relating to the non-compliance and notifies the Commissioner that the trust is a complying trust.

11.16 If the trustee is required to file a return of income for the non-complying year, the notification must be in the return and filed by the due date. For a trust with a balance date of 31 March and no agent, the due date is 7 July.

11.17 If the trustee does not need to file a return of income for the non-complying year, the notification must be given by the due date for a return by a resident foreign trustee required by s 59D of the TAA for the non-complying year. This could be relevant to dual status trusts that do not derive any New Zealand-sourced income in a year.

11.18 Under s HC 30(3)(c), the deemed election applies on and after the beginning of the non-complying year. The election is effective until the beginning of an income year for which a trustee does not (s HC 30(3B):

- meet their tax obligations relating to their income tax liability for the income year; or
- notify the Commissioner that the trust is a complying trust for the income year.

11.19 Example | Tauira 36 and Example | Tauira 37 show the effect of a deemed election and a voluntary election respectively when a settlor has migrated.

Example | Tauira 36: Outbound migrating sole settlor

A sole settlor of a complying trust migrates from New Zealand and is a non-resident starting on 1 April 2021. The trustee is a non-resident. The settlor discloses that there were no New Zealand-resident trustees (s 59 of the TAA).

The trust continues to derive foreign-sourced and New Zealand–sourced rental income in the 2022 income year. Under the settlor regime, the foreign-sourced income is no longer liable for New Zealand tax for the 2022 income year under ss HC 25 and BD 1(4) as a settlor is not resident at any point in the year.

Consequently, the trustee is no longer liable for tax on worldwide trustee income in 2022 and the trust becomes a non-complying trust for subsequent distributions. Amounts other than beneficiary income and corpus are taxable distributions.

However, if the trustee continues to pay tax on worldwide trustee income at the trustee rate and notifies the Commissioner in the trust's annual return of income for 2022 (and subsequent years) by the due date for the return that the trust is a complying trust, the trust's complying trust status is maintained from the beginning of the year that the trustee was no longer subject to worldwide tax. This is provided for in ss HC 33(1B).

For multiple settlors, this example applies only if no settlor remains resident in New Zealand. If a settlor remains resident in New Zealand, then worldwide trustee income remains liable for tax at the trustee rate. If the trustee is a non-resident, then this resident settlor must satisfy the tax obligations on worldwide trustee income (s HC 29 refers). If these obligations are not satisfied, the trust becomes a non-complying trust.

Example | Tauira 37: Outbound migrating sole settlor

A sole settlor of a complying trust migrates from New Zealand and is non-resident starting on 1 April 2021. The trustee of this trust is non-resident, and all beneficiaries are New Zealand–resident individuals. The settlor discloses that there were no New Zealand–resident trustees (s 59 of the TAA).

The trust continues to derive only foreign-sourced income. Under the settlor regime, the foreign-sourced income is no longer liable for New Zealand tax for the 2022 and following income years under ss HC 25 and BD 1(4) as a settlor is not resident at any point in those years.

Consequently, the trustee is no longer liable for tax on worldwide trustee income and the trust becomes a non-complying trust for any subsequent distribution. It is proposed to make a distribution of $650,000 to the beneficiaries on 1 October 2023.

The trustee makes a s HC 33 election on 1 June 2023 before the proposed distribution. The effective date of the election is 1 April 2021 (s HC 33(3)(b)(iii)). The settlor and trustee are treated as being New Zealand resident from 1 April 2021 under s HC 33(1C).

Analysis of the proposed distribution of $650,000 under the ordering rules shows the entire amount is from trustee income derived in previous years:

- $200,000 from trustee income derived before 1 April 2021; and
- $450,000 from trustee income derived from 1 April 2021 until 31 March 2023.

The tax treatment of the distribution is determined by s HC 33(5) and comprises a distribution of exempt income of:

- $200,000 (prior year trustee income derived while a complying trust (s HC 33(5)(b)); and
- $450,000 (prior year trustee income derived while a complying trust (s HC 33(5)(c)(i)).

As long as the trustee satisfies their tax obligations before the distribution is paid relating to the income tax liability for trustee income in prior periods, the distribution will be exempt income for the beneficiaries.

Impact of trustee leaving New Zealand

11.20 Many countries base the tax residence of trusts on the residence of the trustee. Consequently, even if one trustee of a complying trust becomes resident in another country it may result in the new country of residence seeking to tax the trustee income of that trust.

11.21 In New Zealand, the residence of the trustee and the settlor need to be considered in determining the liability of the trustee to pay tax on trustee income. Where a trustee ceases to be New Zealand resident, they remain liable for tax on worldwide trustee income of a trust settled by a person who is resident in New Zealand. 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 subject to two exceptions discussed in Part 7 (Trustee income). New Zealand–sourced income derived by a non-resident trustee does not depend on the residence of the settlor and is taxable based on the source rules in s YD 4.

Beneficiaries ceasing to be resident in New Zealand

11.22 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 at their marginal tax rates on income such as rent. If the income is non-resident passive income such as interest, non-resident withholding tax is withheld. Foreign-sourced amounts are not assessable income of a non-resident under s BD 1(5).

11.23 A taxable distribution from a foreign trust to a non-resident beneficiary is taxable to the extent that 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 associated party capital gains.

11.24 A taxable distribution from a non-complying trust to a non-resident beneficiary is taxed at the non-complying trust rate under s BF 1(b) to the extent that it consists of New Zealand–sourced income and capital gains. Foreign-sourced amounts are not assessable.

Part 12: Associated persons

Overview

12.1 Subpart YB sets out the rules for determining when persons are associated for tax purposes. Several provisions in subpart YB deal with trusts.

12.2 The associated person rules prevent changes to the tax treatment of a transaction by conducting it with or flowing it through an associated party. They also treat transactions between associated persons as being undertaken at arm's length for tax purposes.

12.3 The rules for associated persons in the trust context are summarised in Table | Tūtohi 2:

Table | Tūtohi 2: Associated person rules

Associated person rule	Income tax – land	Income tax – other
Trustee and beneficiary (s YB 6)	No	Yes
Trustee and relative of beneficiary (ss YB 4 and YB 5)	No	Yes
Trustee and settlor (ss YB 8 and YB 10)	Yes	Yes
Settlor and beneficiary (ss YB 9 and YB 10)	No	Yes
Two trustees and same settlor (ss YB 7 and YB 10)	Yes	Yes
Trustee and person with power to appoint and remove the trustee (s YB 11)	Yes	Yes

12.4 Several modifications apply to the trust-based 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;
- excluding charitable trusts from the trustee and settlor test; and
- excluding the provision of services to a trust for less than market value from the definition of settlor for the purposes of the tests in ss YB 7 to YB 9.

Trust-specific associated person tests

12.5 Under s YB 6(1), a trustee is associated with 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:

> **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 beneficiary as well as discretionary beneficiaries 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.

12.8 Exceptions exist for certain employer trusts under s YB 15, the unit trust for the Bonus Bonds Scheme 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 people are associated under s YB 5(1) if one is a trustee and the other is associated under the "two relatives test" (s YB 4) with a person who has benefited or is eligible to benefit under the trust. The two relatives test determines that two people are associated if they are within two degrees of blood 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. Therefore, under s YB 5(1), a trustee is associated to a beneficiary's spouse, civil union partner, de facto partner, parents, grandparents, children, grandchildren, siblings, and parents of the person's spouse, civil union partner or de facto partner. The provision does not apply to land provisions under s YB 5(2), and there are also the same exceptions under s YB 16 (described at [12.8]).

12.10 The trustees of trusts with a common settlor are associated under s YB 7. Under this provision, two people who are married, in a civil union or in a de facto relationship are treated as the same person to prevent circumvention using 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; for example, 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 for the benefit of only employees (s YB 15).

12.11 A trustee and a settlor are associated under s YB 8. The same exceptions listed at [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 at [12.10] apply.

12.13 The associated person 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 (Special cases). 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 Corporate trustees are not looked through when testing association.

12.16 For more details on the associated persons regime, see **A guide to associated persons definitions for income tax purposes – IR620**. IR620 includes examples and an explanation of the reasoning behind various exclusions such as those for charities and energy consumer trusts (lines trusts).

Part 13: Compliance

Introduction

13.1 Various tax obligations are placed on settlors, trustees and beneficiaries of trusts. Many obligations are common to all taxpayers (eg the obligation to pay tax by the due date) and are not dealt with in this statement. This part explains compliance obligations unique to trusts.

Disclosure obligations where no resident trustee exists

Overview

13.2 Section 59 of the TAA requires a resident in New Zealand who makes a settlement on a trust on or after 17 December 1987 to disclose that settlement (and other details) to the Commissioner if there:

- was no resident trustee at the time of settlement; or
- was a resident trustee at the time of settlement but later there is no resident trustee.

13.3 A person who is resident in New Zealand and would be treated as the settlor except for the nominee provisions in s YB 21 must make a disclosure regarding the person deemed to be the settlor if there was no resident trustee at the time of the settlement. This applies, for example, to a New Zealand resident advisor who settles a trust with a non-resident trustee for a client.

13.4 The disclosure requirement does not apply to superannuation funds or any person in respect of a superannuation fund (s 59(4) of the TAA). Consequently, members of such schemes do not have to disclose their contributions.

Disclosure details under s 59

13.5 When s 59 of the TAA requires a resident settlor or nominee to make a disclosure, it must be on the prescribed form **Settlors of trusts disclosure – IR462**. This form requires:

- the name of the trust;
- the trust's IRD number;
- the trust's address;

- details of the settlor or the person treated as being the settlor where a nominee is acting;
- details of the settlement or settlements including:
  - the relevant dates;
  - the market value of property transferred to the trust;
  - details of consideration received by a settlor for property settled on the trust;
  - the legal description and location of any real property settled on a trust;
  - the number, type and name of the company and country of incorporation of any shares settled;
  - details of the parties, interest rate and term of financial arrangements settled;
  - the consideration paid and the nature of the services provided that are settlements;
- names and addresses of trustees and beneficiaries;
- copies of the trust deed and any amending deeds; and
- any other information the Commissioner requires.

13.6 Disclosure on the IR462 is required within three months of the date of settlement or of the date on which there is no longer a trustee resident in New Zealand. A fine not exceeding $50,000 may apply on conviction for knowingly failing to comply with the requirements of s 59 of the TAA.

Disclosure obligations for trustees of foreign exemption trusts

13.7 A trustee of a foreign exemption trust must register it with Inland Revenue (s 59B(2) of the TAA). A "foreign exemption trust" is defined in s 3(1) of the TAA for an income year or part of an income year (the test period). It means a trust for which a trustee is a New Zealand resident in the test period, no election under s HC 33 is effective for the trust and the test period, and:

- no settlor is resident in New Zealand at any time in the period starting on the later of 17 December 1987 and the date on which a settlement was first made on the trust and ending at the end of the test period; and/or
- the trustee takes a tax position that an amount of income derived by the trustee in or before the test period is exempt income under s HC 26.

13.8 A foreign exemption trust is therefore any trust that is a foreign trust with a resident trustee or a trust where the trustee makes use or has made use of the foreign-sourced income exemption under s HC 26. An exception applies if an election under s HC 33 is effective. If an election has been made, the trustee is taxed on their worldwide income and is subject to the domestic trust disclosure rules rather than the foreign trust disclosure rules.

13.9 Note that the definition of foreign exemption trust applies for the purposes of the foreign trust disclosure rules. The definition of foreign trust applies for working out how distributions are taxed under the ITA 2007.

13.10 The registration can be treated as in force at a date prior to the successful application if the Commissioner considers the trustee made reasonable efforts to obtain registration at the earlier date (s 59B(1B) of the TAA). This may allow the trustee to use the foreign-sourced income exemption even though there have been minor compliance issues.

13.11 A trust that was registered as a foreign trust when the Taxation (Annual Rates for 2022-23, Platform Economy, and Remedial Matters) Act 2023 received the Royal assent on 31 March 2023 is treated as being registered as a foreign exemption trust from that day (s 59B(1C) of the TAA) and is not required to register again.

13.12 A trustee that used the foreign-sourced income exemption before the Royal assent on 31 March 2023 of the Taxation (Annual Rates for 2022-23, Platform Economy, and Remedial Matters) Act 2023 and did not need to register previously had until 30 April 2023 to apply for registration of the trust. If the need to register arises after the assent date, the trustee must apply in the period of 30 days from the requirement commencing (s 59C(1)(b) of the TAA).

13.13 Subsections (3) and (4) of s 59C of the TAA provide for a grace period for registration if all trustees of a trust are natural persons who are not professional trustees, and none has been a trustee before with obligations to register a foreign exemption trust. If applicable, the time limit to apply for registration extends to four years and 30 days from the first date on which the trust became a foreign exemption trust.

13.14 This concession recognises that some people may become trustees due to changes of circumstances and allows them time to understand their obligations. However, a trustee must apply for registration by the end of this grace period to obtain the benefit of the tax exemption for foreign-sourced amounts under ss HC 26 and CW 54 for the income years during the grace period. This is the case even if the trust has ceased to be a foreign exemption trust by the time the grace period ends.

13.15 Where more than one trustee of a foreign exemption trust exists, each is responsible for the performance of the trustees' obligations relating to registration, disclosure of information, annual returns, financial statements and payment of fees (s 59B(7) of the

TAA). However, the trustee that applies for registration of the trust is the contact trustee and is responsible for all communication with Inland Revenue (s 59B(3) of the TAA).

13.16 The contact trustee must provide the following information about a foreign exemption trust at the time of registration (s 59B(3) of the TAA):

- the name of the trust;
- information about settlements made on the trust that are not the provision to the trustee of minor services incidental to the activities of the trust at less than market value and cover the period:
    - from when the trust was formed if the trustee is a professional trustee or not a natural person; or
    - from the later of when the trust was formed or four years before the earliest date when the trust was required to be registered if the trustee is a natural person;
- the name, email address, physical residential or business address, jurisdiction of tax residence, taxpayer identification number, and connection with the trust of:
    - settlors who have made settlements requiring disclosure;
    - all trustees and persons with control over the trust (eg protectors and people with powers of appointment); and
    - beneficiaries (information required about beneficiaries varies depending on factors such as whether the trust is fixed or discretionary and the dates of birth of the beneficiaries); and
- a copy of the trust deed, will or other document that creates and governs the trust, including any documents that amend or supplement the former documents.

13.17 The contact trustee must also provide a signed declaration under s 59B(4) of the TAA that each person referred to on the registration form:

- is deceased;
- cannot be located; or
- has been informed of and has agreed to provide the information necessary for compliance with the requirements relating to the provision of information about the trust imposed by the TAA and the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 (including any regulations under that Act).

13.18 Trustees of foreign exemption trusts must also comply with ongoing 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, with the due date for filing the return six months after the trust's balance date or by 30 September if the trust does not have a balance date (s 59D of the TAA);
- provide updates to the information provided at registration before or with the income tax return that is next due after the trustee becomes aware of the addition or alteration (ss 59B(5) and 59C(2) of the TAA); and
- provide a signed declaration for person who becomes a settlor after registration (s 59D(2B)(c) of the TAA).

13.19 If the contact trustee expects to cease to be the contact trustee, they must inform Inland Revenue of the date this is expected to occur, their contact details after that date and the contact details of the replacement contact trustee within 30 days of becoming aware of the anticipated date of cessation (s 59B(6) of the TAA). They must also provide details of changes to a trustee's email address, physical residential address or other contact details within 30 days of the anticipated change (s 59B(6B) of the TAA).

13.20 Trustees must also maintain records required by s 22 of the TAA (discussed from [13.30]).

13.21 A trustee must pay a fee to register a foreign exemption trust and for each annual return. However, no fees are payable where all trustees are natural persons who are not professional trustees (s 59E of the TAA).

13.22 A trust that has a dual status as both a complying trust and foreign trust must still meet the registration and ongoing disclosure requirements of a foreign exemption trust if it has a trustee resident in New Zealand.

13.23 If the trustee of a foreign exemption trust fails to comply with the registration and ongoing disclosure requirements, the trust will cease to be eligible for an exemption from tax on its foreign-sourced income under ss CW 54 and HC 26.

13.24 If a trust no longer meets the definition of foreign exemption trust or has registered by mistake, the Commissioner can deregister the trust on his own initiative (s 59DB(1) of the TAA) or on application by the trust (s 59DB(4) of the TAA). The deregistration is backdated to when the trust did not meet the requirements to register (s 59DB(2) of the TAA).

13.25 If the Commissioner proposes to deregister the trust, he must give 30 days' notice so the trustee can provide information why the trust should remain registered (s 59DB(3) of the TAA). If the trust applies for deregistration, certain information must be provided. This includes a final annual return (s 59DB(5) of the TAA).

13.26 Failure to comply with the disclosure can result in the loss of the foreign-sourced income exemption and/or a civil penalty of $1,000. The Commissioner has discretion to allow the foreign-sourced income exemption if the trustee has made reasonable efforts to comply and corrects the non-compliance (s 139AC of the TAA).

13.27 Inland Revenue can share information it obtains about foreign trusts with the Department of Internal Affairs, New Zealand Police and the Overseas Investment Office. In addition, Inland Revenue can share the information with New Zealand's tax treaty partners.

13.28 For further information on the foreign exemption trust disclosure rules, see Taxation (Annual Rates for 2022–23, Platform Economy, and Remedial Matters) Bill (No 2): Commentary on the Bill at 139–157.

Disclosure obligations for beneficiaries

13.29 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 – IR307**. A new form must be completed for each trust from which income is received. The form is filed with the beneficiary's tax return. This can be done online through myIR.

Records to be kept by resident foreign trustees

13.30 In general, a resident foreign trustee is obliged by s 22(2)(fb) of the TAA to keep sufficient records to enable the Commissioner to ascertain the assessable income, deductions and financial position of the foreign trust. Section 22(7)(d) of the TAA provides that these records should include:

- a record of the trust's assets and liabilities;
- records of sums of money received and expended; and
- records of the accounting system if the trust carries on a business, which extends to the charts and codes of accounts, accounting instruction manuals, and relevant system and programme documentation used in every income year to administer the trust.

13.31 These records are not required for the period covered by s 59C(3) of the TAA. This is the grace period for trustees who are natural persons and not in the business of providing trustee services.

13.32 Records should be retained for a period of at least seven years after the end of the income year to which they relate.

13.33 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.

13.34 Permission can be obtained from the Commissioner to keep records offshore and in languages other than English 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 21/02: Retention of business records in electronic formats, application to store records offshore and keeping records in languages other than English or te reo Māori**.

Sanctions for non-compliance

13.35 The TAA contains sanctions for absolute liability offences and knowledge offences. These sanctions range from fines to imprisonment on conviction of an offence.

13.36 A person commits an absolute liability offence under s 143 of the TAA if, for example, they:

- do not keep documents required to be kept;
- fail to register with a foreign government agency as required by part 11B of the TAA, which relates to the collection and sharing of information with other jurisdictions;
- do not provide information to the Commissioner as they are required to by a tax law; or
- do not provide taxable supply information as required by ss 19K or 19L of the Goods and Services Tax Act 1985.

13.37 A person who is convicted of an offence for the first time is subject to a fine not exceeding $4,000 under s 143(3)(a) of the TAA. If a person is subsequently convicted of the same type of offence, the maximum fine increases to $8,000 and then $12,000 for every other occasion.

13.38 Under s 143(1B) of the TAA, a trustee of a foreign trust cannot be convicted of an offence for not keeping records if they did not know of the requirements or another trustee was appointed as agent of the trustees and the Commissioner was notified of the appointment.

13.39 Under s 143(1C) of the TAA, a trustee of a foreign exemption trust cannot be convicted of an offence for not providing information required by ss 59B or 59D of the TAA if they did not know of the requirements or another trustee was appointed as agent of the trustees and the Commissioner was notified.

13.40 Section 143A of the TAA deals with knowledge offences. A person commits a knowledge offence under this section where they knowingly, for example, do not

keep records or fail to provide information. The range of offences is more extensive than in s 143 of the TAA.

13.41 If the resident trustee of a foreign trust is a corporate, a natural person commits the offence under s 147B of the TAA if they are:

- New Zealand resident;
- a director or have significant influence over the management and administration of the resident trustee; and
- the cause of the offence relates to an act done by the person, an omission by the person or through knowledge attributable to the person.

13.42 The maximum fines are higher for knowledge offences than for absolute liability offences. Under s 143A(7) of the TAA, the maximum fine for a first offence is $25,000. This increases to $50,000 for a second offence of the same type. A person can be liable to a term of imprisonment not exceeding five years and/or a fine not exceeding $50,000 if the offence relates to knowingly not paying withholding tax to the Commissioner.

13.43 As noted at [13.6], if a person knowingly does not provide information about a trust settled by a New Zealand resident with non-resident trustees or that information is false, the maximum fine is $50,000 on conviction.

13.44 Defences against conviction are in s 143A(2) and (4) of the TAA, depending on the category of knowledge offence.

Default assessments relating to trustee income

13.45 Section 93B of the TAA empowers the Commissioner to make default assessments in three situations. If the situations apply, the Commissioner may determine in a fair and reasonable manner the amount of trustee income for the income year. These situations are when a person:

- has failed to disclose the details of a trust settled by a New Zealand resident with non-resident trustees under s 59 of the TAA;
- has failed to provide information in relation to a trust requested by the Commissioner under s 17B of the TAA; or
- is unable to obtain sufficient information to calculate the amount of trustee income of the trust.

Sharing information about trusts with other countries

13.46 Inland Revenue provides information about foreign trusts to countries with which New Zealand has agreements on a case-by-case basis when a treaty partner makes a valid request. Inland Revenue is permitted to require information to be provided under s 17B 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.

13.47 There is no obligation to send information to treaty partners if a risk exists in how that information will be used or disclosed. Disclosure is restricted where the information is contrary to public policy or would disclose any trade, business, industrial, commercial or professional secret or trade process.

13.48 The G20/OECD standard for automatic exchange of financial account information in tax matters (AEOI) focuses on imposing due diligence and reporting obligations on certain financial institutions (OECD, *Standard for Automatic Exchange of Financial Account Information in Tax Matters* (2nd ed, OECD Publishing, Paris, 2017)). These obligations broadly involve identifying and reporting prescribed information to Inland Revenue about relevant foreign tax residents that hold (or in certain circumstances control) accounts with such institutions.

13.49 These obligations are in the Common Reporting Standard (CRS), which is in the AEOI (part II, chapter B) and supplemented with commentary (part III, chapter B). 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 Foreign Account Tax Compliance Act (FATCA) framework in part 11B of the TAA.

13.50 The CRS includes certain unit trusts and managed investment trusts in the term "financial institution". Settlors, mandatory beneficiaries, discretionary beneficiaries (if they receive distributions), any other natural persons who have effective control over the trust, and any persons that provide a loan (or other debt funding) to the trust are deemed to hold a financial account with such a financial institution trust.

13.51 If a trust is not a financial institution but is a type of passive entity (known as a passive non-financial entity) that holds an account with a financial institution, it may be asked by that institution to confirm who its controlling persons are (ie when that financial institution is carrying out its own due diligence on the trust's account). The trust's controlling persons are the settlors, trustees, protectors, beneficiaries, and any other natural person that controls the trust.

13.52 For more guidance on AEOI/CRS obligations at the time of implementation for trusts that are financial institutions, see Taxation (Business Tax, Exchange of Information, and Remedial Matters) Act 2017, *Tax Information Bulletin* Vol 29, No 4 (May 2017): 11.

13.53 See also the two detailed technical guides **Is the Trust a Reporting NZFI under CRS? – IR1052** and **Family Trust obligations under the CRS – IR1053**.

13.54 In addition, guidance on the operation of the FATCA framework as it applies to trusts is in **Foreign Account Tax Compliance Act (FATCA) – trusts guidance notes - IR1087**.

Filing of tax returns and additional information requirements

Overview

13.55 Trustees who derive assessable income must file a return under s 59BA(1) for the tax year of all income derived in the corresponding income year in the form prescribed by the Commissioner. Unless the trust is an excluded trust under s 59BA(3), the trustees are also required to include the information set out in s 59BA(2)(a) to (f).

13.56 Trustees who derive assessable income are also obliged to prepare the financial statements required by the Tax Administration (Financial Statements – Domestic Trusts) Order 2022. However, these financial statements are not required to be provided to the Commissioner (unless the Commissioner requests them). Certain information will need to be copied from the financial statements and included in the tax return filed with the Commissioner.

13.57 The requirements are explained in more detail in **OS 22/02: Reporting requirements for domestic trusts**.

Non-active trusts and estates excused from filing

13.58 Section 43B of the TAA provides that a trustee of a trust or an administrator or executor of an estate is not required to make a return of income for a tax year if:

- the trust or estate is non-active throughout the income year;
- the trust is a complying trust; and
- a **Declaration for trusts and estates not required to file returns – IR633** has been submitted to the Commissioner for trusts or estates with an IRD number. This declaration is not required if the trust or estate does not have an IRD number and the other criteria are met.

13.59 This measure provides relief to trusts or estates with little or no income. For example, it may remove the filing obligations for some trustees that own houses occupied by beneficiaries who do not pay rent. If the trust or estate ceases to be non-active, the

trustee, administrator or executor must inform the Commissioner under s 43B(4) of the TAA.

13.60 Under s 43B(2) of the TAA, a trust or estate is non-active for a tax year if it has:

- not derived any assessable income;
- no deductions; and
- not been a party to any transactions involving assets of the trust or estate with a person who is associated with the trustee of the trust or executor or administrator of the estate that give rise to income in any person's hands or a fringe benefit to an employee or former employee.

13.61 In determining the non-active status of the trust or estate, no account is taken of the following under s 43B(3) of the TAA:

- reasonable fees paid to professional persons to administer the trust or estate;
- total bank charges and other minimal administration fees not exceeding $1,500 per year;
- income derived by a trustee of a trust or an executor or administrator of an estate that would be reportable income for an individual does not exceed $1,000 per year; or
- insurance, rates, interest and other expenditure incidental to a dwelling owned by the trust or estate and incurred by beneficiaries.

13.62 A trustee of a trust is also not required to file a tax return for a tax year if:

- the trust is a testamentary trust;
- the trust is a complying trust;
- the IR633 has been submitted to the Commissioner in cases where the trust has an IRD number;
- no assessable income has been derived by the trustee or the amount derived does not exceed $5,000 and would be reportable income if derived by an individual; and
- assessable income derived by the trustee that would not be reportable income for an individual does not exceed $1,000 and the total of deductible expenditure is not exceeded by the assessable income by more than $200.

Allocation of tax credits by a trustee – imputation credit exception

13.63 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. The exception to this general rule is that imputation credits cannot be streamed.

13.64 Where a beneficiary derives a dividend with an imputation credit, the credit is limited by the formula in s LE 5. This rule prevents trustees from streaming credits to those beneficiaries best able to use them. Note that the beneficiary only needs to include the reduced credit in the amount of dividend income under s CD 15(1)(a). The formula is:

(person's distributions ÷ trust distributions) x (total beneficiary credits – person's supplementary dividend)

13.65 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.

13.66 When applying the formula, all distributions, including those of corpus and non-taxable capital gains, are included, not just beneficiary income. The meaning of distribution is discussed in Part 8 (Distributions from trusts) and includes the use of trust property for less than market value. The formula applies whether or not the trustees have any discretion to differentiate between beneficiaries. The application of the formula is shown in Example | Tauira 38.

Example | Tauira 38: Allocation of imputation credits to beneficiaries

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

The formula requires the imputation credits to be allocated as shown in the following table.

Beneficiary	Distribution	%	Imputation credits
Daniel	$20,000	33.33	33.33% x $600 = $200
Aroha	$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 income beneficiaries.

13.67 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.

13.68 If a trustee derives income because of the minor beneficiary rule, they are treated as a beneficiary for any tax credit (s LE 4(2)). This means the trustee can use the tax credit against tax payable on the income, but it may be limited by the rules in s LE 5.

Resident withholding tax substitution payments

13.69 The RWT rules allow a trustee to choose to detach some or all of an RWT tax credit from distributions made to a beneficiary on a lower tax rate (beneficiary A) and replace those detached RWT credits with a cash payment (referred to as an RWT substitution payment) (ss LB 3(4) and RE 2(7)). The trustee is then allowed to pass all, some or none of those detached tax credits to another beneficiary (beneficiary B) (s LB 3(5)). The trustee can use tax credits not passed to a beneficiary to satisfy the tax liability on trustee income (s LB 3(5)). Importantly, these rules apply only where the trustee pays tax as agent for the beneficiary (s LB 3(7)).

13.70 The effect of these rules is that beneficiary A does 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 RWT substitution payment. The RWT substitution payment is treated by s RE 2(8) as being resident passive income that is beneficiary income. The trustee has no obligation to withhold RWT from the substitution payment despite its deemed status as resident passive income. These rules also allow the trustee to allocate RWT credits to beneficiaries in a way that will ensure they can best be utilised (see Example | Tauira 39).

Example | Tauira 39: Trustee pays RWT substitution payment

The trustees of 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 Manaia, a beneficiary with a marginal tax rate of 17.5%. They resolve to detach $155 of the RWT tax credits from the distribution to Manaia and replace them with an RWT substitution payment of the same amount.

As a result, Manaia 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 that is distributed to her, so she has no further tax to pay. Manaia receives $825 cash, being the net cash from the government stock and the RWT substitution payment of $155. In economic terms, Manaia is in the same position as having received $670 and obtained a refund of $155 from the excess RWT paid.

The trustees choose to allocate the detached RWT tax credit of $155 to another beneficiary, Sarah.

Māori authority tax credits cannot be streamed

13.71 Where a trustee distributes a taxable Māori authority distribution to a beneficiary, they cannot allocate any Māori authority tax credits as they choose. The credit is limited by a formula in s LO 2 to prevent streaming. The formula is:

(person's distributions ÷ trust distributions) × (total beneficiary credits − person's supplementary dividend)

13.72 In this formula:

- **person's distributions** is the total taxable Māori authority distributions for the tax year made to the person in their capacity as beneficiary of the trust;
- **trust distributions** is the total distributions for the tax year made to all beneficiaries of the trust in their capacity as beneficiaries and includes all supplementary dividends paid to them;
- **total beneficiary credits** is the total Māori authority credits attached to taxable Māori authority distributions and total supplementary dividends for the tax year made to all beneficiaries of the trust in their capacity as beneficiaries; and
- **person's supplementary dividend** is the total supplementary dividends for the tax year paid to the person in their capacity as beneficiary of the trust.

13.73 When applying the formula, all distributions, including those of corpus and non-taxable capital gains, are taken into account, not just beneficiary income. The

meaning of distribution is discussed in Part 8 (Distributions from trusts) and includes the use of trust property for less than market value. The formula applies whether or not the trustees have any discretion to differentiate between beneficiaries.

13.74 The formula operates in the same way as the formula used to prevent streaming of imputation credits, illustrated in Example | Tauira 38.

Withholding tax obligations on trustees

13.75 A New Zealand resident trustee has an obligation to withhold RWT from distributions made to beneficiaries of resident passive income if the trustee has RWT-exempt status under s RE 27 such that RWT was not previously withheld on that income (ss RE 3 and RE 4). "Resident passive income" is defined in s RE 2(1) to include interest, dividends, taxable Māori authority distributions and replacement payments under share-lending arrangements.

13.76 The trustee does not, however, have any obligation to withhold RWT if the beneficiary has RWT-exempt status (s RE 5). Under s RE 27(4), a person who has RWT-exempt status must notify their investment provider so the information can be checked against the resident withholding tax exemption register.

13.77 If the trustee does not have RWT-exempt status and receives the resident passive income in the conduct of a taxable activity, the trustee is also obligated to withhold RWT and pay it to the Commissioner if the trustee receives a payment of resident passive income and the correct amount of RWT has not previously been withheld (s RE 7).

13.78 If trustees have RWT-exempt status, the status is reflected in the resident withholding tax exemption register using the trust's IRD number. Therefore, the status 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.

13.79 A resident trustee of a complying trust that 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, which is defined in s RF 2.

13.80 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 six-month intervals if the annual amount is less than $500. For more details on the obligations for NRWT payers, see **NRWT: Payer's guide – IR291**.

13.81 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.

13.82 If RWT has already been deducted from the income, the RWT paid is used to offset the NRWT payable (under s RF 5). 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.

13.83 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 is trustee income. If, however, the trustee makes any charges 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.

13.84 If a non-resident beneficiary has a fixed entitlement under the terms of the trust to any non-resident passive income, the trustee can arrange for the payer at source to deduct NRWT at the appropriate rate rather than have the trustee attend to this. The trustee needs to prove the beneficiary's entitlement to the payer's satisfaction.

13.85 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.

13.86 In general, s 22AAB of the TAA imposes an obligation on a person who is liable to withhold RWT or NRWT to keep proper records in English or te reo Māori for seven years.

Agency obligations for trustees and settlors

Trustee and settlor agency liability

13.87 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 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.

13.88 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 (IR6), attaching form **Estate or trust beneficiary details – IR6B** to record the income distributed and tax paid for each beneficiary.

13.89 An agent is assessed on such income as if they 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.

13.90 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 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.

13.91 Section HC 29(2) makes a settlor liable as agent of a trustee for income tax payable by the trustee. 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 (s HC 29(3)). The settlor also has no liability if they were not resident in New Zealand when any settlement was made on the trust, and they were not, after 17 December 1987, previously resident in New Zealand (s HC 29(5)). Consequently, s HC 29 routinely applies to settlors of non-complying trusts. The intention of the provision is to enable tax to be captured from resident settlors on trustee income when trustees are non-resident.

13.92 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.

13.93 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 certain financial arrangements.

Trustee liability as agent of beneficiary

Residence of a trustee is not relevant

13.94 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.

13.95 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.

Beneficiary may undertake the duties with consent

13.96 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

13.97 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.

13.98 For example, if during the income year ending 31 March 2023 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 shown in Table | Tūtohi 3.

Table | Tūtohi 3: Beneficiary tax calculation

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
Total	**$8,020**
Tax payable on beneficiary income	
$8,020 × ($5,000 ÷ $50,000)	$802

13.99 Where a beneficiary derives a taxable distribution from a non-complying trust, the non-complying trust rate applies (s HC 34 and sch 1, part A, cl 4).

13.100 In practical terms, where the trustee has paid tax on beneficiary income or on a taxable distribution in full, the beneficiary is not 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 is required to pay the difference. If they do not, the trustee remains liable. Ensuring the correct amount of tax is paid requires communication between the trustee and beneficiary.

Right of recovery against beneficiary

13.101 Under s HD 5(2), when an agent pays tax they 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 income or 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

13.102 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.

13.103 If an election is not made under s HC 33 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.

13.104 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).

13.105 The same agency consequences that apply 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. The Commissioner is not required 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.

13.106 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.

13.107 Settlors are 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 other settlors should be liable, having regard to their respective settlements.

Exceptions to settlor liability

Trustee resident

13.108 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.

13.109 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, is liable for the tax on trustee income under s HC 29 unless an exception applies. The most likely exception is the presence of a New Zealand–resident trustee for the entire income year during which the corporate settlor is resident under s HC 29(3).

13.110 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.

Superannuation funds and charities

13.111 Settlors 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 worldwide income, and there is no beneficiary income for members of superannuation funds because all income is taxed to the trustee. Settlors 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 settlors 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.

Non-resident settlors

13.112 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.

13.113 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 settlors 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.

13.114 Immigrants who settled trusts before becoming resident in New Zealand (and expatriate 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 settlors of such trusts are treated in a similar manner to resident settlors who settled trusts before 17 December 1987. For more information on the election procedure for newly resident settlors, see Part 10 (Transitional issues on becoming resident).

13.115 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 to only 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.

13.116 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 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 continues to be exempted from liability for tax on trustee income if s HC 29(5) is satisfied.

Limitation of liability

Requirements and application

13.117 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.

13.118 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.

13.119 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 are acceptable to the Commissioner.

13.120 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 (see Example | Tauira 40).

13.121 The second method is by tracing the income attributable to the property settled on the trust by the settlor.

Example | Tauira 40: Apportioning liability between settlors

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

trustee income × ($10,000 ÷ $20,000)

In year 4, the proportions of trustee income for which Atarangi and Rawiri are liable are recalculated by revaluing the property originally contributed by them and adjusting for the additional settlement made by Rawiri. The proportion of trustee income for which Atarangi is liable to income tax is:

($15,000 ÷ $35,000) x 100% = 43%

Rawiri is liable to income tax on the remaining 57% of the trustee income.

13.122 Where different types of property are settled producing different returns, the tracing method may be more appropriate. This method 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.

13.123 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 does not apply. Whether it can be applied or not depends on the facts of each case.

Limitation of liability and complying trust definition

13.124 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) and (ab) when meeting the requirements of a complying trust.

13.125 Consequently, 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. However, as noted in Part 11 (Transitional issues on becoming non-resident), a trust that loses its complying trust status can regain that status by satisfying the trustee's income tax liability for the life of the trust up to the time of distribution.

Trustee income from remittance of debt

13.126 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 s EW 31 or s EZ 38 from amounts remitted by the settlor using the base price adjustment mechanism under the financial arrangements rules.

13.127 The remittance of a financial arrangement generally gives 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 remains 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.

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