# APPENDIX TO TIB No. 5, NOVEMBER 1989

# EXPLANATION OF TAXATION OF TRUSTS

# INTERPRETATION OF SECTIONS 226 TO 231 OF THE INCOME TAX ACT 1976

## TABLE OF CONTENTS


| | Page |
|---|---|
| 1. INTRODUCTION | 1 |
| 2. OVERVIEW OF TRUST TAXATION REGIME | |
| Basic features of the trust taxation regime | 1 |
| General application of trust regime | 2 |
| Beneficiary income and trustee income | 3 |
| Settlor definition and liability | 3 |
| Classification of trusts and taxable distributions | 4 |
| Trusts settled by persons becoming resident in New Zealand | 5 |
| Trusts settled by residents on non-resident trustees before 17 December 1987 | 6 |
| Disclosure of settlements | 6 |
| 3. APPLICATION DATE | 7 |
| Section 9 Income Tax Amendment Act (No 5) 1988 Proviso to section 9 | 7 |
| - Objective | 7 |
| - Terms of the proviso | 7 |
| - Resettlement of pre-1989 income year amounts | 9 |
| - In specie distributions | 9 |
| - Exception to the proviso | 10 |
| 4. INTERPRETATION AND DEFINITION | 10 |
| Overview of s.226 | 10 |
| Definitions: s.226(1) | 10 |
| - Arrangement | 10 |
| - Beneficiary income | 10 |
| - Controlled foreign company | 10 |
| - Corpus | 10 |
| - Disposition of property | 13 |
| - Distribution | 13 |
| - Foreign trust | 18 |
| - General power of appointment | 19 |
| - Non-qualifying trust | 19 |
| - Qualifying trust | 20 |
| - Taxable distribution | 23 |
| Settlor definition: s.226(2) to (7) | 25 |
| Charitable trusts: s.226(8) and (9) | 25 |
| - Effect of charitable trust status | 25 |
| - General definition: s.226(8) | 26 |
| - Business carried on by or on behalf of trustees: s.226(9) | 26 |

**Unit trusts: s.226(10)** 27

- Exclusion from trust regime 27
- Unit trusts 27
- Foreign investment funds 28
- Summary of treatment of trusts and interests in trusts 29

**Associated persons transactions and foreign trusts: s.226(11)** 30
**Settlements by employers: s.226(12)** 30

5. BENEFICIARY INCOME AND TRUSTEE INCOME 30

**Overview** 30
**Beneficiary income** 30

- Significance and background 30
- Replacement of entitlement in possession with vesting and removal of restrictions on paid or applied limb 31
- Beneficiary income first derived by trustee 31
- Income vesting absolutely in interest in the beneficiary 32
- Income paid or applied by the trustee: comparison with previous regime 32
- Meaning of paid or applied 33
- Six month rule 34
- Trust records 35
- Beneficiary income and the superannuation regime 35

**Trustee income** 35
**Beneficiary income and trustee income where income is passedbetween trusts** 35

- The issue 35
- Examples 36

6. SETTLOR DEFINITION 37

**Significance** 37
**Overview** 37
**Settlements by way of a disposition of property** 38

- Requirements 38
- Definition of disposition of property 38

**Settlements where property is made available to trustees** 42

- Requirements 42
- Timing of transaction 42
- Financial assistance 42

**Provision of services as a settlement** 43
**Trust property used or acquired or servicesprovided by trustees at above market value** 43
**Section 226(2) concluding language** 43

- Description 43
- Objective 43
- Effect of the concluding language 44

**Section 226(2) proviso: value provided by beneficiaries** 45
**Transaction or series of transactions** 45
**Indirect transactions** 46

- Objective 46
- Indirect dispositions of property 46
- Indirectly making property available to a trust 46

- Indirect provision of services to a trust 47
- Indirect acquisition, or use of, property of the trust or indirect provision of services by the trustees 47

**Market value** 47

- Significance 47
- Market value compared with "fully adequate consideration" 47
- General principles 47
- Services provided by professional advisers 49
- Services provided by trustees 49
- Forgiveness of debt 49

**Nominee and nominal settlors** 49

- Significance 49
- Requirements 50
- Disclosure 50

**Settlements by closely held companies: s.226(4)** 50

- Objective 50
- Application of s.226(4) 50
- Effect on the company 52
- Examples 53
- Settlor status and the CFC regime 53
- Section 226(4) and indirect settlements 54

**Settlements by trustees: s.226(5)** 54

- Objective 54
- Application 54

**Settlement definition: s.226(6)** 55
**Acquisition of rights or powers in relation to settlor or trustee: s.226(7)** 55

- Objective 55
- Application 55

**Settlements by employers: s.226(12)** 56

- Objective 56
- Application 56

7. TRUSTS SETTLED BY PERSONS BEFORE BECOMING RESIDENT 57

**Overview** 57
**Elections: s.226A(1)** 57

- Requirements 57
- Conditions for s.226A to apply 58
- Election 58
- Liability to tax on trustee income derived, andtreatment of distributions made, before election 59

**Consequence of election: s.228(7), s.226A(2)** 60

- Trustee income 60
- Distributions 60

**Consequence of not making an election: s.226A(3), s.228** 61

- Trustee income 61
- Distributions 62

Income derived before election or before election expiry date: s.226A(4) 62
Section 227A elections 63
Examples 64

8. INCOME ASSESSABLE TO BENEFICIARIES 70

**Overview of s.227** 70
**Assessable income: s.227(1)** 70

- Inclusion of beneficiary income and taxable distributions in assessable income 70
- Characterisation of beneficiary income and taxable distributions 71
- Residence and source 71
- Income year 72
- Foreign tax credits 73
- Losses 75

**Trustee liability for tax on beneficiary income: s.227(2)** 76
**Beneficiaries temporarily ceasing to be resident: s.227(3)** 77
**Taxable distributions from non-qualifying trusts: s.227(4)** 78

- Special rate of tax 78
- Taxable distributions derived by controlled foreign companies 78
- Derivation of taxable distributions and losses 78

**Arrangements to defeat the intent and application of s.227: s.227(5)** 80
**Distributions from qualifying trusts: s.227(6)** 80
**Trustee returns income to accounting year balancedate: s.227(7)** 81

9. ELECTION FOR TRUSTS SETTLED BEFORE 17 DECEMBER 1987 81

Section 227A election 81
Requirements 81
Election 82
Effect of election 82

10. TAXATION OF TRUSTEE INCOME 83

**Overview of s.228** 83
**Liability for tax on trustee income: s.228(1)** 83
**New Zealand source trustee income : s.228(2)** 84
**Superannuation regime: s.228(2A), s.228(2B)** 84
**Trustee income derived from outside** 84
**New Zealand: s.228(3)** 84

- Overview 84
- Settlor resident in New Zealand 84
- Superannuation funds 85
- Settlor died resident in New Zealand 85
- Liability of trustee resident outside New Zealand 85
- Relevance of settlor liability 86
- Trustee not otherwise liable 86

**Settlor liability in respect of trustee income: s.228(4)** 86
- Overview 86
- Exceptions to settlor liability 87
- Application and effect of s.228(4) 87

Exceptions to settlor liability: s.228(5) 88

- Overview 88
- Trustee resident: s.228(5)(a) 88
- Superannuation funds: s.228(5)(aa) 88
- Non-resident settlors: s.228(5)(b) 88
- Limitation of liability: s.228(5)(c) 89
- Trustee income arising from remittance of debt. s.228(5)(d) 90

Exceptions to trustee liability: s.228(6) 90

- Overview 90
- No settlement after 17 December 198 90
- Settlements made when settlor non-resident 90
- Limitations on application of s.228(6):s.228(6)provisos 91

Elections to pay tax on trustee income: s.228(7) 91

- Overview 91
- Application 91
- Persons who may make s.228(7) election 92
- Time for making an election 92
- Effect of election 92

11. TRUSTS BECOMING SUBJECT TO TAX 92

Overview of s.228A 92
Application of s.228A 93
Premises, plant, machinery, equipment and trading stock 93
Financial arrangements 94
Exceptions to s.228A(1): s.228A(2) 94

12. RENTS, ROYALTIES AND INTEREST DERIVED BY MAORI TRUSTEE 95

13. DISTRIBUTIONS FROM TRUSTS 95

Overview of s.230 95
Ordering rules: s.230(1) 96

- Distribution to consist of current year's income 96
- Distribution to consist of prior years' income 96
- Distribution to consist of current year's capital profits 97
- Distribution to consist of prior years' captial profits 97
- Distribution to consist of corpus 97
- Time of application of s.230(1) 97

Exceptions to s.230(1): s.230(2) 98

- Distributions from qualifying trusts 98
- Distributions from non-discretionary trusts 98
- Distributions where property disposed of to beneficiary, or where services provided by trustee, at less than market value 98
- Distributions from trust to which s.226A applies 99

Inadequate records 99
Distributions to other beneficiaries: s.230(4) 99

- Overview 99
- Application and effect 100
- Example 100

14. DISCLOSURE 101

Overview of s.231 101
Non-qualifying trusts in existence at 31 May 1989 101
Settlement by resident after 17 December 1987 102
Settlement by nominee or nominal settlor 102
Default assessment 102
Returns 103
Superannuation regime 103
Offences and penalties 103

15. TRUSTEES OF ESTATES 103

Income received by trustee after death of deceased person: s.232 103
Deduction of irrecoverable book debts: s.233 104

## PART 1: INTRODUCTION

1.1 The taxation treatment of income derived through trusts was revised by s.11 of the Income Tax Amendment Act (No 5) 1988. That section repealed ss 226 to 233 of the Income Tax Act and substituted new ss 226 to 233.

1.2 The basic scheme of taxing income derived by trustees either to the trustee or to the beneficiary is largely unchanged. Income is assessable to the beneficiary (or to the trustee as agent of the beneficiary) if during the income year in which it was derived by the trustee it vests absolutely in interest in the beneficiary or if during that income year or within six months thereafter it is paid or applied to or for the benefit of the beneficiary. This income is referred to as "beneficiary income". All income derived by the trustee which is not beneficiary income is assessable to the trustee as trustee income.

1.3 However, there are three main changes to the taxation of income derived through trusts. The first is that the distinction between specified trusts and non-specified trusts has been removed and income derived by trustees which is not also derived by a beneficiary (ie trustee income) is taxed at the same rate for all trusts. The second is that the test for determining when income is assessable to beneficiaries has been broadened. This has been achieved by replacing the entitled in possession test under the previous trust regime with a vesting absolutely in interest test and by removing limitations on the ability to have income taxed as beneficiary income by paying or applying it to or for the benefit of the beneficiary.

1.4 The distinction between specified trusts and non-specified trusts, and the restrictions on paying or applying income to a beneficiary, were introduced in order to limit opportunities for income splitting through trusts. The removal of the specified - non-specified trust distinction, the replacement of the entitled in possession test with the vesting absolutely in interest test and the removal of the restrictions on paying or applying income to a beneficiary reflect the fact that income splitting through trusts is not considered to be a matter of concern in view of the flatter personal income tax rates now prevailing. However, the extent to which trusts can be used to have income taxed at a lower rate has been limited by excluding income derived by beneficiaries from the low income rebate calculated under s.50D of the Income Tax Act.

1.5 The third major change to the taxation of income derived through trusts is in relation to the treatment of income derived through trusts with non-resident trustees. Under the previous trust regime foreign source income derived by non-resident trustees of a trust settled by a person resident in New Zealand was not liable for income tax as it was derived and it was generally considered that it was not assessable to resident beneficiaries if it was distributed more than six months after the end of the income year in which it was derived by the trustee. These defects are dealt with under the new trust regime in two ways. First, subject to several exceptions it is provided that resident settlors of trusts are liable to income tax on trustee income derived during an income year if no trustee of the trust is resident in New Zealand at all times during the income year. Second, it is provided that beneficiaries of certain trusts (referred to as foreign trusts and non-qualifying trusts in the legislation) are liable for income tax in respect of certain distributions which do not constitute beneficiary income. The combined effect of these two measures is to limit opportunities for using trusts with non-resident trustees to accumulate and distribute foreign source income free of New Zealand tax.

1.6 This bulletin provides an explanation of the new trust taxation regime. Part 2 of the bulletin contains a broad overview of the main features of the new regime. It is general in nature and if a more detailed explanation is required the succeeding parts of the bulletin, Parts 3 to 15, should be considered. Parts 3 to 15 of the bulletin generally follow the scheme of the legislation, starting with the provision governing the application of the new regime and then proceeding sequentially through the provisions which comprise the new regime. The bulletin does not discuss the taxation treatment of superannuation funds in detail. For a description of the new superannuation taxation regime Appendix D to TIB No. 3 should be consulted.

1.7 This bulletin represents the Inland Revenue Department's interpretation of the law as it stands at 1 October 1989.

## PART 2: OVERVIEW OF TRUST TAXATION REGIME

**Basic features of the trust taxation regime**

2.1 The new trust taxation regime is contained in ss.226 to 233 of the Income Tax Act. It applies with respect to income derived in the income year that commenced on 1 April 1988 and in every subsequent income year: s.9 Income Tax Amendment Act (No 5) 1988. The only exception to this rule is in respect of distributions of income, capital profits or capital gains that were derived by trustees in income years commencing before

1 April 1988. The proviso to s.9 of the No 5 Amendment Act provides that, generally, the new regime does not apply to distributions of such amounts and that such distributions are not assessable for income tax.

2.2 The main provisions of the new regime:

- define and provide for the taxation of beneficiary income and trustee income;

- define the term "settlor" and provide for the liability of settlors to income tax in respect of trustee income;

- classify trusts into qualifying trusts, foreign trusts and non-qualifying trusts for the purpose of determining the treatment of distributions from trusts where the distribution does not constitute beneficiary income to the beneficiary;

- provide for the treatment of trusts settled by persons becoming resident in New Zealand;

- provide for the treatment of trusts settled by residents on non-resident trustees before 17 December 1987;

- require the disclosure of settlements made on trusts where there are no resident trustees.

General application of trust regime

2.3 Much of the complexity of the trust regime described in this bulletin arises from the inclusion in the regime of provisions dealing with foreign source income derived through trusts with non-resident trustees. The complexities arise from the need to tax such income as it is derived or to tax it on distribution to a beneficiary. Also, complexities arise from the transitional provisions which apply where income derived by trustees which may not previously have been subject to tax in New Zealand potentially becomes liable to tax.

2.4 In the case of most trusts established by persons resident in New Zealand the treatment of income derived through the trust has been simplified. This is because the distinction between specified trusts and non-specified trusts and restrictions on passing income through to beneficiaries for taxation in their hands have been removed. Under the new regime income derived by a trustee in a particular income year is assessable to the beneficiary as "beneficiary income" if it vests absolutely in interest in the beneficiary during that year or if it is paid or applied to or for the benefit of the beneficiary during or within six months after that year. If income is not beneficiary income it is assessable to the trustee as "trustee income".

2.5 The treatment of trust income is at its simplest under the new regime if the trust was settled by a person resident in New Zealand on a trustee who is resident in New Zealand and if the trust income is derived from New Zealand. This is illustrated in the following example:

Example 1

Facts:
(i) A, a New Zealand resident individual, settles a New Zealand farm property on trust for B (A's spouse), and A's and B's two infant children. The trustees are resident in New Zealand. In terms of the trust the trustees, at their discretion, may pay or apply income to or for the benefit of the beneficiaries.

(ii) During the income year ending 31 March 1990 the trustees derive $40,000 assessable income from the farm. On 30 June 1990 the trustees pass a resolution allocating $20,000 to B and $5,000 to each of the infant beneficiaries. In terms of the trust the amounts thus allocated become absolutely the property of the beneficiaries and the allocated amounts, including the $5,000 allocated to each of the infant beneficiaries, are paid to B. B periodically applies the $5,000 allocated to each of the infant beneficiaries to meet expenses incurred on their behalf.

Result:
(i) B derives beneficiary income of $20,000 because there is a payment of income to B within six months from the end of the income year in which the income was derived by the trustees. The income is assessable at B's normal marginal rates and the trustees are liable to tax in respect of the income as agents for B.

(ii) The resolution and the payment of the $5,000 allocated to each of the infant beneficiaries to B constitutes an application of the income for the benefit of the beneficiaries. The infant beneficiaries thus each derive $5,000 beneficiary income. This is the case even though the income is not paid directly to the beneficiary. The important point is that in terms of the trust the income becomes absolutely the property of the beneficiaries. The beneficiaries are assessable on the beneficiary income at their normal rates and the trustees are liable to tax in respect of the income as agents for the beneficiaries.

(iii) The remaining $10,000 income derived by the trustees is trustee income. The trustees are assessable for tax on this income at the rate of 33 percent.

**Beneficiary income and trustee income**

2.6 Income derived by a trustee is either "beneficiary income" or "trustee income". Income will be beneficiary income if during the income year in which it is derived by the trustee it vests absolutely in interest in the beneficiary or if during that income year or within six months thereafter it is paid or applied to or for the benefit of the beneficiary. All income derived by a trustee which is not beneficiary income is trustee income.

2.7 Beneficiaries are liable for income tax in respect of beneficiary income, and trustees are liable for income tax in respect of beneficiary income as agents of beneficiaries. The liability to income tax in respect of beneficiary income depends upon the residence of the beneficiary and the source of the income. Beneficiaries resident in New Zealand are liable to income tax in respect of beneficiary income derived from both inside and outside New Zealand. Beneficiaries not resident in New Zealand are liable to income tax only in respect of beneficiary income derived from New Zealand. Beneficiary income is assessable for income tax at the beneficiary's normal rates of tax.

2.8 A trustee is liable to income tax in respect of trustee income as if the trustee were an individual beneficially entitled to the income. The trustee is liable to income tax on all trustee income derived from New Zealand. The trustee is also liable to income tax on trustee income derived from outside New Zealand during an income year if a settlor of the trust is resident in New Zealand at any time during that income year, if the trust is a superannuation fund as defined in s.2 of the Income Tax Act, or if the trustee is resident in New Zealand at any time during that income year and a settlor of the trust died resident in New Zealand. However, notwithstanding these rules there are two situations in which a trustee is not liable to income tax in respect of trustee income derived from outside New Zealand. The first is where the trustee is resident outside New Zealand at all times during the income year and no settlement (as defined in s.226) has been made on the trust since 17 December 1987. The second is where the trustee is resident outside New Zealand at all times during the income year and the only settlements ever made on the trust were by settlors who were not resident in New Zealand at the time of settlement and who have never been resident in New Zealand since 17 December 1987.

**Settlor definition and liability**

2.9 A person is a settlor of a trust if that person -

(i) makes a disposition of property (as defined in s.226) to the trust for less than market value;

(ii) makes property available to the trust for less than market value, including the provision of financial assistance for less than market value and the provision of financial assistance where amounts payable in relation to the financial assistance are payable on demand and the right to demand payment is not exercised;

(iii) provides any service to the trust for less than market value;

(iv) acquires or obtains the use of any property of the trust or obtains any service from the trustee for greater than market value;

(v) acts or abstains from acting or directly or indirectly enters into a transaction or series of transactions with or in relation to the trust with the effect of defeating the intent and application of the "settlor" definition.

2.10 This definition of "settlor" is extended by rules to the effect that -

(vi) where a person (for example, a solicitor or a relative) has made a settlement on a trust as a nominee for another person, or where the settlement is of a nominal amount made at the request of another person, that other person is deemed to be the settlor of the trust rather than the person actually making the settlement;

(vii) where a settlement is made by a controlled foreign company (CFC), or by a company which would be a CFC if it were a foreign company, any person holding a control interest of 10 percent or more in the company at the time of settlement is a settlor of the trust;

(viii) where a trustee of one trust (the first trust) settles a trust or makes a distribution to another trust (the second trust) any person who is a settlor of the first trust is a settlor of the second trust;

(ix) where any person acquires any rights or powers in relation to a trustee or settlor of an existing trust, and the acquisition has the purpose or effect of enabling the person to require the trustee to treat the person or any other person nominated by that person as a beneficiary of that trust, the person is deemed to be a settlor of the trust.

2.11 The significance of the definition of "settlor" is twofold. First, as indicated above, except in the case of a trust which is a superannuation fund trustee income derived from outside New Zealand during any particular income year is liable to income tax only if a settlor of the trust is resident in New Zealand at any time during the income year or if a settlor of the trust at any time died resident in New Zealand and during the income year a trustee is resident at any time in New Zealand. (In the case of a superannuation fund trustee income derived from outside New Zealand is always liable to income tax).

2.12 Second, if a settlement has been made on the trust after 17 December 1987, and the trust is not a charitable trust, any settlor of the trust who is resident in New Zealand during an income year will be liable to tax on trustee income derived during that year unless any one of a number of exceptions applies. A settlor of a trust on which a settlement has been made after 17 December 1987 is not liable to income tax on trustee income derived during an income year if during that income year a trustee of the trust is at all times resident in New Zealand; if the trust is a superannuation fund; or if the settlor was not resident in New Zealand at the time of any settlement by that settlor or at the time of any settlement made on the trust after 17 December 1987. Where a trust was settled before 17 December 1987, and no settlement was made on the trust after that date, the settlor is not liable to tax on trustee income unless the settlor makes an election to pay tax on trustee income.

2.13 In two other situations the liability of a settlor to tax on trustee income is limited. First, a settlor is not liable to tax on trustee income to the extent that the settlor can establish to the satisfaction of the Commissioner that the liability of the settlor to income tax exceeds the liability which that settlor should bear by comparison to other persons who have made a settlement on the trust having regard to the settlements made by the settlor and by those other persons. Second, a settlor is not liable to income tax on trustee income to the extent that the trustee income is derived because of the application of s.64B to s.64M of the Income Tax Act to amounts remitted under any financial arrangement.

Classification of trusts and taxable distributions

2.14 Trusts are classified into three categories for the purpose of determining the treatment of "distributions" (as defined) to beneficiaries. The three categories of trust are -

(i) Qualifying trusts

A trust is a qualifying trust in relation to any income year in which a distribution is made if all trustee income derived by the trustee in income years commencing with the income year in which a settlement was first made on the trust until the income year in which the distribution is made has been liable to New Zealand income tax other than as non-resident withholding income, and the trustee's obligations in relation to that liability have all been satisfied. In determining whether a trust is a qualifying trust the fact that there is no trustee income liable to income tax in a particular income year is ignored if all of the income derived by the trustee in that income year would have been liable to income tax if not for:

- the fact that no income was derived during any relevant income year;
- the application in any income year of s.61 of the Income Tax Act;
- deductions exceeding income derived by the trustee in any relevant income year, or losses carried forward pursuant to s.188, offsetting all of the income derived by the trustee in any income year.

(ii) Foreign trusts

A trust is a foreign trust in relation to a distribution if at all times from the later of 17 December 1987 or the date on which a settlement was first made on the terms of the trust until the date of distribution no settlor of the trust was resident in New Zealand.

(iii) Non-qualifying trusts

A trust is a non-qualifying trust at the time at which a distribution is made if it is neither a qualifying trust nor a foreign trust. In broad terms, this will be a trust where a settlor has been resident in New Zealand after the later of 17 December 1987 or the date on which the trust was first settled but either all of the trustee income derived by the trustee has not been liable to New Zealand income tax, or the trustee income has been liable to income tax but the trustee's obligations in respect of that liability have not been satisfied.

2.15 When a distribution is made from a qualifying trust it will not be assessable if it does not constitute beneficiary income. In this situation income accumulated by the trustee has been liable to New Zealand income tax as trustee income and it is not appropriate to tax it again when it is distributed to the beneficiary. When a distribution is made from a foreign trust, and the distribution does not constitute beneficiary income, it may be assessable as a taxable distribution. The distribu-

tion will constitute a taxable distribution if it does not constitute beneficiary income and if it does not consist of a distribution of any part of the corpus of the trust or of capital profits or capital gains realised by the trustee (unless the capital profit or gain was realised in a transaction with a person associated with the trustee).

2.16 When a distribution is made from a non-qualifying trust, and the distribution does not constitute beneficiary income, it may be assessable as a taxable distribution. A distribution which does not constitute beneficiary income will be a taxable distribution if it does not represent a distribution of any part of the corpus of the trust. Taxable distributions from non-qualifying trusts are taxable at a rate of 45 percent. This higher rate, and the inclusion of distributions of capital profits or gains within the taxable distribution definition, is because New Zealand income tax has been avoided or deferred through the use of trusts which are now classified as non-qualifying trusts. It is also intended to encourage non-qualifying trusts to be converted to qualifying trusts by an election procedure provided in the legislation.

2.17 The legislation contains ordering rules for determining the constituent elements of distributions from foreign trusts and non-qualifying trusts. These rules override the terms of the trust deed or the terms of the exercise of the trustee's discretion. The rules provide that a distribution from a foreign trust or a non-qualifying trust is deemed to consist of the following elements in the following order -

(i) income derived by the trustee in the income year in which the distribution is made;

(ii) income derived by the trustee in all previous income years;

(iii) capital profits or gains derived by the trustee in the income year in which the distribution is made;

(iv) capital profits or gains derived in all previous income years;

(v) corpus of the trust.

2.18 The ordering rules do not apply with respect to distributions from the following trusts:

(i) qualifying trusts;

(ii) non-discretionary trusts

- created by will or codicil or by order of Court varying or modifying the provisions of any will or codicil;
- created on any intestacy; or
- on which no settlement has been made after 17 December 1987;

(iii) trusts which were foreign trusts before a settlor of the trust became resident in New Zealand and in respect of which an election to pay tax on trustee income has been made in accordance with the election procedure provided in the legislation.

2.19 In these circumstances the constituent elements of the distribution are determined in accordance with the terms of the trust or in accordance with the exercise of the trustee's discretion. The ordering rules also do not apply where the distribution arises from the disposition or making available of property to the beneficiary, or the provision of services to the beneficiary, at less than market value. These distributions are deemed to be taxable distributions.

**Trusts settled by persons becoming resident in New Zealand**

2.20 A New Zealand resident settlor of a trust on which a settlement has been made after 17 December 1987 is not liable to tax on trustee income if the settlor was not resident at the time of any settlement by that settlor on the trust, or if the settlor was not resident at the time of any settlement after 17 December 1987. Also, in these circumstances a trustee who is resident outside New Zealand at all times during the income year is not liable to income tax on trustee income. However, if a settlor of the trust is resident in New Zealand the trust will not be a qualifying trust in relation to any distribution which does not constitute beneficiary income unless all of the trustee income derived by the trustee between the date on which the trust was first settled and the date of the distribution has been liable to New Zealand income tax and the trustee's obligations in respect of that liability have been satisfied. Therefore, to permit a trust to be classified as a qualifying trust where settlements were made on the trust before the settlor became resident in New Zealand a procedure has been provided for any settlor, trustee or beneficiary of the trust to elect to pay tax on trustee income.

2.21 The election procedure is available where a settlor of a trust becomes resident in New Zealand and the trust would have been a foreign trust in relation to a distribution made from the trust on the day immediately preceding the day on which the settlor became resident. That is, it must be a trust where no settlor had been resident in New Zealand from the later of 17 December 1987 or the day on which the trust was first settled until the day immediately preceding the day on which the

settlor became resident in New Zealand. In these circumstances any settlor, trustee or beneficiary of the trust may elect to pay tax on trustee income within 12 months of the later of 31 May 1989 or the day on which the settlor became resident. If an election is made the person making the election is liable to income tax in respect of trustee income from the date of the election.

2.22 If an election is made to pay tax on trustee income the trust is deemed to be a foreign trust in relation to distributions of income, capital profits or capital gains derived by the trustee before the election was made, and a qualifying trust in relation to distributions of income, capital profits or capital gains derived after the date on which the election was made. Thus, distributions of income derived before the election was made will be assessable, while distributions of amounts derived after the election was made (except distributions which constitute beneficiary income) will not be assessable because tax has already been paid on the trustee income derived by the trustee. The ordering rules described in paras 2.17 and 2.18 above will not apply in determining the constituent elements of distributions from such trusts. Distributions will thus be deemed to consist of such amounts as reflect the terms of the trust or the terms of the exercise of the trustee's discretion.

2.23 This treatment does not apply where an election is made to pay tax on trustee income but the obligations to pay tax on trustee income are not satisfied. In this situation distributions made in the income year in which the obligations were not satisfied and in succeeding income years are deemed to be from a non-qualifying trust, except to the extent that the distribution is from amounts derived before the election to pay tax on trustee income was made. Moreover, in this situation the ordering rules do apply in determining the constituent elements of a distribution.

2.24 If an election is not made to pay tax on trustee income the trust is deemed to be a foreign trust in relation to distributions of income, capital profits or capital gains derived before the date on which the time for making an election expires (ie 12 months from the later of 31 May 1989 or the date on which the settlor became resident), and a non-qualifying trust in relation to distributions of income, capital profits or capital gains derived after the expiry of the time for making an election. The ordering rules apply in determining the constituent elements of a distribution.

**Trust Settled by Residents on Non-Resident Trustees Before 17 December 1987**

2.25 Where a trust was settled by a person resident in New Zealand on non-resident trustees before 17 December 1987 the trust will probably be a non-qualifying trust because all of the trustee income will not have been liable to New Zealand income tax. To allow such trusts to be brought within the New Zealand tax system provision was made for any settlor, trustee or beneficiary of the trust to elect to pay tax on trustee income derived in income years commencing on and after 1 April 1988.

2.26 An election must have been made on or before 31 May 1989. If an election was made all trustee income derived from outside New Zealand in income years commencing before 1 April 1988, or derived from New Zealand in income years commencing before 1 April 1988 where the income was liable to income tax only as non-resident withholding income, is deemed to have been liable to income tax other than only as non-resident withholding income and the trustee's obligations to pay tax in respect of that income are deemed to have been satisfied.

2.27 Thus, the effect of an election is that a trust which would be a non-qualifying trust because all of the trustee income derived before the income year commencing on 1 April 1988 was not liable to New Zealand income tax, and because a settlor of the trust was resident after 17 December 1987, may become a qualifying trust because the income derived in income years commencing before 1 April 1988 is deemed to have been liable to income tax and the trustee's obligations in respect of that liability are deemed to have been satisfied.

Disclosure of Settlements

2.28 The legislation requires persons who have made settlements on a trust to make a disclosure in relation to the trust in three situations. The first is where a person made a settlement on a trust on or before 31 May 1989, the trust is still in existence on 31 May 1989 and if a distribution were made on 31 May 1989 the trust would be a non-qualifying trust in relation to the distribution. In this case the person was required to disclose to the Commissioner by 31 May 1989 the existence of the trust, the name and address of the trustee and beneficiary of the trust and any further details required by the Commissioner.

2.29 The second situation in which a disclosure is required is where a person resident in New Zealand made a settlement on a trust on or after 17 December 1987 and at the time of settlement there was no trustee of the trust resident in New Zealand or, if a trustee of the trust was resident in New Zealand at the time of settlement, there is at any time after the settlement no trustee resident in New Zealand. In this case a disclosure is required within three months of the date of settlement,

within three months of the date on which there is no trustee resident in New Zealand or, if later, by 31 May 1989. The person is required to disclose the fact of the settlement, the name and address of the trustee and beneficiary of the trust and any further details required by the Commissioner.

2.30 The third situation in which disclosure is required is where a settlement is made on or after 17 December 1987 and the person making a settlement does so as a nominee for another person, or the settlement is of a nominal amount made at the request of another person, and at the time of settlement no trustee of the trust is resident in New Zealand. In this situation the person for whom the nominee or nominal settlor acted is deemed to be the settlor of the trust but the nominee or nominal settlor is required to disclose the settlement to the Commissioner, the name and address of the settlor of the trust (ie the person for whom the nominee or nominal settlor acted) and any further details required by the Commissioner. Disclosure is required within three months from the date of the settlement or, if later, by 31 May 1989.

## PART 3: APPLICATION DATE

**Section 9 Income Tax Amendment Act (No 5) 1988**

3.1 The new trust taxation regime applies with respect to income derived in the income year commencing on 1 April 1988 and in every subsequent income year: s.9 Income Tax Amendment Act (No 5) 1988. An exception is provided in relation to distributions of income, capital profits or capital gains derived by the trustees of a trust in income years commencing before 1 April 1988. The new regime largely does not apply with respect to these distributions and, with several specific exceptions, it is provided that they are not assessable to the recipient.

**Proviso to Section 9**

Objective

3.2 The exclusion from the new trust regime of distributions of income, capital profits or capital gains derived in income years commencing before 1 April 1988 is contained in the proviso to s.9 of the Income Tax Amendment Act (No 5) 1988. Under the legislation which previously applied in respect of income derived through trusts it was generally considered that a distribution was not assessable for income tax where it consisted of foreign source income derived by trustees in prior years and where the trustees were not resident in New Zealand. Where income derived by trustees had been subject to New Zealand tax in the hands of the trustees it was clear that it was not subject to tax again on distribution to the beneficiary: *CofT* v *Luttrell* [1949] NZLR 823. However, the position was less clear in relation to trusts where the income derived by the trustees had not been liable to New Zealand income tax on accumulation.

3.3 To ensure a smoother transition to the new regime by avoiding arguments as to whether income accumulated tax free by trustees was assessable on distribution, the proviso to s.9 provides that distributions of amounts derived by trustees in income years commencing before 1 April 1988 are not assessable for income tax where the distribution is made after 1 April 1988. With respect to amounts derived by trustees in income years commencing after 1 April 1988, it is clear from the new trust regime that amounts accumulated by trustees may be liable for tax on distribution if the trust is a "foreign trust" or a "non-qualifying trust" in relation to the distribution (see Part 4 of this bulletin for a discussion of those terms).

Terms of the Proviso

3.4 The proviso to s.9 states that Part II of the Income Tax Amendment Act (No 5) 1988, which enacts the new trust taxation regime, does not apply with respect to a distribution received from a trust to the extent that the distribution consists of income, capital profits or capital gains derived by the trustee in any income year commencing before 1 April 1988. This rule applies where the amount distributed was not also income derived by a beneficiary entitled in possession to the receipt of the income in the same year that it was derived by the trustee. In these circumstances the income would have been assessable to the beneficiary under the previous trust regime although it was not actually distributed to the beneficiary. Therefore, as under general principles this income would clearly not be assessable to the beneficiary on distribution it is not necessary to apply the proviso to s.9 to ensure that it is not assessable on distribution.

3.5 The proviso to s.9 applies to distributions of capital profits or gains "derived" by the trustee in income years commencing before 1 April 1988. In this context, a capital profit or gain is "derived" if it has been received or if it has become due or receivable. Thus, a capital profit or gain which was accrued before 1 April 1988 but which was not realised before that date will not have been received or become due or receivable before 1 April 1988 and will therefore not have been derived before that date.

3.6 Although the new regime does not generally apply with respect to distributions of amounts derived in income years commencing before

1 April 1988 there are two stated exceptions. These are the definition of the term "distribution" in s.226 and the provisions of s.230 (s.230 is discussed in Part 13 of this bulletin). Section 230 contains ordering rules for determining the constituent elements of distributions from most trusts which are not "qualifying trusts". In terms of these rules distributions are deemed to consist first of income derived by the trustees in the income year during which the distribution is made to the extent of such income; second, income derived in prior income years to the extent of that income; third, capital profits or gains derived in the income year of distribution; fourth, capital profits or gains derived in prior income years; and fifth, corpus. By applying these rules to distributions of amounts derived in income years commencing both before and after 1 April 1988 it is possible to isolate the taxable and non-taxable components of the distribution. As s.230 only applies in relation to "distributions", it follows that in order to apply that section it is necessary to apply the "distribution" definition with respect to amounts derived in income years commencing before 1 April 1988.

3.7 The following example illustrates the interaction of the s.9 proviso, s.230 and the "distribution" definition.

Example 2

Facts: On 1 April 1986 a New Zealand resident individual settled property on a trust with trustees who were all resident in Hong Kong. The property thus settled produces income from sources outside New Zealand. The value of the property at the time of settlement was NZ $100,000. It is assumed that the trust is a "non-qualifying trust" (see Part 4 of this bulletin for a discussion of this expression) in relation to any distributions made from the trust. A distribution of $6,000 is made from the trust in the income year ending 31 March 1988. A further distribution of $45,000 is made on 31 March 1990. It is assumed that the beneficiary is resident in New Zealand on this date. The amounts derived by the trustees and the distributions made are as follows:

| Year Ending | Income $ | Capital Profits $ | Distributions $ |
|---|---|---|---|
| 31/03/87 | 10,000 | | |
| 31/03/88 | 11,000 | 5,000 | 6,000 |
| 31/03/89 | 10,000 | | |
| 31/03/90 | 5,000 | 10,000 | 45,000 |

Result:

(i) The $6,000 distributed in the income year ending 31 March 1988 is deemed to have been made from the income derived in that income year, leaving a balance of $5,000 income derived during that income year available for distribution. The treatment of the distribution is determined under the previous trust regime.

(ii) Thus, the amounts available for distribution on 31 March 1990 may be represented as follows:

| Year Ending | Income $ | Capital Profits $ | Corpus $ |
|---|---|---|---|
| 31/03/87 | 10,000 | | 100,000 |
| 31/03/88 | 5,000 | 5,000 | |
| 31/03/89 | 10,000 | | |
| 31/03/90 | 5,000 | 10,000 | |

(iii) Applying s.230, the $45,000 distribution is deemed to consist of:

- first, the $5,000 income derived in the income year ending 31 March 1990;
- second, the $25,000 income derived in the previous income years which is available for distribution;
- third, the capital gain derived in the income year ending 31 March 1990;
- fourth, the capital gain derived in the income year ending 31 March 1988.

(iv) The tax status of each portion of the distribution is determined by analysing it separately:

- first, the portion representing the $5,000 income derived in the income year ending 31 March 1990 will be assessable to the beneficiary on distribution as beneficiary income. This income was paid to the beneficiary in the same year in which it was derived by the trustees and therefore constitutes "beneficiary income" as defined in s.226.
- second, the portion representing the $25,000 income derived in the prior income years will be assessable on distribution to the extent of $10,000 and non-assessable to the extent of $15,000. The $10,000 constitutes a taxable distribution, assessable under s.227, because it is a distribution of an amount other than beneficiary income from a non-qualifying trust. The $15,000 is non-assessable by virtue of the proviso to s.9 of the Income Tax Amendment Act (No 5) 1988 because it represents a distribution of income

derived by the trustees in income years which commenced before 1 April 1988.

- third, the portion representing the capital gain of $10,000 derived in the income year ending 31 March 1990 is assessable on distribution because distributions of capital gains from non-qualifying trusts are assessable as taxable distributions (see Part 4 of this bulletin for a discussion of the expression "taxable distribution").

- fourth, the portion representing the capital gain of $5,000 derived in the income year ending 31 March 1988 is not assessable on distribution by virtue of the proviso to s.9 of the Income Tax Amendment Act (No 5) 1988 because the distributed gain was derived in an income year commencing before 1 April 1988.

(iv) Of the total distribution of $45,000 the amount which is assessable is $25,000. Of this, $5,000 is assessable at normal rates as beneficiary income and the remainder is assessable at 45 percent as a taxable distribution from a non-qualifying trust (s.227(4)).

Resettlement of pre-1989 income year amounts

3.8 If amounts derived by trustees in income years commencing before 1 April 1988 are distributed directly to beneficiaries the effect of the proviso to s.9 is that the distribution is not assessable. Where such amounts are settled on another trust, and then later distributed from that other trust, the result is the same. In these circumstances the amount settled will not constitute a "distribution" to the second trust from the first trust. Paragraph (d) of the definition of "distribution" provides that where a settlement is made by one trust on another trust the settlement constitutes a distribution to the extent that the amounts included in the settlement would have constituted income if distributed to a resident beneficiary. This provision will not apply where the settlement includes amounts derived before the income year commencing on 1 April 1988 because if those amounts had been distributed to a resident beneficiary, instead of being settled on the second trust, they would not have been assessable by virtue of the s.9 proviso. As the resettlement does not constitute a distribution to the second trust it will not be a taxable distribution to that trust. Thus, the resettlement will not give rise to income in the accounts of the second trust. Moreover, the amount resettled will constitute "corpus" in the accounts of the second trust which is available for tax-free distribution.

In specie distributions

3.9 Where a trustee distributes a trust asset to a beneficiary (ie an "in specie" distribution) the question arises as to the treatment of the distribution where the asset was purchased with income or gains derived before the income year commencing on 1 April 1988 or with corpus.

3.10 Distributions in specie are treated in the same manner as any other distribution. Such distributions are included within the s.226(1) definition of "distribution" as "property of the trust" which vests absolutely in interest in or is paid or applied to or for the benefit of the beneficiary or which is disposed of to the beneficiary at below market value. Where the distribution is made from a "foreign trust" or a "non-qualifying trust" (these terms are discussed in Part 4 of this bulletin) the ordering rules in s.230(1) apply, subject to any exceptions in s.230(2), to establish the extent to which the distribution is a "taxable distribution" (this term is also discussed in Part 4 of this bulletin).

3.11 In applying s.230(1) the income and gains derived before the income year commencing on 1 April 1988 and the trust corpus used to acquire the asset that is distributed are available to determine the extent to which the distribution is an assessable taxable distribution. However, s.230(1) deems distributions to be made from income derived in the year of distribution before income derived in prior years and then from current year capital profits and gains before capital profits and gains realised in prior years and before corpus. Thus, although the distributed asset may have been acquired with income and gains derived before the income year commencing on 1 April 1988, or with trust corpus, the s.230(1) ordering rules may deem the distribution to have been made from income and gains derived in income years commencing on and after 1 April 1988. If this is the case the distribution may be assessable as a taxable distribution. However, the income and gains derived in income years commencing before 1 April 1988 and the trust corpus would remain available to characterise any subsequent distributions to the beneficiary.

3.12 In some cases an asset acquired before the income year commencing on 1 April 1988 may have appreciated in value prior to its distribution after 1 April 1988. In these circumstances the capital profit or gain accrued in respect of the asset prior to the income year commencing on 1 April 1988 will not not constitute a capital profit or gain "derived" by the trustee before that date. Consequently, the proviso to s.9 would not apply to

exclude that portion of the capital profit or gain from the assessable income of the beneficiary on distribution.

Exception to the proviso

3.13 The s.9 proviso was amended by s.78 of the Income Tax Amendment Act 1989 to exclude from its ambit distributions which constitute dividends for the purpose of the Income Tax Act and distributions made from superannuation schemes. The amendment applied with respect to the tax on income derived in the income year which commenced on 1 April 1988 and in every subsequent year.

3.14 The exclusion of distributions which constitute dividends from the operation of the s.9 proviso ensures that distributions from certain categories of trust which were previously assessable as dividends will remain assessable. Distributions from unit trusts (assessable as dividends under s.4, subject to any relevant exceptions in s.4A), from Maori Authorities (assessable as dividends under s.236) and from group investment funds (assessable as dividends in some cases under s.211A) fall into this category.

3.15 Distributions from superannuation schemes are excluded from the application of the proviso to ensure that distributions from such schemes which were previously taxable will remain taxable during the transitional period of the superannuation regime enacted by the Income Tax Amendment Act 1989.

## PART 4: INTERPRETATION AND DEFINITIONS

**Overview of s.226**

4.1 Section 226(1) contains definitions of terms used in sections 226 to 233. Included within s.226(1) are definitions of the terms "beneficiary income" and "trustee income". These terms, which are relevant in determining whether income derived by a trustee is assessable to the trustee or to the beneficiary, are discussed in Part 5 of this bulletin. Section 226(2) contains the general definition of the term "settlor". This definition is central to the new regime, and the general definition is buttressed by specific rules contained in s.226(3), (4), (5), and (7) which deem persons to be settlors in certain circumstances. The "settlor" definition, the definitions contained in s.226(1) which are relevant to that definition and the specific deeming provisions contained in the subsections referred to in the preceding sentence are discussed separately in Part 6 of this bulletin.

4.2 Section 226(8) and (9) define the term "charitable trust", s.226(10) excludes unit trusts from the ambit of the trust regime, and s.226(11) contains a rule which is designed to prevent the artificial creation of capital gains in relation to foreign trusts. Section 226(12) contains a rule excluding from the settlor definition certain employers who establish trusts for the purpose of providing retirement benefits for employees. This special rule is discussed in Part 6 of this bulletin.

**Definitions: s.226(1)**

Arrangement

4.3 The term "arrangement" is relevant for the purpose of the anti-avoidance rule contained in s.227(5). That provision strikes down arrangements involving transactions with persons other than beneficiaries where the effect is to defeat the intent and application of s.227. This provision is discussed in Part 8 of this bulletin.

4.4 An "arrangement" is defined as meaning any contract, agreement, plan or understanding, whether enforceable or unenforceable, including all steps and transactions by which it is carried into effect. It is significant that the contract, agreement, plan or understanding need not be enforceable. Thus, for the purposes of the "arrangement" definition it is not necessary that each party has the ability to force the other party to carry out their part of the bargain.

Beneficiary income

4.5 This term is discussed in Part 5 of this bulletin.

Controlled foreign company

4.6 The expression "controlled foreign company" is relevant in relation to s.226(4). That provision, discussed in Part 6 of this bulletin, contains rules dealing with settlements made through closely held companies. The expression "controlled foreign company" has the meaning attributed to it by s.245C. That provision will be considered in detail in a later bulletin on the controlled foreign company legislation contained in Part IVA of the Income Tax Act.

Corpus

(a) Significance

4.7 The definition of "corpus" is relevant in relation to the definition of the expression "taxable distribution" contained in s.226 and in relation to the ordering rules contained in s.230.

4.8 Distributions from non-qualifying trusts and foreign trusts (other than non-qualifying and foreign trusts which are superannuation funds) of amounts other than beneficiary income are assessable as taxable distributions except to the extent that they constitute distributions of capital gains or corpus in the case of foreign trusts or distributions of corpus in the case of non-qualifying trusts. The "corpus" definition is therefore important in establishing the extent to which distributions from non-qualifying and foreign trusts are assessable for income tax.

4.9 The "taxable distribution" definition must be read in conjunction with the ordering rules contained in s.230 (s.230 is discussed in Part 13 of this bulletin). These determine the constituent elements of distributions from most non-qualifying and foreign trusts, thus permitting the taxable component of a distribution to be isolated. The rules require income and capital gains derived by the trustees to be exhausted before corpus can be distributed.

4.10 The term "corpus" is not relevant in determining the treatment of distributions from "qualifying trusts". In the case of qualifying trusts it is clear that only distributions which constitute beneficiary income are assessable. Distributions of other amounts, whether of income which has been taxed to the trustees, of capital profits or gains or of property settled on the trust, are non-assessable by virtue of s.227(6) and by virtue of the general principles established in *CofT* v *Luttrell* [1949] NZLR 823.

(b) Amounts included in corpus

4.11 "Corpus" is defined as meaning an amount equal to the market value, at the date of settlement, of any property settled on the trust. The meaning of the expression "market value" is considered in greater detail in Part 6 of this bulletin. However, in broad terms it means the amount at which a reasonable and willing vendor would sell the property to a willing, well informed and prudent purchaser.

4.12 The value of the corpus is determined at the time of the settlement. Post-settlement revaluations or devaluations of the settled property are therefore not taken into account.

(c) Amounts excluded from corpus

4.13 Property settled on trust does not qualify as corpus in four situations:

(i) Paragraph (a) of the "corpus" definition

4.14 Property settled on trust does not qualify as corpus where it is settled by the trustees of another trust and, if that property had been distributed to a resident beneficiary, it would have constituted beneficiary income or a taxable distribution in the hands of that beneficiary. The objective of this exception is to prevent the creation of corpus by resettling amounts accumulated in one trust on the terms of another trust. In the absence of this provision it would be possible to avoid tax on distributions of amounts accumulated in foreign and non-qualifying trusts simply by settling those amounts on other trusts and then distributing them from those other trusts as tax free corpus.

4.15 The rule applies only to the extent that the property settled would have constituted income to a resident beneficiary if distributed to such a beneficiary at the time of settlement. Thus, if the property settled would not have been assessable if distributed to a resident beneficiary, because it constituted corpus in relation to the trust from which the settlement was made or because the trust from which the settlement was made was a foreign trust and the amount settled represented a capital profit or gain, paragraph (a) of the "corpus" definition will not exclude the property settled from constituting corpus in relation to the trust on which the settlement was made.

4.16 In determining whether the settled property would have constituted beneficiary income or a taxable distribution to a resident beneficiary if distributed at the time of settlement it is necessary, first, to categorise the trust which is making the settlement and, second, to establish the sources from which the settlement was made. The first step is necessary because trust categorisation is relevant in determining the extent to which distributions from trusts are taxable. If the trust making the settlement is a foreign trust distributions of current and accumulated income only would be assessable on distribution to resident beneficiaries. Therefore, the paragraph (a) exception would apply only to the extent that the amount settled is drawn from current and accumulated income. However, if the trust making the settlement is a non-qualifying trust distributions of current and accumulated income and capital gains would be assessable on distribution to a resident beneficiary. Consequently, the paragraph (a) exception would apply to the extent that the amount settled is drawn from current and accumulated income and capital gains.

4.17 Having established which components of distributions from the trust making the settlement would be assessable it is necessary to determine the extent to which the amount settled would have been assessable if distributed to a resident beneficiary. This determination is made by discovering

the character of the amount comprising the settlement. This is achieved by applying s.230 on the basis of the settlement constituting a distribution (s.230 is discussed in Part 13 of this bulletin). In these circumstances the settlement constitutes a distribution by virtue of paragraph (d) of the definition of "distribution".

4.18 The following example illustrates the operation of paragraph (a) of the "corpus" definition in conjunction with the s.230 ordering rules and the proviso to s.9 of the Income Tax Amendment Act (No 5) 1988 (s.9 is discussed in Part 3 of this bulletin).

Example 3

Facts:

(i) Trust A is a non-qualifying trust which was established on 1 April 1987 by a settlement of property to the value of $100,000. The following table records the amounts accumulated by the trustees as at 31 March 1990:

| Year Ending | Income $ | Capital Profits $ | Corpus $ |
|---|---|---|---|
| 31/03/88 | 8,000 | 5,000 | 100,000 |
| 31/03/89 | 12,000 | 5,000 | |
| 31/03/90 | 5,000 | | |

(ii) On 1 April 1990 the trustees of Trust A establish a new trust, Trust B, and settle the $25,000 income and $10,000 capital gains accumulated by the trustees of Trust A, and the $100,000 corpus settled originally on Trust A, on the terms of Trust B.

Result:

(i) Trust A is a non-qualifying trust. Therefore, any distribution made to a resident beneficiary on 1 April 1990 would have been assessable, either as beneficiary income or as a taxable distribution, to the extent that it consisted of a distribution of income, capital profits or captial gains.

(ii) By virtue of the proviso to s.9 of the Income Tax Amendment Act (No 5) 1988, the $8,000 income and the $5,000 capital gains derived by the trustees in the income year ending 31 March 1988 would not be assessable if distributed to a resident beneficiary.
Therefore, these amounts do not fall within paragraph (a) of the "corpus" definition because they would not be beneficiary income or a taxable distribution in relation to a resident beneficiary if distributed to such a beneficiary at the time of settlement. These amounts are treated as corpus in relation to Trust B.

(iii) If the $17,000 income and the $5,000 capital gains derived in the income years ending 31 March 1989 and 1990 were distributed to a resident beneficiary on 1 April 1990 they would be assessable to that beneficiary. Therefore, these amounts fall within paragraph (a) of the exceptions to the "corpus" definition, and they do not qualify as corpus in relation to Trust B.

(iv) Of the total settlement from Trust A to Trust B of $135,000, $113,000 is characterised as corpus in relation to Trust B: i.e., $135,000 - ($17,000 + $5,000). The remaining $22,000 is not treated as corpus in relation to Trust B and therefore is not available for tax free distribution from Trust B.

4.19 For paragraph (a) of the "corpus" definition to apply it is not necessary to identify a beneficiary of the trust making the settlement who is resident in New Zealand. Rather, in applying paragraph (a) it is assumed that there is a hypothetical resident beneficiary and that a hypothetical distribution is made to that beneficiary.

(ii) Paragraph (b) of the "corpus" definition

4.20 Property settled on trust by a disposition of property is not corpus where, but for the disposition, the property would have constituted assessable income of the settlor or would have constituted assessable income if the settlor were a person resident in New Zealand.

4.21 The objective of this exception is to prevent income being converted into corpus by a transfer of the income to a trust. For example, in the absence of this rule a resident deriving foreign source income could assign the income to a trust and the income could be distributed tax free to a resident beneficiary as corpus. The same opportunity would arise if the settlor was non-resident. Rather than assigning the income to a resident directly, the non-resident could assign the income to a trust with the trustees later distributing it to a resident as a distribution of corpus.

4.22 The settlement in question must have been made by way of a "disposition of property". This is a defined term and is discussed in Part 6 of this bulletin.

(iii) Paragraph (c) of the "corpus" definition

4.23 Property settled on trust by a disposition of property does not constitute corpus where, but for the disposition, the property would have constituted a dividend in respect of which the settlor would have been liable to deduct an amount by way of a dividend withholding payment or, where the settlor is non-resident, the settlor would have been liable to deduct such an amount if the settlor was resident in New Zealand.

4.24 The intention of this provision is to ensure that dividends which would otherwise be derived by a company are not converted into corpus by the transfer to a trust of an amount which would have constituted a dividend if distributed to the company. Paragraph (b) would not apply with respect to such a transfer because dividends do not constitute assessable income to companies. Instead, such dividends are subject to the dividend withholding payment regime contained in Part XIIB of the Income Tax Act. Consequently, paragraph (c) is targeted at schemes which are designed to allow companies deriving dividends to avoid the dividend withholding payment regime by deriving corpus distributions in lieu of dividends which would otherwise be derived.

(iv) Paragraph (d) of the "corpus" definition

4.25 Property settled on trust by a disposition of property does not constitute corpus when the settlor claims a deduction in respect of the disposition in calculating the settlor's assessable income for New Zealand tax purposes. The intention here is to ensure that where a deduction is claimed in relation to property settled on a trust a further benefit cannot be obtained in the form of a tax free repatriation of corpus.

Disposition of property

4.26 The expression "disposition of property" is relevant primarily in relation to the definition of settlor in s.226(2) and it is discussed in Part 6 of this bulletin.

Distribution

(a) Significance

4.27 The definition of "distribution" is of significance in two contexts. First, it is relevant in relation to the definition of "taxable distribution" and in relation to the s.230 ordering rules which determine the extent to which a distribution constitutes a taxable distribution. Thus, the term "distribution" defines a broad class of transactions involving trusts which may constitute taxable distributions depending upon the category of the trust in relation to the distribution and the nature of the distribution.

4.28 Second, the "distribution" definition is relevant in relation to the rule contained in s.227(6) which ensures that beneficiaries are not assessable on distributions from qualifying trusts other than distributions which constitute beneficiary income. Although taxable distributions can only be derived with respect to foreign and non-qualifying trusts, distributions can be derived with respect to all categories of trust. However, in the case of distributions from qualifying trusts s.227(6) makes it clear that only distributions which constitute beneficiary income are assessable. Thus, if the trustees of a qualifying trust made trust property available to a beneficiary at below market value there would be a distribution to the extent that the property was made available for less than market value (paragraph (a) of the "distribution" definition). However, the distribution would not constitute beneficiary income because the distribution does not constitute income which has been derived by the trustees. Consequently, s.227(6) applies to render the distribution non-assessable. For the same reason distributions of capital gains from a qualifying trust are not assessable to the beneficiary.

(b) Amounts vesting in or paid to or applied for a beneficiary

4.29 The term "distribution" is defined as meaning any property of the trust which vests absolutely in interest in a beneficiary or which is paid to or applied for the benefit of a beneficiary.

4.30 The expressions "vests absolutely in interest" and "paid or applied" are also used in the definition of "beneficiary income" and are considered in Part 5 of this bulletin in the context of the discussion of the "beneficiary income" definition. However, the application of the vests absolutely in interest test and the paid or applied test differs as between the "distribution" definition and the "beneficiary income" definition as follows:

(i) For the purposes of the "distribution" definition the question is whether "property" of the trust vests in, or is paid to or applied for, the beneficiary. In the case of the beneficiary income definition the question is whether "income" derived by the trustees vests in, or is paid or applied to, the beneficiary.

(ii) For the vests absolutely in interest test to apply in the context of the "beneficiary income" definition the income must vest absolutely in interest in the beneficiary during the income year in which it is derived by the trustee. In the case of the "distribution" definition there is no time

period within which the property must have been acquired by the trustee.

(iii) In the case of the "beneficiary income" definition the paid or applied test is satisfied if income derived by a trustee during an income year is paid or applied to or for the benefit of a beneficiary during the income year or within six months after the end of the income year (the six month rule is discussed in Part 5 of this bulletin). However, in the case of the distribution definition there is no six month rule and property which is paid or applied during an income year is treated as a distribution for that income year.

4.31 Property of a trust may be "applied" for the benefit of a beneficiary in a wide range of circumstances. A resolution of the type considered in *CIR v Ward* [1970] NZLR 1, where income was appropriated to beneficiaries in the trust accounts, would constitute an application of trust property for the benefit of the beneficiary where the result is that the beneficiary acquires an absolute interest in the property. There would also be an application of trust property for the benefit of a beneficiary if the trustee paid for services to be provided to a beneficiary or if the trustee discharged a debt owing by the beneficiary. In both cases the beneficiary clearly benefits because his or her material situation has been improved: that is, if the trustee did not pay for the services or discharge the debt the beneficiary would have paid for the services or discharged the debt out of his or her own pocket.

4.32 There may also be an application of trust property where the trustee makes a payment to a family member and the effect of the payment is to relieve the beneficiary of an expense which he or she would otherwise have incurred. For example, the payment of school or university fees of a child of a beneficiary may constitute an application of trust property for the benefit of the beneficiary, the benefit to the beneficiary being that he or she does not personally have to meet those payments. This would also be the case where the trustee purchased an asset and gave it to a member of the beneficiary's family.

4.33 In some cases it may be difficult to establish that a payment or application by the trustee constitutes an application for the benefit of a beneficiary. In these circumstances s.227(5) may apply to deem the payment or application to have been made to the beneficiary. That provision applies where pursuant to an arrangement property or services or other benefits are provided to a person other than a beneficiary and the effect is to defeat the intent and application of s.227. The intent and application of s.227 will be defeated in cases where the beneficiary derives an economic advantage from the arrangement but in technical terms there is no beneficiary income or taxable distribution to the beneficiary. Secton 227(5) is discussed in Part 8 of this bulletin.

4.34 Where property of a trust vests absolutely in interest in a beneficiary or is paid to or applied for the benefit of a beneficiary the s.230 ordering rules apply, subject to any exceptions in s.230(2), in determining the extent to which the property thus vested or paid or applied is beneficiary income or a taxable distribution.

4.35 Example 4 illustrates the interaction of the "distribution" definition and the s.230 ordering rules (s.230 is discussed in Part 13 of this bulletin):

Example 4

Facts:

(i) The amounts accumulated, and derived, by the trustees of a non-qualifying trust as at 31 March 1990 are as follows:

| Year Ending | Income $ | Capital Gains $ |
|---|---|---|
| 31/03/89 | 10,000 | 5,000 |
| 31/03/90 | 10,000 | 5,000 |

(ii) On 31 March 1990 the trustees passed a resolution allocating $22,000 absolutely to the beneficiary of the trust.

Result:

(i) The resolution allocating $22,000 to the beneficiary constitutes a distribution because it effects an application of trust property for the benefit of the beneficiary.

(ii) Applying the ordering rules in s.230, the $22,000 distribution is deemed to consist of $10,000 income derived in the income year ending 31 March 1990, $10,000 income derived in the income year ending 31 March 1989, and $2,000 capital gains derived in the income year ending 31 March 1990.

(iii) The portion of the distribution which consists of the $10,000 income derived by the trustees in the income year ending 31 March 1990 is beneficiary income of the beneficiary because it constitutes income derived by the trustees in the income year ending 31 March 1990 which

is applied for the benefit of a beneficiary during that income year.

(iv) The remaining portion of the distribution (the $10,000 income derived in the income year ending 31 March 1989 and the $2,000 capital gain derived in the income year ending 31 March 1990) constitutes a taxable distribution derived by the beneficiary.

4.36 In terms of the "beneficiary income" definition, discussed in Part 5 of this bulletin, amounts vested in or paid to or applied for a beneficiary do not constitute beneficiary income unless they constitute income which was first derived by the trustee. Therefore, in Example 4 the portion of the distribution which consists of the $2,000 capital gain derived by the trustees in the income year ending 31 March 1990 does not constitute beneficiary income because it is not income which is derived by the trustee. Current year capital gain distributions may constitute taxable distributions but they cannot constitute beneficiary income. In this context, the capital gains referred to are capital gains other than those which are included in assessable income under the Income Tax Act. Capital gains which are assessable as income, for example in terms of s.67 of the Income Tax Act, may be assessable as beneficiary income if the requirements of the beneficiary income definition are satisfied.

(c) Property disposed of or made available to the beneficiary

4.37 Paragraph (a) of the definition of "distribution" provides that any property of a trust which has been disposed of or made available to the beneficiary constitutes a distribution to the extent that the property was made available or disposed of to the beneficiary for less than market value.

4.38 Transactions of this type are included within the definition because they are an obvious means of transferring benefits to a beneficiary. To exclude such transactions from taxation in the context of foreign and non-qualifying trusts would create opportunities for benefits to be transferred to resident beneficiaries in a tax free form. The trustees may be better able to make such benefits available because the trustee income derived by the trustees was accumulated free of tax.

4.39 Property may also be made available or disposed of to beneficiaries of qualifying trusts at below market value. In the case of qualifying trusts distributions of this type will be assessable only if they constitute beneficiary income. To constitute beneficiary income the distribution must represent income derived by the trustee which vests absolutely in interest in the beneficiary or which is paid or applied to or for the benefit of the beneficiary. This could occur, for example, where the trustee uses income derived during an income year to purchase property for distribution to the beneficiary during that income year or within six months thereafter and the beneficiary does not provide a market value consideration for the property. However, there would not be beneficiary income where the trustee simply made property available to the beneficiary because the distribution would not represent income derived by the trustee.

4.40 The concept of "market value" is discussed in Part 6 of this bulletin. In broad terms, the market value of property is the amount at which a reasonable and willing vendor would sell the property or make it available to a willing, well informed and prudent purchaser or lessee.

4.41 By s.230(2)(c), the ordering rules do not apply with respect to distributions of the type described in paragraph (a) of the "distribution" definition and such distributions are deemed to be taxable distributions. The ordering rules do not apply because there may be no income derived by the trustees which corresponds to the distribution. For example, if in a particular income year the trustees derive income of $5,000 and make property available to the beneficiary for an annual rental of $10,000 where the market rental is $15,000, the distribution of $5,000 which arises because the property is made available at below market rates does not constitute a distribution of the $5,000 income derived by the trustees. That $5,000 of income remains available for distribution and its treatment is unaffected by the paragraph (a) distribution. In this case the amount which is treated as a distribution reflects the income which the trustees would otherwise have derived in relation to the property; it does not reflect income actually derived by the trustees.

4.42 Section 230(2) further provides that distributions of the type described in paragraph (a) of the "distribution" definition are taxable distributions. However, this rule applies only where the ordering rules do not apply to a distribution by virtue of s.230(2)(c). In the case of qualifying trusts s.230(2)(c) does not operate to prevent the ordering rules from applying to distributions from the trust because the ordering rules are already prevented from applying by virtue of s.230(2)(a). Therefore, where a distribution from a qualifying trust is of a type described in paragraph (a) of the "distribution" definition s.230(2)(c) and the concluding language of s.230(2) do not operate to treat the distribution as a taxable distribution.

(d) Services provided to the beneficiary

4.43 Paragraph (b) of the "distribution" definition provides that where services are provided by trustees to a beneficiary at below market value the difference between the market value of the services and the value provided by the beneficiary constitutes a distribution.

4.44 Transactions of this nature are treated as distributions because, as with transactions of the type described in paragraph (a) of the "distribution" definition, they would otherwise provide opportunities for providing benefits to beneficiaries on a tax free basis. For example, if the trustee provides services to a beneficiary which have a market value of $10,000 and the beneficiary does not pay for the services, the transaction is equivalent to the trustees distributing $10,000 to the beneficiary and the beneficiary then paying for the services.

4.45 Section 230(2)(c) provides that the s.230(1) ordering rules do not apply to distributions of the type described in paragraph (b) of the "distribution" definition and the concluding language of s.230(2) provides that such distributions are taxable distributions. However, this rule applies only where the ordering rules do not apply to a distribution by virtue of s.230(2)(c). In the case of qualifying trusts s.230(2)(c) does not operate to prevent the ordering rules from applying to distributions from the trust because the ordering rules are already prevented from applying by virtue of s.230(2)(a). Therefore, where a distribution from a qualifying trust is of a type described in paragraph (b) of the "distribution" definition s.230(2)(c) and the concluding language of s.230(2) do not operate to treat the distribution as a taxable distribution.

4.46 Paragraph (b) applies where the trustee provides services to the beneficiary. That is, the trustee must be actually providing the services. Paragraph (b) does not apply where the trustee pays another person to provide services to the beneficiary. In these circumstances the payment to the person providing the services will constitute a payment or application of property of the trust for the benefit of the beneficiary in terms of the introductory words of the "distribution" definition.

(e) Beneficiary disposing of property, or providing services, to the trustees.

4.47 By paragraph (c) of the "distribution" definition, the following transactions constitute distributions:

(i) the disposition of property by the beneficiary to the trust for an amount which is greater than the market value of the property. The transaction gives rise to a distribution to the extent that the value provided by the trustee exceeds the market value of the property.

(ii) the making available of property by the beneficiary to the trust for an amount which is greater than the market value of the services. The distribution is the difference between the value provided by the trustee for the use of the property and the market value of the use of such property.

(iii) the provision of services by the beneficiary to the trustees for an amount which is greater than the market value of those services. The distribution is the difference between the value provided by the trustee for the services and the market value of the services.

4.48 These transactions are treated as distributions because they involve a transfer of amounts from a trustee to a beneficiary. For example, if a beneficiary sells to a trustee an asset with a market value of $1,000 for consideration of $10,000 the trustee has effectively distributed $9,000 to the beneficiary.

4.49 The ordering rules apply to distributions in this category which are made from non-qualifying and foreign trusts. Thus, in the example given in the preceding paragraph the $9,000 distribution would consist of beneficiary income, a taxable distribution or non-assessable amounts according to the classification arrived at on application of s.230 (s.230 is discussed in Part 13 of this bulletin).

(f) Settlements by trustees on other trusts

4.50 Paragraph (d) of the "distribution" definition provides that amounts settled by the trustees of one trust to or for the benefit of or on the terms of another trust are distributions to the extent that the amounts constituting the settlement would have constituted beneficiary income or a taxable distribution if, at the time of settlement, those amounts had been distributed to a resident beneficiary of the trust making the settlement.

4.51 The objective of this provision is to ensure that amounts accumulated or derived by the trustees of a trust which would be assessable on distribution to a resident beneficiary cannot be converted into a non-assessable distribution by

settlement on another trust. This is achieved by treating the settlement of such amounts as a distribution from the trust making the settlement to the trust on which the settlement is made, and by providing that property contained in the settlement does not constitute corpus in relation to the trust on which the settlement is made (paragraph (a) "corpus" definition).

4.52 Where amounts are settled by the trustee of one trust on the terms of another trust (referred to below as "the second trust") the legislation operates as follows:

(i) Paragraph (d) of the "distribution" definition treats the sums, amounts or property settled by the trustees as a distribution only to the extent that these would have constituted beneficiary income or a taxable distribution to a resident beneficiary if distributed at the time of settlement. Therefore, it is necessary to categorise the trust from which the settlement is made and then to apply s.230 to determine what the hypothetical distribution to a resident beneficiary from that trust would have consisted of. This is the same process as that undertaken for the purpose of paragraph (a) of the "corpus" definition. Thus, amounts which, by virtue of paragraph (d) of the "distribution" definition, are treated as a distribution to the second trust will at the same time be prevented from constituting corpus of that trust by virtue of paragraph (a) of the "corpus" definition.

(ii) The second trust is a beneficiary of the trust making the settlement (this is clear from the introductory language of the "distribution" definition). Therefore, to the extent that the amounts settled on the second trust constitute a distribution they will be income derived by the second trust. This is because the distribution will constitute either beneficiary income or a taxable distribution to the second trust.

(iii) To the extent that the settlement constitutes a distribution to the second trust, and therefore constitutes income derived by the second trust, the pool of income available in the second trust for characterising distributions from that trust is increased.

4.53 In order to apply paragraph (d) of the "distribution" definition it is not necessary that there actually be a resident beneficiary of the trust making the settlement. The provision is applied by assuming that there is such a beneficiary and by determining what the treatment would be if a distribution were made to such a beneficiary.

4.54 The following example demonstrates the effect of paragraph (d) of the "distribution" definition:

<u>Example 5</u>

Facts:

(i) Trust A is a non-qualifying trust which was established on 1 April 1987 by a settlement of property to the value of $100,000. The following table records the amounts accumulated by the trustees as at 31 March 1990:

| Year Ending | Income $ | Capital gains $ | Corpus $ |
|---|---|---|---|
| 31/03/88 | 8,000 | 5,000 | 100,000 |
| 31/03/89 | 12,000 | 5,000 | |
| 31/03/90 | 5,000 | | |
| Totals | 25,000 | 10,000 | 100,000 |

(ii) On 1 April 1990 the trustees of Trust A establish a new trust, Trust B, and settle the $25,000 income and $10,000 capital gains accumulated in Trust A, and the $100,000 corpus settled originally on Trust A, on the terms of Trust B.

(iii) On 2 April 1990 the trustees of Trust B distribute $135,000 to a beneficiary of that trust who is resident in New Zealand.

Result:

(i) Trust A is a non-qualifying trust. Therefore, any distribution on 1 April 1990 to a beneficiary who was resident in New Zealandwould have been assessable to the extent that it consisted of a distribution of income or capital gains.

(ii) By virtue of the proviso to s.9 of the Income Tax Amendment Act (No 5) 1988, the $8,000 income and the $5,000 capital gains derived by the trustees in the income year ending 31 March 1988 would not be assessable if distributed to a resident beneficiary.
These amounts do not fall within paragraph (a) of the "corpus" definition or paragraph (d) of the "distribution" definition because they would not be beneficiary income or a taxable distribution in relation to a resident beneficiary if

distributed to such a beneficiary at the time of settlement. Therefore, together with the $100,000 corpus originally settled on Trust A, these amounts do not constitute a distribution from Trust A to Trust B and are treated as corpus in relation to Trust B.

(iii) If the $22,000 income and capital gains derived in the income years ending 31 March 1989 and 31 March 1990 were distributed to a resident beneficiary on 1 April 1990 they would be assessable to that beneficiary. Therefore, these amounts fall within paragraph (d) of the "distribution" definition and there is a distribution of $22,000 from Trust A to Trust B. This distribution constitutes income derived by Trust B: $5,000 constitutes beneficiary income because it represents a payment or application of the $5,000 income derived by the trustees of Trust A in the income year ending 31 March 1990; and the remaining $17,000 constitutes a taxable distribution. Further, no portion of the $22,000 distribution constitutes corpus because the entire amount falls within the terms of paragraph (a) of the "corpus" definition.

(iv) The distribution to the beneficiary of Trust B constitutes corpus to the extent of $113,000: ie the sum of the $100,000 corpus originally settled on Trust A and the $8,000 income and $5,000 capital gains derived by the trustees of Trust A in the income year ending 31 March 1988. The remaining $22,000 constitutes beneficiary income in the hands of the beneficiary because it constitutes income derived by the trustee during the income year ending 31 March 1991 which is paid to the beneficiary during that income year.

(g) Value and beneficiaries

4.55 The concluding language of the "distribution" definition provides that the fact that a beneficiary is or will become a beneficiary under the terms of a trust does not constitute the giving or receiving of any value. In the absence of this provision a beneficiary could argue that the beneficiary's claim on trust property is of value and that where this claim is given up in consideration for the transfer of trust property from the trustee there is no distribution from the trust because the value provided by the beneficiary in giving up the claim is equivalent to the value of the property transferred by the trustee. The concluding language of the "distribution" definition leaves no scope for this argument by providing that the beneficiary's claim on the trust has no value in determining whether a transaction results in a distribution.

(h) In specie distributions

4.56 The definition of "distribution" encompasses distributions of trust assets (these are commonly referred to as "in specie" distributions). The introductory language of the "distribution" definition treats as a distribution "any property" of the trust which vests absolutely in interest in a beneficiary or which is paid to or applied for the benefit of a beneficiary. Where the "property" of the trust vested in or paid or applied to or for the benefit of the beneficiary constitutes an asset the distribution will be the market value of the asset. Paragraph (a) of the "distribution" definition provides that where "property" of the trust is disposed of to a beneficiary at below market value there is a distribution to the extent that the market value of the property exceeds the value provided by the beneficiary.

4.57 If an asset of a qualifying trust is distributed to a beneficiary the distribution will not be assessable to the beneficiary unless the distribution constitutes beneficiary income: s.227(6). A distribution of an asset may give rise to beneficiary income if, for example, the trustee used income derived in an income year to purchase an asset to distribute to a beneficiary during or within six months after that income year. In these circumstances the distribution will constitute beneficiary income if the asset is convertible into cash, if the beneficiary is entitled to distributions of income from the trust and if the distribution is in satisfaction of that entitlement.

4.58 If an asset of a foreign trust or a non-qualifying trust is distributed to a beneficiary s.230(1) is applied, subject to s.230(2), to determine the constituent elements of the distribution. Where the asset has appreciated in value since acquisition by the trustee the accrued increase in value will be "realised" on distribution of the asset. The capital profit or gain thus realised will be available to characterise the distribution in accordance with s.230(1). The distribution to the beneficiary "realises" the accrued capital profit or gain in the asset because it satisfies any claim of the beneficiary against the trust.

Foreign trust

(a) Significance

4.59 The definition of "foreign trust" is relevant in determining the treatment of distributions to beneficiaries. Broadly, distributions of income accumulated by trustees of foreign trusts are

assessable to resident beneficiaries but distributions of capital gains and corpus are not. The rationale for this treatment is discussed in para. 4.96 below.

(b) Definition

4.60 A trust is a foreign trust in relation to a distribution where no settlor of the trust has been resident in New Zealand at any time from the later of 17 December 1987 or the date on which a settlement was first made on the terms of the trust until the date of the distribution.

4.61 Thus, if the trust was settled before 17 December 1987 it will be a foreign trust in relation to a distribution if no settlor was resident in New Zealand at any time between 17 December 1987 and the date of the distribution. A trust settled by a New Zealand resident before 17 December 1987 may therefore be a foreign trust in relation to a distribution, but only if the settlor was not resident at any time between 17 December 1987 and the date of distribution.

4.62 If the trust was first settled on or after 17 December 1987 it will be a foreign trust in relation to a distribution if from the date of first settlement no settlor has been resident in New Zealand. Thus, a trust will be a foreign trust in relation to a distribution if:

(i) it was settled after 17 December 1987 by a person who has never been resident in New Zealand between the date of settlement and the date of distribution; or

(ii) it was settled after 17 December 1987 by a person who has been resident in New Zealand but not between the date on which a settlement was first made on the trust and the date of distribution.

4.63 Also, a trust will be a foreign trust if a settlor had been resident in New Zealand after the later of 17 December 1987 or the date of first settlement of the trust but the settlor was not a settlor of the trust while he or she was resident in New Zealand. For example, if A, a resident of Australia, settles a trust on 1 June 1989 while B is resident in New Zealand, and if B, after ceasing to be resident in New Zealand, settles property on the trust on 1 October 1989, the trust will be a foreign trust in relation to distributions because B was not a settlor of the trust while B was resident in New Zealand.

4.64 Where a trust was first settled before 17 December 1987 and the settlor died resident in New Zealand before 17 December 1987 the trust may technically be a foreign trust. However, if the trust also satisfies the definition of a "qualifying trust" it will be treated as a qualifying trust rather than as a foreign trust. If a settlor of a testamentary trust dies resident in New Zealand after 17 December 1987 the deceased is treated as a settlor of the trust and the trust will not be a foreign trust because there will have been a resident settlor of the trust after 17 December 1987. It is clear from s.228(3)(b) and from the concluding language to the "disposition of property" definition that persons who create trusts on their death are treated as settlors whose residence status must be determined at death.

4.65 The significance of 17 December 1987 in the context of the "foreign trust" definition is that residents were placed on notice in the Government's Consultative Document on International Tax Reform, released on 17 December 1987, that they would be liable for tax on trustee income if they settled trusts with non-resident trustees after that date. Therefore, it was appropriate to ensure that the relatively favorable treatment afforded in respect of foreign trusts was not available where a settlor of a trust settled before 17 December 1987 was resident in New Zealand after that date, or where a trust was settled after 17 December 1987 and the settlor was resident at any time after the settlement.

General power of appointment

4.66 This expression is used in the definition of "disposition of property". That expression is discussed in Part 6 of this bulletin and for ease of reference the expression "general power of appointment" is also discussed in Part 6.

Non-qualifying trust

(a) Significance

4.67 As with the definition of "foreign trust", the definition of "non-qualifying trust" is relevant in determining the treatment of distributions.

4.68 Broadly, distributions of income and capital gains, but not of corpus, are assessable to beneficiaries of non-qualifying trusts either as beneficiary income or as taxable distributions. Except to the extent that such distributions constitute beneficiary income, they are taxed at a rate of 45 percent: s.227(4).

(b) Definition

4.69 Non-qualifying trusts are all trusts other than qualifying trusts and foreign trusts. Thus, the following trusts will not be non-qualifying trusts in relation to a distribution:

(i) trusts where no settlor has been resident in New Zealand between the

later of 17 December 1987 or the date on which a settlement was first made on the trust and the date of distribution. These are foreign trusts.

(ii) trusts where all of the trustee income derived by the trustees from the income year in which the trust was first settled until the income year in which the distribution is made has been liable to New Zealand income tax other than as non-resident withholding income and the trustee's obligations in relation to this liability have been satisfied. These are qualifying trusts.

4.70 In broad terms, this means that non-qualifying trusts are those where there has been a settlor resident in New Zealand since the later of 17 December 1987 or the date of first settlement of the trust and either:

(i) any portion of the trustee income derived by the trustees from the income year in which the trust was first settled until the income year in which the distribution is made has not been liable to New Zealand tax (except where the trustee income was not liable to income tax in one of the circumstances listed in paras (a) to (c) of the definition of "quali fying trust") or has only been liable to New Zealand income tax as non-resident withholding income; or

(ii) any portion of the trustee income derived by the trustees from the income year in which the trust was first settled until the income year in which the distribution is made has been liable to tax but the trustee's obligations in respect of that liability have not been satisfied.

4.71 The following are examples of trusts which may fall into the first category (ie those where not all of the trustee income has been liable to New Zealand income tax):

(i) Trusts which have been settled by a person resident in New Zealand before 17 December 1987 on trustees resident outside New Zealand where the settlor has been resident in New Zealand since 17 December 1987. These trusts are likely to be non-qualifying trusts (unless an election to pay tax on trustee income was made under s.227A before 31 May 1989) because all foreign source trustee income will not have been liable to New Zealand income tax and New Zealand source trustee income may have been liable to New Zealand income tax only as non-resident withholding income.

(ii) Trusts which have been settled by a person who was non-resident at the time of settlement or, if resident at the time of settlement, who has been non-resident since 17 December 1987, and in both cases the settlor subsequently became resident and no election to pay tax on trustee income has been made in accordance with s.226A. These trusts will be non-qualifying trusts in relation to distributions of income and capital profits or gains derived after the date for making a s.226A election expires: s.226A(3) (s.226A is discussed in Part 7 of this bulletin).

(iii) Trusts which have been settled by a person resident in New Zealand who later ceases to be resident in New Zealand and no election to pay tax on trustee income is made in accordance with s.228(7). In these circumstances the trustee income derived from outside New Zealand will cease to be liable to New Zealand income tax, unless there is another settlor of the trust resident in New Zealand. Also, if the trustee is resident outside New Zealand any trustee income derived from New Zealand may be liable to New Zealand income tax only as non-resident withholding income. Consequently, the trust may become a non-qualifying trust in relation to distributions made after the settlor ceases to be resident in New Zealand because there will have been a resident settlor of the trust (ie the trust will not be a foreign trust) and not all of the trustee income will have been liable to New Zealand income tax other than as non-resident withholding income (ie the trust will not be a qualifying trust).

Qualifying trust

(a) Significance

4.72 "Qualifying trusts" constitute the third category of trust which is relevant for the purpose of determining the treatment of distributions from trusts, the other two categories being foreign trusts and non-qualifying trusts.

4.73 Broadly, distributions from qualifying trusts of amounts other than beneficiary income are not assessable to beneficiaries: s.227(6).
This contrasts with the position in relation to foreign trusts and non-qualifying trusts where distributions of amounts other than beneficiary

income may be assessable. The reason for this different treatment is that in the case of qualifying trusts trustee income has already been liable to New Zealand tax in the hands of the trustee. Therefore, given that trustees pay tax as representatives for beneficiaries it is not appropriate to tax the income a second time in the hands of the beneficiary. By contrast, in the case of foreign trusts and non-qualifying trusts the trustee income may not all have been liable to New Zealand income tax. Consequently, it is appropriate to tax the income when it is ultimately distributed to a resident beneficiary.

(b) Requirements

4.74 A trust will be a qualifying trust in relation to a distribution if two requirements are satisfied:

(i) from the income year during which a settlement was first made on the terms of the trust until the income year in which the distribution is made all trustee income derived by the trustees has been liable to New Zealand income tax other than only as non-resident withholding income; and

(ii) the trustee's obligations in respect of that liability have been satisfied.

4.75 It is anticipated that most trusts established by resident settlors where the trustees are resident in New Zealand will satisfy these requirements. For example, if a resident individual settles income producing property on the terms of a trust and resident trustees are appointed, the trust will most likely be a qualifying trust because the trustee income will have been liable to tax from the date on which the settlement was first made. Consequently, in the case of such trusts distributions of amounts other than of beneficiary income will not be assessable: s.227(6).

(c) Liability for income tax

4.76 The definition of "qualifying trust" requires that all of the trustee income derived by the trustees from the income year in which a settlement was first made on the trust until the income year in which the distribution is made has been liable to New Zealand income tax. The liability must have existed in relation to the "trustee income" derived by the trustees. This is the income derived by the trustees which is not also beneficiary income (see Part 5 of this bulletin for a discussion of the "beneficiary income" and "trustee income" definitions). The definition is applied by considering the liability for tax in relation to income which was not assessable to beneficiaries in all income years from the income year in which the trust was first settled until the income year in which the distribution was made. This includes income years falling before the 1989 income year (ie the income year from which the new trust regime applied).

4.77 With respect to income years commencing on and after 1 April 1988 the question of whether the trustee income is liable to New Zealand income tax is determined in accordance with s.228. With respect to earlier years the question is determined in accordance with the provisions contained in the previous trust regime. Inland Revenue considers that trustee income derived from New Zealand and from outside New Zealand would have been liable to New Zealand income tax under the previous trust regime if a trustee of the trust was resident in New Zealand. The decision of the Australian High Court in *Union Fidelity Trustee Company of Australia Ltd* v *FCT* (1969) 119 CLR 117 that income from foreign sources is not assessable on the basis of the residence of the trustee did not apply in the context of the previous New Zealand trust regime because the Australian legislation on which the decision was based was different in significant respects from the New Zealand legislation. For example, under the New Zealand legislation trustees were assessable on trustee income as if they were "beneficially entitled" to the income. This language was not used in the Australian legislation.

4.78 The trustee income must have been liable to New Zealand income tax other than only as non-resident withholding income. Thus, a trust will not be a qualifying trust if any or all of the trustee income was liable to tax only as non-resident withholding income (as defined in s.310 of the Income Tax Act).

(d) Satisfaction of trustee's obligations

4.79 The definition of "qualifying trust" requires the satisfaction of the trustee's obligations rather than actual payment of all income tax for which the trustees are liable. This ensures that a trust may still be a qualifying trust where the trustees have entered into deferred payment arrangements with the Commissioner.

4.80 If all of the trustee income has been liable to tax but the trustee's obligations have not been satisfied it will be possible to convert the trust into a qualifying trust by satisfying the trustee's obligations. For example, if the trustees had failed to declare income from a particular source for several years the trust would be a qualifying trust if the trustees furnished amended returns declaring the income and satisfied their obligations in respect of that income.

(e) Situations where the trustee income would have been liable to income tax

4.81 In some cases it may not be possible to satisfy the requirement that all of the trustee income has been liable to New Zealand income tax because during one or more of the income years falling between the income year in which the trust was first settled and the income year in which the distribution is made there may have been no trustee income, or there may have been trustee income but it may have been exempt from income tax. In these circumstances it is necessary to ensure that the fact that no trustee income was derived in a particular income year, or if income was derived the fact that such income was exempt from tax, does not prevent the trust from being a qualifying trust. The definition achieves this result by providing that where during any income year -

(i) no income was derived by the trustees (paragraph (a) of the "qualifying trust" definition); or
(ii) the trustee income was exempt from income tax by virtue of s.61 (paragraph (b) of the "qualifying trust" definition); or

(iii) allowable deductions exceeded income derived by the trustees, or losses carried foward exceeded income derived by the trustees (paragraph (c) of the "qualifying trust" definition); -

the "qualifying trust" definition is applied by determining whether trustee income would have been liable to New Zealand income tax other than as non-resident withholding income if not for the fact that during that income year no income was derived by the trustees, the trustee income was exempt by virtue of s.61, or allowable deductions or losses carried over exceeded income derived by the trustees.

4.82 The trustees may derive no income in terms of the trustee income definition in two situations. First, they may have derived no income at all because the trust was dormant or their investments yielded no income during the income year. Second, they may have derived income but there was no trustee income because all of the income was beneficiary income. In both situations the "qualifying trust" definition is applied on the basis of whether there would have been a liability to income tax if there had been trustee income. Where all of the income derived by the trustee is beneficiary income it is consistent with the purpose of the "qualifying trust" definition to ensure that the fact that there is no trustee income does not prevent the trust from being a qualifying trust. In cases where the trustee passes all of the income through to the beneficiaries there is no deferral of tax with respect to any New Zealand resident beneficiaries. Thus, if the trustee income would have been liable to New Zealand income tax in a particular income year if the income had not all been passed through to the beneficiaries it is appropriate to treat the requirements of the "qualifying trust" definition as having been satisfied for that income year.

4.83 Paragraph (b) of the "qualifying trust" definition would apply in relation to a charitable trust the income of which is exempt from income tax under s.61 of the Income Tax Act. Thus, where the income of a charitable trust is exempt from income tax under s.61 any distribution from the trust which does not constitute beneficiary income will be a non-assessable distribution from a qualifying trust: s.227(6). Where a distribution from a charitable trust constitutes beneficiary income it will be exempt from tax if it satisfies s.61(25), s.61(26) or s.61(27). Subject to several limitations, those provisions operate to exempt the income derived in trust for charitable purposes, whether the income is trustee income or beneficiary income.

4.84 Paragraphs (a) to (c) of the "qualifying trust" definition merely ensure that if the circumstances specified in those paragraphs occur during any income year that does not necessarily preclude the trust from being a qualifying trust. To be classified as a qualifying trust it is necessary that the trust satisfy the requirements of the definition in relation to other income years during which the trust was in existence. For example, if in year one the expenses incurred by the trustees exceeded the income derived by them to the extent of $5,000 and this amount was carried foward to year two and offset against income of $10,000 derived by the trustees in that year, and if a distribution of $5,000 was made in year three, the trust would be a qualifying trust in relation to the distribution only if -

(i) during year one the trustees would have been liable for New Zealand income tax on trustee income other than only as non-resident withholding income if trustee income had been derived;

(ii) during years two and three the trustees are liable to New Zealand income tax on the trustee income other than only as non-resident withholding income; and

(iii) the trustees' obligations in respect of their liability to New Zealand income tax on the trustee income have been satisfied.

(f) Qualifying trusts resulting from elections

4.85 In some cases a trust which would not otherwise satisfy the requirements of the qualifying trust definition may nevertheless be a qualifying trust by reason of a settlor, trustee or beneficiary of the trust making an election to pay tax on trustee income under s.228(7). The circumstances in which a s.228(7) election may allow a trust which would not otherwise be a qualifying trust to become a qualifying trust are specified in ss.226A and 227A. Those provisions are discussed in Parts 7 and 9 of this bulletin respectively.

(g) Superannuation regime

4.86 Income derived by "superannuation funds" (as defined in s.2 of the Income Tax Act) is assessable as trustee income under the provisions of the trust regime. The normal treatment of income derived through trusts is modified in the case of superannuation funds. These modifications are discussed in Appendix D to TIB No. 3.

4.87 Superannuation funds are specifically precluded from being qualifying trusts in relation to distributions. However, a proviso to the qualifying trust definition was inserted by the Income Tax Amendment Act 1989 to the effect that all superannuation funds are qualifying trusts from 1 April 1990. Also, the concluding language to the beneficiary income definition provides that income derived by trustees of superannuation funds does not constitute beneficiary income. The effect of these provisions is that distributions from superannuation funds will not be beneficiary income but until 1 April 1990 s.227(6) will not prevent the distributions from being assessable under other provisions of the Income Tax Act. After that date superannuation funds will be qualifying trusts and by s.227(6) distributions from superannuation funds will not be assessable.

Taxable distribution

(a) Significance

4.88 The general scheme of the taxation of income derived through trusts, both under the previous and new trust taxation regimes, is that trustees derive income in a representative capacity for the ultimate owners of the income, the beneficiaries. Therefore, when the trustees have paid New Zealand tax on income which they derive in one year, and that income is subsequently distributed in another year, tax is not imposed on the beneficiary on that subsequent distribution because tax has already been paid on that income on the beneficiary's behalf: *CofT* v *Luttrell* [1949] NZLR 823.

4.89 Under the previous trust taxation regime, one consequence of the fact that there is only one trust income was that it was generally considered that a distribution to a beneficiary was not assessable if it consisted of income derived from outside New Zealand which was accumulated by a non-resident trustee and which was paid out more than six months after the income year in which it was derived by the trustee. It was argued that to tax the beneficiary would amount to double taxation in the *Luttrell* sense or that because the income was derived on behalf of the beneficiary in one year it could not be derived by the beneficiary in a later year when it was paid to the beneficiary. This argument is no longer available in relation to distributions from foreign trusts and non-qualifying trusts of amounts which do not constitute beneficiary income. Distributions of accumulated income - in the case of foreign trusts - and of accumulated income and current and accumulated capital gains - in the case of non-qualifying trusts - are now clearly assessable to resident beneficiaries as taxable distributions. This is the case whether or not any portion of the accumulated income was derived from New Zealand sources and was subject to tax in New Zealand.

(b) Definition

4.90 In broad terms a taxable distribution is a distribution from a non-qualifying trust or a foreign trust (but not from a superannuation fund as defined in s.2 of the Income Tax Act) which:

(i) does not constitute beneficiary income;

(ii) in the case of a foreign trust does not consist of a distribution of capital profits or gains or a distribution of corpus;

(iii) in the case of a non-qualifying trust does not consist of a distribution of corpus.

4.91 Therefore, there are three questions to consider in determining whether a beneficiary has derived a taxable distribution:

(i) has the beneficiary derived a distribution?

(ii) is the trust a foreign trust or a non-qualifying trust, but not a superannuation fund, in relation to any such distribution?

(iii) what are the component parts of any such distribution as determined by s.230(1) or, where that provision does not apply, by the terms of the trust or the terms of the exercise of the trustee's discretion ?

4.92 The first question has been discussed above in relation to the definition of "distribution". The second question turns upon the definitions of "foreign trust", "non-qualifying trust" and "superannuation fund". The first two expressions are discussed above. "Superannuation fund" is defined in s.2 as superannuation category 1 and 2 schemes and superannuation schemes registered under the Superannuation Schemes Act 1989. Superannuation schemes constituted outside New Zealand and classified by the Government Actuary under the Superannuation Schemes Regulations 1983 are excluded from the "superannuation fund" definition. Superannuation funds will be non-qualifying trusts until 1 April 1990 because they are expressly excluded from the "qualifying trust" definition until that date. The objective of this exclusion is to ensure that distributions from superannuation funds remain assessable under the general provisions of the Income Tax Act until 1 April 1990 (although such distributions will not be assessable as beneficiary income by virtue of the concluding language of the "beneficiary income" definition). However, it is intended that these distributions will be assessable at the recipient's normal rates rather than at the higher rate applying in relation to distributions from non-qualifying trusts. Thus, distributions from superannuation funds are excluded from the definition of "taxable distribution".

4.93 The third question, applying s.230 to determine the constituent elements of the distribution, finally establishes the extent to which the distribution is assessable to the beneficiary. The application of s.230 is discussed in Part 13 of this bulletin.

4.94 The exception to the "taxable distribution" definition applies in respect of "a distribution of (or a payment or transaction which represents a distribution of) -". The language in brackets recognises that because of the operation of s.230 the distribution may not actually consist of corpus or a capital gain or profit but rather it may be deemed to consist of such amounts while actually consisting of something else.

(c) Taxable distributions and foreign trusts

4.95 Distributions from foreign trusts are taxable distributions to the extent that they consist of income other than beneficiary income. Essentially, this ensures that distributions of income accumulated by the trustees of foreign trusts are assessable to resident beneficiaries. Distributions of profits made on the realisation of a capital asset or of other capital profits or capital gains realised by the trustee and distributions of corpus are not taxable distributions (subject to the application of s.226(11) discussed below).

4.96 Taxable distributions are therefore more narrowly defined in respect of foreign trusts than in respect of non-qualifying trusts. This is because New Zealand income tax has been avoided or deferred by accumulating income in trusts which are classified as "non-qualifying trusts". The wider definition of taxable distribution and the higher rate of tax on such distributions reflects this and is intended to encourage such trusts to be wound up or brought within the new regime. In the case of foreign trusts it is appropriate to tax distributions of accumulated income to ensure that resident beneficiaries do not obtain a tax advantage through income being converted into a non-income form through a simple accumulation by the trustees. However, it is not appropriate to tax a beneficiary of a foreign trust on distributions of capital profits or gains because the trust is not connected to New Zealand by a resident settlor. Thus, New Zealand income tax will not have been avoided or deferred to the extent that it will have been avoided or deferred in the case of a non-qualifying trust.

4.97 The exclusion, in relation to foreign trusts, of distributions of capital profits from the "taxable distribution" definition is contained in paragraph (b) of the definition. The amounts excluded are distributions of, or payments or transactions which represent a distribution of, profits derived from the realisation of a capital asset or of any other capital profit or capital gain realised by the trustee less any capital loss incurred by the trustee in the income year during which the profit or gain was realised. The capital profit or gain must be realised by the trustee. "Realised" in this context indicates that there must be a gain which has been received or which is receivable by the trustee. Capital losses are offset against the capital profits or gains where they are incurred on the realisation of a capital asset or where they are otherwise incurred. The use of "incurred" indicates that the losses in question are not accrued losses.

4.98 The exclusion of capital profits or gains applies subject to s.226(11). That provision recharacterises as income any capital profits or gains realised by the trustee of a foreign trust where the gain was realised in a transaction with a person associated with the trustee. This is intended to ensure that, for distribution purposes, capital profits or gains cannot be created artificially by trustees in transactions with associated persons.

4.99 Paragraph (b) of the "taxable distribution" definition does not apply to amounts which are "required to be taken into account under this Act for the purpose of assessing income tax". Thus, capital gains of the type which are assessable income under the Income Tax Act are treated as

income for distribution purposes. For example, if the trustees realised a gain on the realisation of a piece of land, and the gain was of a type specified in s.67, that gain would be treated as income in calculating the taxable distribution derived by a beneficiary from the trust.

(d) Taxable distributions and non-qualifying trusts

4.100 Distributions from non-qualifying trusts are taxable distributions to the extent that the distribution does not constitute beneficiary income or does not consist of corpus.

(e) Taxable distributions and distributions between trusts

4.101 Where a distribution is made from a foreign trust or a non-qualifying trust to another trust the distribution may constitute a distribution to a resident beneficiary of the foreign trust or non-qualifying trust if it amounts to a payment or application of property of the trust to or for the benefit of the beneficiary. The paid or applied limb of the beneficiary income definition is discussed in Part 5 of this bulletin and the comments there are relevant in relation to the question of whether a transaction constitutes a distribution to a beneficiary by virtue of being a payment or application of trust property to or for the benefit of a beneficiary. If the distribution by the foreign trust or non-qualifying trust to the other trust does constitute a distribution to a resident beneficiary of the foreign trust or non-qualifying trust it may constitute a taxable distribution, depending upon the constituent elements of the distribution and the category of trust from which the distribution was made.

4.102 If a distribution from a foreign trust or non-qualifying trust to a second trust does not constitute a taxable distribution to a resident beneficiary of the foreign trust or non-qualifying trust it may constitute income derived by the trustee of the second trust. If so, it will constitute beneficiary income or trustee income in relation to the second trust. Where the distribution vests absolutely in interest in the beneficiary during the income year in which it was derived or is paid or applied to a beneficiary during or within 6 months after that income year it will be beneficiary income in relation to the second trust. The treatment of distributions between trusts is discussed above in relation to para (d) of the definition of "distribution".

(f) Indirect taxable distributions

4.103 The definition of "taxable distribution" does not refer specifically to "indirect" taxable distributions. However, the definition of "distribution", and thus the definition of "taxable distribution", encompasses indirect distributions because where trust property is "applied" for the benefit of a beneficiary there is a distribution to the beneficiary and, as discussed in relation to the "beneficiary income" definition in Part 5 of this bulletin, amounts can be applied for the benefit of a beneficiary without being directly paid or distributed to the beneficiary.

4.104 Two specific rules are also relevant. First, s.227(5) provides that where an arrangement has been entered into in relation to any trust and any beneficiary pursuant to which property is transferred, or services or other benefits are provided to a person other than the beneficiary, then if the effect is to defeat the intent and application of s.227 the property, services or benefits are deemed to be provided to the beneficiary. The intent and application of s.227 will be defeated where the effect of the arrangement is to provide a direct or indirect benefit to the beneficiary which benefit does not constitute beneficiary income or a taxable distribution. Section 227(5) is discussed in Part 8 of this bulletin.

4.105 Second, where a taxable distribution is derived by a controlled foreign company (CFC) from a non-qualifying trust that distribution is excluded from the branch equivalent income calculated in relation to the CFC (s.245J(24)) and it is attributed separately to any person resident in New Zealand who has an "income interest of 10 percent or greater" (as defined in s.245A) in the CFC. The amount thus attributed is liable to tax at the higher rate applying to taxable distributions from non-qualifying trusts. This ensures that taxable distributions which are liable for tax at the higher rate of 45 percent cannot be converted to attributed foreign income which is taxable at normal rates. The treatment of taxable distributions derived by CFCs is discussed in Part 8 of this bulletin.

Trustee income

4.106 The "trustee income" definition is discussed in Part 5 of this bulletin.

**Settlor definition: s.226(2) to (7)**

4.107 These subsections are relevant to the definition of a "settlor" and are considered in Part 6 of this bulletin.

**Charitable trusts: s.226(8) and (9)**

Effect of charitable trust status

4.108 If a trust is a charitable trust in terms of s.226(8) or s.226(9) any person who is a settlor of that trust will not be liable for tax on the trustee

income derived by the trustees: s.228(4). The intention of this exemption is to ensure that residents who make donations to charitable trusts which have non-resident trustees are not liable to tax on the income derived by those trustees.

4.109 The legislation does not operate by deeming a settlor of a charitable trust not to be a settlor. Rather, it exempts such a settlor from liability to tax on trustee income. It follows that if there is a resident settlor of a charitable trust the trustees will be liable for tax on the trustee income: ss.228(2), 228(3). However, ss.61(25) and 61(27) may operate to exempt the trustees from tax on the trustee income.

4.110 A charitable trust may be a qualifying trust in relation to distributions: paragraph (b) "qualifying trust" definition. If so, distributions which do not constitute beneficiary income will not be assessable: s.227(6). Further, where the income derived by the trustees of the charitable trust is exempt by virtue of s.61 distributions to beneficiaries which constitute beneficiary income will also be exempt by virtue of s.61.

General definition: s.226(8)

4.111 Section 226(8) provides that a trust is a charitable trust for the purposes of ss.226 to 233 if in any income year the income derived by the trustees in that income year, and the income derived in previous income years but not distributed, is held in trust solely for charitable purposes. The expression "charitable purpose" is defined in s.2 as "including any charitable purpose, whether it relates to the relief of poverty, the advancement of education or religion, or any other matter beneficial to the community".

4.112 In determining whether a trust has a charitable purpose it is necessary to decide whether "the real fundamental purpose of [the] trust is charitable": *CIR* v *Carey's (Petone and Mirimar) Ltd* [1963] NZLR 450, 456; *Cowey Mills & Co Ltd* v *CIR* (1982) 5 NZTC 61,172. This is an important point in the context of s226(8) because trusts which are purportedly charitable are commonly used in schemes involving tax havens. Although such trusts may appear charitable in essence they will often be non-charitable, for example because there is a power to appoint additional non-charitable beneficiaries.

4.113 Where a trust has charitable and non-charitable objects charitable status will not be lost where the non-charitable object is merely ancillary, secondary, subordinate or incidental to the charitable purposes of the trust: *CIR* v *New Zealand Council of Law Reporting* (1981) NZTC 61,053; *CIR* v *Carey's (Petone and Mirimar) Ltd* (above). The non-charitable object will be ancillary, subordinate or incidental to the charitable objects if there is "no diversion of ... income into non-charitable channels" (*CIR* v *Carey's (Petone and Mirimar Ltd* ) p 455). However, where income is diverted to non-charitable objects, or where there is the potential for such diversion, the non-charitable objects will not be merely ancillary, subordinate or incidental. Thus, if the trustee has the power to appoint non-charitable beneficiaries this power will be treated as an independent object, rather than as an ancillary, subordinate or incidental object, because it makes provision for the alteration of the very basis of the trust and for the diversion of income to non-charitable objects. Consequently, the trust will not be a charitable trust.

4.114 Section 226(8) is applied on a year by year basis. To satisfy the test in any income year the income derived by the trustees in any income year, and any income derived in prior years but not distributed, must be held in trust solely for charitable purposes.

Business carried on by or on behalf of trustees: s.226(9)

(a) Effect

4.115 Section 226(8) applies subject to s.226(9). In broad terms s.226(9) provides that a trust which would otherwise be charitable in terms of s.226(8) is not charitable for the purpose of ss.226 to 233 if a business is carried on by or on behalf of the trustees and any benefit or advantage or any income is able to be derived by a person associated with the charity and that person is able to determine or materially influence the nature or amount of the benefit, advantage or income.

(b) Requirements

4.116 The provision applies where the benefit, advantage or income is able to be afforded to or received, gained, achieved or derived by any person who -

(i) is a settlor or trustee of the trust by which the business is carried on: in this context the broad definition of "settlor" contained in s.226 applies;

(ii) is a shareholder or director of the company by which the business is carried on;

(iii) is a settlor or trustee of a trust that is a shareholder of the company by which the business is carried on;

(iv) is associated in terms of ss.8 or 245B with any such settlor, trustee, shareholder or director.

4.117 For this requirement to be satisfied it is only necessary that a benefit or advantage or income be able to be afforded to or received, gained, achieved or derived by such a person: it is not necessary that a benefit or advantage or income actually be afforded, received, gained, achieved or derived.

4.118 The provision applies where the person to whom the benefit, advantage or income is able to be afforded or who is able to receive, gain, achieve or derive such benefit, advantage or income is by virtue of that person's capacity as settlor, trustee, shareholder, director or associated person able to determine or materially influence the nature or the amount of the benefit, advantage or income or the circumstances in which it is to be received. In some cases where trusts have been settled with non-resident trustees "protectors" may be appointed to ensure that the trustees administer the trust in accordance with the wishes of the settlor. Influence exercised through the medium of such protectors, or through the medium of any other person performing the same function as a protector, will be relevant in establishing whether material influence is able to be exercised by the settlor.

(c) Retention of interest in, or reversion of, asset

4.119 By paragraph (e) of s.226(9), any person who disposes of an asset to the trust which is used in the business carried on by or on behalf of the trust is deemed to be a settlor and to gain a benefit or advantage in the carrying on of the business where that person retains or reserves an interest in the asset or where that asset will revert to that person. This operates as an extension to the settlor definition for the purpose of s.226(9). The material influence requirement must still be satisfied before the trust fails as a charitable trust.

(d) Deemed business in relation to use of assets

4.120 By paragraph (f) of s.226(9), where a person described in paragraphs (a) to (d) of s.226(9) disposes of an asset to the trustees of the trust and that asset is used by the trustees to derive rent, fines, premiums or other revenues the trustees are deemed to be carrying on business if the person retains or reserves an interest in the asset or if the asset will revert to the person.

4.121 In the absence of this provision the derivation of rents, fines, premiums or other revenues by the trustees may not constitute the carrying on of a business. Paragraph (f) deems the trustees to be carrying on a business, however the material influence requirement must be satisfied before the trust fails as a charitable trust.

(e) Interest at commercial rates

4.122 By paragraph (g) of s.226(9), income is deemed not to be derived by a person described in paragraphs (a) to (d) of s.226(9) if the income consists of interest on money lent where, in the opinion of the Commissioner, the interest is payable at a rate which does not exceed a commercial rate. The provision of a loan to trustees at a rate not exceeding commercial rates will therefore not of itself result in the trust failing as a charitable trust.

(f) Rendering of professional services

4.123 By paragraph (h) of s.226(9), where a person renders professional services to a trust or to a company by which a business is carried on, and those services are rendered in the ordinary course of the carrying on of a business of a professional public practice by the person, then that person is not merely by reason of rendering those services considered to be able to determine or to materially influence the determination or nature or amount of the benefit, advantage or income which is to be afforded, received, gained, achieved or derived. This does not mean that a trust can never fail as charitable when services are provided by a person carrying on a professional public practice. Rather, it only ensures that the mere provision of such services cannot result in the trust failing as charitable.

Unit trusts: s.226(10)

Exclusion from trust regime

4.124 Section 226(10) provides that ss.226 to 233 do not apply to any trust which is a unit trust. The tax treatment of unit trusts is determined under s.211, and the tax treatment of distributions from and interests in unit trusts is determined under s.4 and s.4A and under s.245R.

Unit trusts

4.125 By s.211, a "unit trust" is defined as a scheme or arrangement whereby facilities are provided for subscribers, purchasers or contributors to participate as beneficiaries under a trust in income and gains arising from the investments of the trust. The essential feature is that persons who subscribe to, purchase interests in, or contribute to the trust fund are thereby able to participate as beneficiaries in the income and gains earned from the trust's investments.

4.126 Several categories of trust are specifically excluded from the definition. These include superannuation funds. By s.2, a superannuation fund is defined as a superannuation category 1 or a superannuation category 2 scheme and a superannuation scheme which is registered under the Superannuation Schemes Act 1989. Schemes which are constituted outside New Zealand and which are classified by the Government Actuary under the Superannuation Schemes Regulations 1983 are excluded from the superannuation fund definition. Superannuation funds fall outside the scope of s.211 and the tax treatment of their income is governed by the trust regime (subject to a number of modifications: see Appendix D to TIB No. 3).

4.127 A unit trust is deemed to be a company and the interests of the unit holders are deemed to be shares in the company. The unit holders are deemed to be shareholders and the income derived by the trustees is deemed to be income derived by the unit trust. If pursuant to s.241(6) the unit trust is resident in New Zealand it will be liable to tax on income derived from within and outside New Zealand. If the unit trust is not resident in New Zealand it will be liable for tax only on income derived from New Zealand. Distributions derived by unit holders are treated as dividends to the extent that they constitute income of the unit trust distributed to the unit holder and other payments or transactions with a unit holder which would be a dividend if made to or with a shareholder: s.4(1)(j). The treatment of distributions from unit trusts as dividends is subject to any relevant exceptions contained in s.4A.

Foreign investment funds

4.128 The foreign investment fund (FIF) regime contained in s.245R applies to residents who have an interest in a "foreign entity" or who have an "interest in a foreign personal savings scheme". An interest in a foreign personal savings scheme includes an entitlement to benefit under a "foreign superannuation scheme". That expression is defined as meaning a foreign entity established principally for the purpose of providing retirement benefits to beneficiaries. A foreign entity includes a "foreign unit trust", and a foreign unit trust is essentially a unit trust which is non-resident in terms of s.241(6). If none of the exceptions contained in paragraphs (c) to (h) of s.245R(2) apply, any resident holding an interest in the foreign entity will have an interest in a FIF. Briefly, an interest in a foreign entity will not be an interest in a FIF if any one of the following exceptions is satisfied:

(i) the foreign entity is resident in a country specified in the Fifteenth Schedule to the Act: i.e., Australia, Canada, France, Japan, the United Kingdom, the United States and West Germany;

(ii) the foreign entity distributes as dividends during its accounting period more than 60 percent of the aggregate of its income, capital profits and capital gains;

(iii) as at the end of its accounting period less than 40 percent by market value of the assets of the foreign entity are

- interests in companies which, if the company were a controlled foreign company, would constitute income interests of less than 25 percent;
- rights as a beneficiary in relation to a trust;
- rights as a partner in relation to a partnership;
- interests in FIFs;
- financial arrangements, other than financial arrangements where the foreign entity is engaged principally in the business of issuing or holding financial arrangements;
- annuities;
- land acquired or held for the purpose of deriving rent, except where the foreign entity is engaged principally in the business of renting land;
- certain rights or forbearances which are treated as royalties under the Income Tax Act;
- rights or options to dispose of any of the above;

(iv) the aggregate of the income tax and tax on capital profits paid by or on behalf of the foreign entity is not less than 20 percent of the income, capital profits and capital gains derived by the entity;

(v) the Commissioner has issued a determination under s.245S that interests in the foreign entity do not constitute interests in a FIF;

(vi) the person's interest in the foreign entity constitutes an income interest of 10 percent or greater in a controlled foreign company.

4.129 By s.245R(2)(j) these exceptions, except for the rule excluding interests of 10 percent or greater in controlled foreign companies, do not apply where the foreign entity is specified in Part B of the Sixteenth Schedule to the Income Tax Act or where the Commissioner has determined under s.245S that interests in the foreign entity constitute interests in a foreign investment fund.

4.130 If a person is required to calculate FIF income under s.245R, any consideration derived by the person in relation to that interest which is required to be taken into account under s.245R is not taken into account in calculating the person's assessable income under s.65: s.245R(3). Further, such amounts are excluded from the dividend definition by s.4A(1)(m). Thus, if the person derives amounts from the FIF which would normally be assessable as dividends these amounts are taken into account in calculating FIF income instead of being assessable as dividends.

Summary of treatment of trusts and interests in trusts

4.131 In summarising the treatment of interests in trusts other than trusts which constitute superannuation funds it is convenient to distinguish between trusts in relation to which the beneficiary is a subscriber, purchaser or contributor and other trusts. For convenience, the first category of trust can be referred to as "contributory" and the others as "non-contributory". The treatment of income derived by the trustees of trusts other than superannuation funds and of distributions from such trusts can be summarised as follows:

Non-contributory

(i) Income derived by trustees:

- assessable as trustee income if not beneficiary income and:
    - if derived from New Zealand (s.228(2));
    - if derived from outside New Zealand and a settlor of the trust is resident in New Zealand or a trustee is resident in New Zealand and a settlor of the trust at any time died resident in New Zealand (s.228(3)).
- subject to several exceptions, resident settlors of trusts settled after 17 December 1987 are liable to tax on trustee income (s.228(4),(5)).
- in the circumstances set out in s.228(6) (discussed in Part 10 of this bulletin) non-resident trustees are not liable to tax on foreign source trustee income.

(ii) Income derived by beneficiaries:

- assessable as beneficiary income (s.227(1));
- treatment of distributions of amounts other than beneficiary income depends upon whether the trust is a qualifying trust, foreign trust or non-qualifying trust in relation to the distribution:
    - qualifying trust: distribution non-assessable (s.227(6));
    - foreign trust: distributions of accumulated income assessable as a taxable distribution to the extent that the distribution does not consist of income derived by the trustees in income years commencing before 1 April 1988 (s.226(1) "taxable distribution" definition, proviso to s.9 Income Tax Amendment Act (No 5) 1988, s.227(1));
    - non-qualifying trust: distributions of accumulated income and current or accumulated capital gains assessable as a taxable distribution to the extent that the distribution does not consist of income or capital gains derived in income years commencing before 1 April 1988 (s.226(1) "taxable distribution" definition, proviso to s.9 Income Tax Amendment Act (No 5) 1988, s.227(1)).

Contributory

(i) Income derived by trustees:

- trust is a unit trust and liable for tax as a company (s.211);
- foreign and New Zealand source income assessable if unit trust is resident in New Zealand, otherwise only New Zealand source income assessable (s.242).

(ii) Income derived by beneficiaries:

- if unit trust is resident, or is non-resident but is not a foreign investment fund (FIF), distributions from the unit trust are dividends to the extent that they consist of distributions of income of the unit trust or of a payment or other transaction to or with the unit holder which would constitute a dividend if made to or with a shareholder

of a company (s.4(1)(j)). Any relevant exceptions to the "dividend" definition contained in s.4A apply in determining whether the distribution is a dividend.

- if unit trust is not resident in New Zealand and is a FIF income is attributed to the taxpayer annually under the FIF regime (s.245R(3), s.65(2)(eb));

**Associated persons transactions and foreign trusts: s.226(11)**

4.132 Distributions of capital gains from foreign trusts are not treated as taxable distributions. Consequently, there is an incentive for trustees of foreign trusts to create capital gains in transactions with associated persons. Section 226(11) is intended to limit opportunities for capital gains to be created in this manner.

4.133 Section 226(11) applies to transactions between the trustee and any person associated with the trustee. The associated person rules which apply in this context are those contained in s.8 and in s.245B. These rules will be discussed in detail in a later bulletin on the controlled foreign company legislation contained in Part IVA of the Income Tax Act.

4.134 If s.226(11) applies the profit or gain realised in the transaction between the trustee and the associated person is treated as income, other than beneficiary income, derived by the trustee. The profit or gain is treated as an amount derived otherwise than as beneficiary income to ensure that it is available as part of the pool of current and accumulated income which is used in characterising distributions under s.230.

**Settlements by employers: s.226(12)**

4.135 This provision is relevant in relation to the settlor definition and is considered in Part 6 of this bulletin.

## PART 5: BENEFICIARY INCOME AND TRUSTEE INCOME

**Overview**

5.1 Under the previous trust taxation regime income derived by a trustee was taxed either to the trustee or to the beneficiary. Income derived by a trustee was taxed to the beneficiary (and to the trustee as agent for the beneficiary) if it was also income derived by a beneficiary entitled in possession, or who was deemed to be entitled in possession, to the receipt thereof. If there was no beneficiary entitled in possession to the income, or who was deemed to be entitled in possession to the income, it was assessable to the trustee.

5.2 This general pattern of taxation is preserved in the new trust taxation regime. Income derived by a trustee is assessable to the beneficiary, and to the trustee as agent of the beneficiary, if it constitutes "beneficiary income" and to the trustee if it constitutes "trustee income". The income which is assessable to beneficiaries is more broadly defined than under the previous trust regime and there is a new category of income assessable to the beneficiary, referred to as a "taxable distribution", which was generally considered not to be assessable under the previous regime. However, the general pattern of taxing income to trustees or to beneficiaries remains the same.

**Beneficiary Income**

Significance and background

5.3 Under the previous trust regime there was no definition of "beneficiary income". Instead, it was provided that income which was derived in trust for a beneficiary who was "entitled in possession" to the income during the income year in which it was derived by the trustee was taxable to that beneficiary. Also, it was provided in the case of discretionary trusts that where a payment or application of income was made to or for the benefit of a specified beneficiary during or within 6 months of the end of the income year, the beneficiary was deemed to be entitled in possession to that income within the income year. This deeming provision was restricted in application to the circumstances where the payment or application was a bona fide transaction which placed the whole or part of the income beyond the possession and control of the trustee in the trustee's capacity as trustee.

5.4 The paid or applied rule was further limited in relation to infant beneficiaries of "specified trusts" (i.e., those created on or after 19 July 1968 other than by will). In such cases income was deemed not to have been paid or applied to or for the benefit of the beneficiary if it came within the possession or under the control of the trustees or was used for the purpose of a business carried on by the trustees. In the case of infant beneficiaries of non-discretionary trusts which were not specified trusts it was provided that income vested in the beneficiary in terms of the trust was deemed to be income to which the beneficiary was entitled in possession. Consequently, the infant beneficiary was assessable on the income.

5.5 The trustees of the trust were liable to tax on all other income derived by them: that is,

income to which a beneficiary was not entitled in possession or deemed to be entitled in possession during the same income year in which it was derived by the trustees.

5.6 The new trust taxation regime is of similar effect. All income derived by the trustees of a trust is characterised as either "beneficiary income" or "trustee income". Both expressions are defined in s226(1). "Trustee income" encompasses all income derived by the trustee of the trust which is not beneficiary income. "Beneficiary income" is defined as income derived during an income year by a trustee which either:

(a) vests absolutely in interest in a beneficiary of the trust during that income year; or

(b) is paid or applied to or for the benefit of the beneficiary during or within 6 months after the end of the income year.

5.7 If income derived by a trustee is beneficiary income it is assessable to the beneficiary: s.227(1). The trustee is also liable for tax in respect of such income as agent of the beneficiary: s.227(2). If the income derived by the trustee is trustee income it is assessable to the trustee, and in some instances to the settlor of the trust, in accordance with s.228.

Replacement of entitlement in possession with vesting and removal of restrictions on paid or applied limb

5.8 The previous trust regime was generally considered to be ineffective to frustrate income splitting through trusts. For example, although it was not possible for infant beneficiaries to be entitled in possession to income derived by the trustee, income could often be taxed to the infant beneficiary by passing it through to a sub-trust in the beneficiary's favour. Rather than placing further restrictions on the ability of trustees to have income taxed to beneficiaries, and therefore further to limit opportunities for income splitting through trusts, it was decided to make it easier to have income taxed to beneficiaries. This approach was taken because of the substantial flattening of income tax rates. It was considered that the flatter rate scale justified giving trustees greater flexibility in determining whether income should be taxed to the trustee or to the beneficiary. The removal of the distinction between specified and non-specified trusts also reflects reduced concern in relation to income splitting through trusts in the context of the flatter tax rates. However, the extent to which trusts can be used to have income taxed at lower rates is limited by excluding income derived by beneficiaries through trusts from the low income rebate calculation: s.50D.

5.9 The entitlement in possession requirement of the previous trust regime has been replaced by a less stringent absolute vesting requirement. Consequently, a beneficiary who is unable to demand the receipt of his or her income, such as an infant or a person of unsound mind, may derive beneficiary income where previously this may have been precluded by the terms of the legislation. Further, the restrictions placed upon the paid or applied limb have been removed. To qualify as beneficiary income under this limb a payment or application by the trustees must still be made to or for the benefit of a beneficiary. However, the requirement that the payment or application be achieved by a *bona fide* transaction which places the income beyond the possession and control of the trustees, and the rule assessing income paid or applied to infant beneficiaries of specified trusts to the trustee where it came under the control of the trustee or was used in a business carried on by the trustee, have been removed.

5.10 *Simpson* v *CIR* (1989) 11 NZTC 6,144 provides a practical example of how the new definition of beneficiary income will operate. There, trustees of a family trust appropriated trust income for the benefit of infant beneficiaries by paying the income into the bank account of the beneficiaries' parents. The trust deed provided that any beneficiary to whom trust income was appropriated was deemed to have an absolutely and indefeasibly vested interest in the income. In terms of the definition of beneficiary income, it is clear that the appropriation would result in the income being vested absolutely in interest in the beneficiary and that the income would therefore be assessable to the beneficiary as beneficiary income. Alternatively, the appropriation would be treated as a payment or application of income to or for the benefit of the beneficiary.

Beneficiary income first derived by trustee

5.11 Beneficiary income is defined as income derived by a trustee which vests absolutely in interest in the beneficiary or which is paid or applied to or for the benefit of the beneficiary. Thus, income only constitutes beneficiary income if it first constitutes income derived by the trustee.

5.12 Where a distribution derived by a beneficiary does not constitute income which has also been derived by the trustee it will not be beneficiary income, although it may constitute a taxable distribution. For example, if the trustee distributes an amount derived in realising a capital asset the amount thus distributed is not income which was first derived by the trustee (assuming that the capital gain is not required to be taken into account under the Income Tax Act in calculating

assessable income). Consequently, the distributed capital gain will not be beneficiary income to the beneficiary.

5.13 Another example is where a distribution from a trust is of a type described in paragraphs (a) and (b) of the definition of "distribution". Pursuant to those paragraphs, the term "distribution" includes the disposition or making available of trust property to the beneficiary for less than market value and the provision of services to the beneficiary for less than market value. In these circumstances there will often be no income derived by the trustee which is then distributed to the beneficiary. For example, if the trust assets include a house and the trustee allows the beneficiary to occupy the house for a below market rental the distribution to the beneficiary (i.e., the difference between the market rental and the rental paid by the beneficiary) does not constitute income derived by the trustee which was then distributed to the beneficiary. Therefore, the distribution will not be beneficiary income.

Income vesting absolutely in interest in the beneficiary

5.14 The expression "vests absolutely in interest" is not defined in the legislation. Income vests in a beneficiary where the beneficiary obtains an immediate fixed right of present or future possession of the income. Thus, income vests absolutely in interest in a beneficiary if the beneficiary obtains an immediate right to possession of the income. Also, income vests absolutely in interest in a beneficiary if the beneficiary obtains an immediate right to the future possession of the income.

5.15 Income vests absolutely in interest in a beneficiary only if it vests indefeasibly in the beneficiary in the sense that the income is finally or absolutely vested in the beneficiary. This interpretation arises from the use of the word "vests" and from the use of the word "absolutely" to qualify the expression "vests in interest". It has been held in the context of New Zealand trust taxation legislation (in particular s102(b) of the Land and Income Tax Act 1923) that "vested" means indefeasibly vested in the sense of finally and absolutely vested and not merely defeasibly vested: *CofT* v *Johnson and Maeder* [1946] NZLR 446. The use of the word "absolutely" makes it even clearer that income must vest indefeasibly in a beneficiary in order to satisfy the vests absolutely in interest requirement.

5.16 Thus, where income vests in interest in a beneficiary but the vesting is not indefeasible the income will not be vested absolutely in interest in the beneficiary. For example, if income is vested in an infant beneficiary subject to the beneficiary attaining the age of 21 the income will not be indefeasibly vested because the beneficiary may not reach that age. On the other hand, if the income vests in interest in an infant beneficiary in year 1 but is not payable until year 3, and the payment of the income in year 3 is not subject to divestment or to the satisfaction of any conditions, the income will vest absolutely in interest in the beneficiary in year 1 because the beneficiary has an indefeasible title to the income in year 1 even though possession is not obtained until year 3. Thus, in contrast to the entitlement in possession test under the previous trust regime, it is not necessary that the beneficiary be entitled in possession to the income. One consequence of income being vested absolutely is that even though the beneficiary may not yet be entitled to possess the income (by reason of infancy, for example) if the beneficiary dies the income belongs to his or her estate; it does not fall back to the trust.

5.17 Income will only vest absolutely in interest in a beneficiary if the income is existing property at the time of vesting. Where the income is future property or an expectancy the vesting will not be effective until the income is received or is receivable: *Hadlee* v *CIR* (1989) 11 NZTC 6,155.

5.18 In summary, income vests absolutely in interest in a beneficiary if the income is indefeasibly vested in the beneficiary in the sense of absolutely and finally vested. The following points are relevant in determining whether income vests absolutely in interest in the beneficiary:

(i) income vests absolutely in interest in a beneficiary where the beneficiary obtains an immediate fixed right to the present or future possession of the income and the interest of the beneficiary is not subject to a contingency and is not subject to being divested in the future;

(ii) where (i) is satisfied the income vests absolutely in interest in the beneficiary whether or not the beneficiary is entitled in possession to the income or is able to demand receipt of the income;

(iii) income only vests absolutely in interest in the beneficiary if it is existing property rather than a mere expectancy or future property.

Income paid or applied by the trustee: comparison with previous regime

5.19 Paragraph (b) of the s.226(1) "beneficiary income" definition provides that income derived by a trustee during an income year is beneficiary income if it is paid or applied to or for the benefit

of the beneficiary during or within 6 months after the end of the income year.

5.20 The previous trust regime contained a paid or applied provision which was in similar terms to that now contained in the s.226(1) definition of beneficiary income. Where income derived by a trustee during an income year was paid or applied to or for the benefit of a beneficiary during or within 6 months after the income year, the beneficiary was deemed to be entitled in possession to the income and the income was thus assessable to the beneficiary or to the trustee as agent for the beneficiary. However, several restrictions were placed upon the application of this provision. These restrictions have been omitted from the new legislation.

5.21 The restrictions on the paid or applied limb which have now been removed are:

(i) First, the requirement that the payment or application had to be achieved by a "bona fide" transaction.

(ii) Second, the requirement the transaction must place the income beyond the possession and control of the trustee in the trustee's capacity as trustee of the trust. This provision was designed to counter transactions of the type dealt with in *CIR* v *Ward* [1970] NZLR 1 where income which was appropriated to the beneficiary in the accounts of the trust was held to have been applied for the benefit of the beneficiary.

(iii) Third, the provision that amounts were deemed not to have been paid or applied to or for the benefit of infant beneficiaries of discretionary specified trusts if the income came under the control of the trustee in his or her capacity as trustee, or if the income was used in a business carried on by the trustee. In these circumstances the income was taxed to the trustee.

5.22 One result of removing these restrictions is that it is now no longer necessary for trustees to channel income through sub-settlements to ensure that the income has been placed beyond their control and possession. The fact that income is under the control of the trustee or is used in a business carried on by the trustee as trustee of the trust does not of itself mean that the paid or applied limb (or the vesting limb) is not satisfied.

5.23 The paid or applied test under the previous regime applied where the trustee exercised a power to pay or apply income. The paid or applied test under the new regime also applies only where the trustee exercises a power to pay or apply income. Therefore, the test does not apply where income vests in the beneficiary in terms of the trust deed.

Meaning of paid or applied

(a) Payment of income

5.24 Income derived by the trustee will be "paid" to a beneficiary in terms of the "beneficiary income" definition if the income is transferred to the beneficiary in money or money's worth. It is not necessary that the income should be transferred directly to the beneficiary: it is sufficient that the income is placed unreservedly at the disposal of the beneficiary.

(b) Application of income

5.25 The meaning of the term "applied" was considered by the Court of Appeal in *CIR* v *Ward* [1970] NZLR 1. This case remains good authority in interpreting the term "applied" in the context of the s.226(1) "beneficiary income" definition.

5.26 The question in *Ward* was whether a resolution by the trustee that a certain amount of income was to be held on trust for the beneficiaries constituted an application of the income to or for the benefit of the beneficiaries although the income was not severed from the trust fund. The majority of the Court held that the resolution did constitute an effective application of the income because it resulted in the income becoming the absolute property of the beneficiaries. Under the trust deed the beneficiaries had only a contingent interest in the income because they were not entitled to it until they attained the age of 21. The effect of the trustee's resolution was that the income immediately became the absolute property of the beneficiaries and would have constituted part of their estates if they had died before the age of 21. Thus, by converting a contingent interest to an absolute one the resolution constituted an application of the income. The income remained in the trustee's hands; however it was held that this factor did not mean that there could not have been an application. For that purpose, it was not necessary that the income be physically severed from the trust fund.

5.27 The *Ward* case is authority for the following propositions in relation to the meaning of "applied" in the paid or applied limb of the "beneficiary income" definition:

(i) There is an application of income if by virtue of the exercise by the trustee of a power to pay or apply income the income derived by the trustee becomes the

absolute property of the beneficiary. But income allotted to a beneficiary by the trustee will not become the absolute property of the beneficiary, and therefore will not be applied for the benefit of the beneficiary, if the trustee has the power to vary or alter any share of the income allotted to the beneficiary.

(ii) Where the trustee exercises a power to pay or apply income for the benefit of a beneficiary who has only a contingent interest in the income it is immaterial whether the income is immediately used for the benefit of the beneficiary. The important consideration is whether the income becomes the absolute property of the beneficiary rather than whether it is severed from the trust fund.

(iii) For there to be an application of income it is not necessary that the income be invested by the trustee on behalf of the beneficiary. The question of whether there is an application of income turns upon the effect of the exercise of the trustee's power and not upon what the trustee does with the income after the power has been exercised.

(iv) Entries in the trust accounts alone do not establish that income has been applied for the benefit of a beneficiary. To establish that income has been applied it is necessary to produce more concrete evidence that the trustee has exercised the power to apply income. For example, a written and recorded resolution of the trustee that the power has been exercised will suffice.

5.28 For there to be an application of income it is not necessary that there be a specific sum allocated to the beneficiary: *Davidson* v *CIR* [1976] NZLR 705. Thus, a resolution that two thirds of the income is allocated to a particular beneficiary would constitute an application of income. Also, it is not necessary that the resolution by the trustee effecting the application use the word "applied" or "application": *Davidson*. The relevant question is whether the resolution constitutes an exercise of the power to apply income. Thus, words such as "allocate", "disposed of", that income "shall belong to" a beneficiary and that income is "held for the credit of" a beneficiary may effect an application of income.

5.30 Income cannot be paid or applied to or for the benefit of a beneficiary unless it is existing property. Income cannot be paid or applied if it is future property or an expectancy.

(c) To or for the benefit of the beneficiary

5.31 The payment or application must be made "to or for the benefit of the beneficiary": that is, the test is satisfied if the income is paid "to" the beneficiary or is applied "for the benefit of" the beneficiary. Although this issue is largely dependent upon the facts of each case, in general terms a transaction will be for the benefit of a beneficiary where it improves the material situation of the beneficiary: *Re Pilkington's Will Trusts* [1964] AC 612 HL; *CIR* v *Simpson* (1989) 11 NZTC 6,140, 6,144.

5.32 From the *Ward* case it is clear that if the exercise of a power to pay or apply income by the trustee constitutes an application of income it will generally follow that the application will be for the benefit of the beneficiary. The fact that the beneficiary's interest in the income changes from contingent to absolute means that the exercise of the trustee's power constitutes an application of income and, because the beneficiary's title to the income is improved, the application is for the benefit of the beneficiary. In cases where the trustee exercises a power to pay or apply income by paying income to the beneficiary's parents or guardian for expenditure on behalf of the beneficiary the exercise of the power will result in an application of income for the benefit of the beneficiary.

5.33 Where the trustee makes a payment of income to a person other than the beneficiary, and the payment discharges an obligation of the beneficiary, the payment will constitute an application of the income for the benefit of the beneficiary: *Re Clore's Settlement Trusts* [1966] 2 All ER 272. In that case 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 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" (p 274). Thus, a payment to a dependant of a beneficiary will constitute an application of income for the benefit of the beneficiary.

<u>Six month rule</u>

5.34 Income derived by a trustee during an income year will be taxed in the hands of a beneficiary if a payment or application is made by the trustee during or "within six months after the end of that income year". This additional 6 month period enables the trustee to calculate the trust's income for the relevant year before paying or applying any income to or for the benefit of a

beneficiary. This is especially relevant for trustees with farming or business income, who may be unable to calculate the amount of income available for distribution to the beneficiaries until after the end of the income year. Finally, where income is paid or applied to or for the benefit of a beneficiary during the six month period after the end of the income year in which the income was derived by the trustee, that income is assessable income of the beneficiary for the income year during which the income was derived by the trustee.

Trust records

5.35 Trusts often provide for income to be paid to a parent or guardian of a beneficiary, that receipt of the income by the parent or guardian is sufficient discharge for the trustee and that the trustee does not have to ensure that the parent or guardian pays the income to the beneficiary. In these circumstances, the payment of the income to the parent or guardian will be sufficient evidence for tax purposes that the income vests absolutely in interest in the beneficiary or is applied for the benefit of the beneficiary.

Beneficiary income and the superannuation regime

5.36 The concluding language of the definition of "beneficiary income" provides that beneficiary income does not include income derived by the trustee of the trust in any income year during which the trust is a "superannuation fund" (as defined in s.2).

5.37 The new superannuation taxation regime, enacted by the Income Tax Amendment Act 1989, has been integrated with the trust taxation regime subject to several qualifications. One of the more significant qualifications is that income derived by superannuation funds is to be taxed to the trustee and not to the beneficiary. This is achieved in three ways. First, the concluding language of the definition of "beneficiary income" ensures that income derived by a trustee of a superannuation fund is not beneficiary income and that therefore it constitutes trustee income. Second, the definition of "taxable distribution" in s.226(1) specifically does not apply in relation to superannuation funds. Thus, beneficiaries of superannuation funds cannot derive taxable distributions. Third, the proviso to the definition of "qualifying trust" in s.226(1) provides that superannuation funds are qualifying trusts on and after 1 April 1990. Consequently, distributions made from superannuation funds after 1 April 1990 are not included in the beneficiary's assessable income (s.227(6)), although distributions made before that date will be included in assessable income, for example as pensions, if they fall within s.65(2).

**Trustee income**

5.38 The expression "trustee income" is defined in s.226(1) in relation to any trust and any income year as meaning the income derived in that income year by a trustee of that trust which is not beneficiary income for any beneficiary of the trust. Trustee income is assessable for income tax to the trustee, and in some instances to the settlor, in accordance with the rules in s.228. Those rules are discussed in Part 10 of this bulletin. The distinction between specified trusts and non-specified trusts which was contained in the previous trust taxation regime has been removed and all trustee income is taxed in the same manner.

**Beneficiary income and trustee income where income is passed between trusts**

The issue

5.39 In some cases income derived by the trustee of one trust may be passed through to the trustee of another trust (the second trust) before it is distributed to a beneficiary of the second trust. The beneficiary of the second trust may also be a beneficiary of the first trust. Where income is passed through several trusts in this manner, the question arises as to how the income is to be treated in relation to each trust. In particular, the question is whether there is any possibility of double taxation arising when income is passed through several trusts to the ultimate beneficiary.

5.40 Where the trusts in question are all qualifying trusts double taxation will not arise when income is passed through tiers of trusts.
If the beneficiary of the second trust is also a beneficiary of the first trust the distribution to the second trust may be an application of income for the benefit of the beneficiary. In these circumstances the income will be beneficiary income in relation to the first trust and the beneficiary will be assessable for tax on the income. The trustee of the first trust will be liable to tax as agent of the beneficiary. If the distribution to the second trust is not an application of income for the benefit of a beneficiary of the first trust the treatment of the income as it passes between the trusts is determined by applying the "beneficiary income" and "trustee income" definitions in relation to each trust. The effect of this analysis, illustrated in the examples discussed below, is that the income will be assessable for tax only once.

5.41 Several examples of the treatment of income flowing through tiers of trusts are discussed below. It is emphasised that the analysis applies only in relation to trustee income and beneficiary income. It does not apply with respect to amounts which are classified as taxable distri-

butions. Where income is distributed as a taxable distribution it may have borne New Zealand tax as trustee income but it will still be liable to tax in the beneficiary's hands as a taxable distribution.

Examples

(a) Assumptions

5.42 Several simplifying assumptions are adopted in the following examples. These are that each trust has a settlor that is resident in New Zealand, and that the trustees and beneficiaries of each trust are also resident in New Zealand.

(b) Case 1

5.43 In this case it is assumed that income is derived by the trustee of Trust A in a particular income year and that some or all of this income is distributed to the trustee of Trust B during that income year. Trust B is a member of the class of discretionary beneficiaries of Trust A. The trustee of Trust B either retains the income or distributes it to the beneficiary of Trust B during the same income year.

5.44 In these circumstances the income will be beneficiary income with respect to Trust A because it constitutes income derived by the trustee of Trust A that is paid to or applied for the benefit of a beneficiary of Trust A, i.e., Trust B, during the income year in which the income was derived by the trustee of Trust A.

5.45 The income derived by the trustee of Trust B from Trust A is treated in the same manner as any other income derived by the trustee. Thus, if the income is retained by the trustee of Trust B it will be trustee income in relation to Trust B. In this situation the income will be beneficiary income with respect to Trust A and trustee income with respect to Trust B. If the income is vested absolutely in interest in, or is paid to or applied for the benefit of, the beneficiary of Trust B it will be beneficiary income in relation to Trust B. In this situation the income will be beneficiary income in relation to both Trust A and Trust B.

5.46 The result is that double taxation of the income is avoided as it passes through to Trust B. As the income is beneficiary income in relation to Trust A the primary liability to tax lies with Trust B: the trustee of Trust A is liable to tax only as agent for Trust B (s.227(1)). If the income is retained by the trustee of Trust B it constitutes trustee income in relation to that trust and the trustee of Trust B is liable to tax on that income: s.228. The trustee of Trust A will be liable for tax on the income as agent for the trustee of Trust B. If the income is vested in or paid to or applied for a beneficiary of Trust B the beneficiary will be liable to tax on the income as beneficiary income. The trustee of Trust B will be liable to tax on the income as agent for the beneficiary. The trustee of Trust A will also have an agency liability in respect of the income.

(c) Case 2

5.47 In this case it is assumed that the trustee of Trust A retains the income beyond the one year plus six month period and pays New Zealand income tax on that income. The income is distributed to the trustee of Trust B and the trustee of Trust B immediately distributes the income to a beneficiary of that trust.

5.48 In these circumstances the income is trustee income in relation to Trust A. The trustee of Trust A will be liable to tax in respect of the income: s.228. When the income is later distributed to the trustee of Trust B it will constitute a distribution from a qualifying trust of an amount which does not constitute beneficiary income. Therefore, the trustee of Trust B will not be assessable for income tax in respect of the distribution: s.227(6). As the distribution is not income derived by the trustee of Trust B it will not be beneficiary income to the beneficiary of that trust. Thus, it will be a distribution from a qualifying trust of an amount which does not constitute beneficiary income. Consequently, the distribution will not be assessable to the beneficiary of Trust B: s.227(6).

(d) Case 3

5.49 In this case it is assumed that, during the year of derivation, income derived by the trustee of Trust A is settled on a sub-trust, Trust B, for the benefit of a beneficiary of Trust A. Under the previous trust regime this transaction would have satisfied the paid or applied limb (assuming that the restrictions on that limb did not apply) and the income would have been taxed to the beneficiary.

5.50 The income will constitute beneficiary income in relation to Trust A if the settlement constitutes a payment or application of the income to or for the benefit of the beneficiary (i.e., if the income becomes the property of the beneficiary absolutely). Assuming that the income is beneficiary income in relation to Trust A, the beneficiary will be liable to tax in respect of the income and the trustee of Trust A will be liable to tax in respect of the income as agent for the beneficiary.

5.51 With respect to Trust B the income will be neither trustee income nor beneficiary income because it constitutes a settlement of property on

that trust. Accordingly, the trustee of Trust B will not be liable to tax in respect of the income.

(e) Case 4

5.52 In this case it is assumed that the trustee of Trust A derives income during a particular income year and during the same income year resettles the income on Trust B under a power to resettle the income. This case differs from case 3 in that the resettlement does not confer a benefit on any particular beneficiary. Also, the case differs from case 1 in that Trust B is not named as a beneficiary of Trust A.

5.53 The result in this case is the same as in case 1. Trust B is a beneficiary of Trust A, although it is not named as a beneficiary. This is because Trust B benefits from the distribution from Trust A. As Trust B is a beneficiary of Trust A the income will be beneficiary income in relation to Trust A and trustee income or beneficiary income in relation to Trust B, depending upon whether the trustee of Trust B accumulates the income or distributes it to a beneficiary of that trust. The analysis is not the same as in case 3 because the distribution to Trust B does not benefit a particular beneficiary of Trust A.

## PART 6: SETTLOR DEFINITION

### Significance

6.1 The term "settlor" is defined in s.226(2) and several other subsections of s.226 extend or limit that definition. The "settlor" definition is important in two respects. First, except in the case of trusts which are superannuation funds, the foreign source income of which is always liable to income tax, the taxation of trustee income from sources outside New Zealand is determined on the basis of the residence of the settlor. Two rules apply in this context. The first is that the trustee income derived from outside New Zealand in an income year is liable to income tax if at any time during that income year a settlor of the trust is resident in New Zealand: s.228(3)(a). The second rule is that the trustee income derived from outside New Zealand in an income year is liable to income tax if a trustee of the trust is resident in New Zealand at any time during that income year and a settlor of the trust died resident in New Zealand in any income year.

6.2 The second respect in which the settlor definition is important is that, as a general rule, if a settlement has been made to or for the benefit or on the terms of the trust after 17 December 1987 any settlor who is resident in New Zealand at any time during an income year is liable to income tax on the trustee income derived in that income year as agent of the trustee: s.228(4). There are several exceptions to this rule. The most significant are that the settlor is not liable to tax on trustee income derived in an income year if at all times during that income year a trustee of the trust is resident in New Zealand or if the settlor was not resident in New Zealand at the time of any settlement by that settlor or at the time of any settlement since 17 December by any settlor.

### Overview

6.3 The expression "settlor" is defined in broad terms to ensure that any person who transfers value to a trust is treated as a settlor. Although aspects of the definition are based on the definition of "gift" in the Estate and Gift Duties Act 1968 there are significant differences between that definition and the definition of "settlor". The differences reflect an intention not to incorporate the technical deficiencies of the "gift" definition into the "settlor" definition. In particular, the definition of the expression "disposition of property" has been modified in important respects, the definition focuses on whether the transaction took place at "market value" rather than on whether adequate consideration was provided, and the treatment of on-demand loans where the power to demand interest is not exercised has been specifically prescribed.

6.4 The main definition of "settlor" is contained in s.226(2). In general terms, a settlor is defined as meaning a person who -

(i) makes or who has made a disposition of property to the trust for less than market value;

(ii) makes, or has made, property available to the trust, including the provision of financial assistance, for less than market value;

(iii) provides or has provided services to the trust for less than market value;

(iv) acquires or obtains, or has acquired or obtained, the use of trust property or any service provided by the trustee for greater than market value;

(v) acts or abstains from acting or enters into a transaction or series of transactions with or in respect of the trust with the effect of defeating the intent and application of the "settlor" definition.

6.5 Section 226(3) provides that persons who make settlements while acting as nominees, or who settle nominal amounts on trust while acting

on the instructions of another person, are not settlors. Rather, the person on behalf of whom the nominee or nominal settlor acts is the settlor. By s.226(4), if a controlled foreign company (as defined in s.245C), or a resident company which would be a controlled foreign company if it were a foreign company, makes a settlement any person who has a control interest of 10 percent or more in the company at the time of settlement, or who would have such an interest if the company were a foreign company, is a settlor of the trust.

6.6 By s.226(5), if the trustee of a trust settles a trust or makes a distribution to or on the terms of another trust any person who is a settlor of the trust making the settlement or distribution is a settlor of the trust to or on the terms of which the settlement is made. Section 226(6) defines a "settlement" as any action or failure to act on the part of a person which has the effect of making the person a settlor. Section 226(7) includes as a settlor any person who has acquired rights or powers in relation to a trustee or settlor of a trust where the purpose or effect of that acquisition was to enable the person to require the trustee to treat the person, or any other person, as a beneficiary of the trust. By s.226(12), an employer is not a settlor if that employer makes a settlement for the benefit of employees on the terms of a trust established principally for the purpose of providing retirement benefits.

Settlements by way of a disposition of property

Requirements

6.7 Section 226(2)(a) provides that a person is a settlor of a trust if that person makes, or has made at any time, a disposition of property to or for the benefit of the trust or on the terms of the trust for less than market value.

6.8 The provision applies if the person has made a settlement at any time. That is, the person will be a settlor if the disposition of property was made either before or after the application date of the new trust regime. The person may be a settlor if the disposition of property is made, or was made, to or for the benefit of the trust or on the terms of the trust. The disposition of property will render the person making, or who made, the disposition a settlor if it is at below market value. The concept of market value is discussed below at paras 6.76 to 6.91.

Definition of disposition of property

(a) Introductory language

6.9 In terms of the introductory language of the definition of "disposition of property" that expression means "any conveyance, transfer, assignment, settlement, delivery, payment or other alienation of property, whether at law or in equity".

6.10 This language brings within the definition only transactions that involve an alienation of property; that is, a transfer of ownership of the property: *CSD* v *Card* [1940] NZLR 637. Transactions involving the use, rather than the change in ownership, of property are dealt with in paragraph (c) of the definition and in s.226(2)(b). The introductory language is wide enough to encompass loans: *Rossiter* v *CIR* [1977] NZLR 195. Loans are also dealt with in s.226(2)(b). Thus the provision of a loan at an interest rate which is below the market rate may result in the lender being a settlor either by virtue of the introductory language of the "disposition of property" definition and s.226(2)(a) or by virtue of s.226(2)(b).

6.11 "Delivery" in the context of the introductory language means a change in both the ownership and the possession of property. Thus, if in terms of a contract title to the property passes on delivery there will be a disposition of property at the time of delivery. Also, the making available of property without the transfer of ownership does not constitute a disposition of property in terms of the introductory language.

6.12 The Estate and Gift Duties Act definition of "disposition of property" includes an additional paragraph that is not contained in the s.226 definition. That paragraph provides that any transaction entered into by any person with intent thereby to diminish, whether directly or indirectly, the value of that person's own estate and to increase the value of the estate of any other person is treated as a disposition of property: s.2(1) Estate and Gift Duties Act 1968, "disposition of property" definition para (f). That paragraph has been omitted from the s.226 definition in response to suggestions that the effect of para (f) of the Estate and Gift Duties Act definition is that transactions involving an indirect conveyance, transfer, assignment, settlement, delivery, payment or alienation cannot be caught by the introductory language of the definition: Adams and Richarson *Law of Estate and Gift Duty* (5 ed Butterworths 1978) para 2/29. Consequently there is nothing in the "disposition of property" definition which prevents the introductory language of that definition from applying to indirect transactions. Finally, the transactions contemplated in para (f) of the Estate and Gift Duties Act definition of "disposition of property" are encompassed within the concluding language of the s.226(2) "settlor" definition.

6.13 Five paragraphs dealing with specific circumstances succeed the general introductory

language. These paragraphs are expressed to apply "without limiting the generality of the foregoing provisions of this definition". This wording must be given effect to by ensuring that the introductory language is not read down by the succeeding specific paragraphs. The objective of paragraphs (a) to (e) of the "disposition of property" definition is to catch situations where there is in substance a settlement but where there is no alienation of property: *FCT* v *St Helens Farm (ACT) Pty Ltd* (1981) 11 ATR 544, 557.

(b) Paragraph (a): allotment of shares

6.14 By para (a) of the definition of "disposition of property", an allotment of shares in a company constitutes a disposition of property. This ensures that transactions involving the reorganisation of a company and the issue of shares to trustees at below market value do not fall outside the "settlor" definition. This may occur because little or no consideration is provided by the trustees. Another possibility is that the trustees may pay an amount reflecting the market value of the other shares issued by the company but this may not reflect the market value of the shares issued to the trustees because special rights attach to those shares or because limitations are imposed on shares issued to other shareholders.

6.15 The facts of *FCT* v *St Helens Farm (ACT) Pty Ltd* (1981) 11 ATR 544 illustrate the application of para (a). In that case the owner of property sold it to a private company and was allotted a number of ordinary shares in the company. Those shares were then converted to preference shares carrying the right to a fixed dividend and to a return of capital and payment of any arrears of dividend on winding up. The company then allotted ordinary shares to several relatives of the original owner of the property or to certain companies to be held in trust for such relatives. Those ordinary shares carried unrestricted rights to share in the assets of the company so that if the company were wound up the ordinary shareholders would be entitled to the whole of the property transferred to the company less only the face amount of the original owner's preference shares and the costs of realisation. The amount paid by the ordinary shareholders for the shares, Aus$500, was considerably less than the value of the company's assets, Aus$1,206,314.

6.16 On these facts it was held that the allotment of shares to the ordinary shareholders was an allotment of shares in terms of para (a) of the "disposition of property" definition contained in the Australian Gift Duty Assessment Act 1941 (that definition was, in relevant part, in the same terms as the s.226(1) "disposition of property" definition). The argument that para (a) applies only when the allotment of shares constitutes an alienation of property, as for example where shares in a company are allotted to a non-shareholder on the direction of a shareholder who would otherwise have been entitled to the shares, was rejected. Paragraph (a) thus applies whether or not the allotment involves an alienation of property.

6.17 In the *St Helens Farm case* the disposition of property was made by the company which allotted the shares. In the context of the s.226(2) definition of "settlor" the company would be a settlor of a trust if the allotment was made to the trust at below the market value of the shares. A shareholder in the company may also be a settlor of the trust in these circumstances by virtue of the concluding language of the s.226(2) definition of "settlor". This language is discussed below at paras 6.48 to 6.59.

(c) Paragraph (b): creation of a trust

6.18 By para (b) of the "disposition of property" definition, the creation of a trust is treated as a disposition of property. A trust is created when property is impressed with the terms of a trust: that is, when the trustees accept property which is to be held in trust. Thus, where a person transfers property to trustees to be held in trust, thereby creating a trust, the transferor will be settlor of the trust if the transfer is effected at below market value.

(d) Paragraph (c): granting of rights or interests in or over property

6.19 By paragraph (c) of the "disposition of property" definition, the grant or creation of any lease, mortgage, charge, servitude, licence, power, or other right, estate or interest in or over any property is treated as a disposition of property. This brings within the definition several transactions that do not involve a transfer in the ownership of property.

6.20 To some extent there may be an overlap between s.226(2)(a) and s.226(2)(b) arising from the inclusion within para (c) of the "disposition of property" definition of transactions involving the use of property. For example, if a person leased property to trustees that would be a para (c) disposition of property, and if the lease was for a below market rental, the person would be a settlor under s.226(2)(a) by virtue of making a disposition of property at below market value and also under s.226(2)(b) by virtue of making property available at below market value.

6.21 However, although there is an overlap para (c) of the "disposition of property" definition

includes within its terms a wider range of transactions than is contemplated by s.226(2)(b). Among these are transactions involving the granting or creation of mortgages or charges. Thus, the granting to trustees of a mortgage or charge over an asset will constitute a disposition of property. If the person granting the mortgage or charge does not receive an amount representing the market value of the interest created by the mortgage or charge the person will be a settlor in terms of s.226(2)(a). If this type of transaction were not caught the creation of mortgages or charges would create opportunities for transferring value to trusts. For example, if a person who owns shares with a value of $1,000 grants a charge over the shares to a trustee, and the trustee acquires the shares or is entitled to dispose of the shares on crystalisation of the charge, the person effectively transfers value to the trust if a market value consideration is not provided by the trustee in respect of the creation of the charge.

6.22 Paragraph (c) applies where a power is granted or created over any property. Thus, if a person confers on trustees a power of appointment over property owned by that person the granting or creation of the power will constitute a disposition of property. For example, there is a disposition of property where a person who owns a parcel of shares grants trustees of a trust a power to appoint the shares to any members of a class of persons. The conferral of the power will give rise to a fiduciary obligation on the part of the trustees. Consequently, there may be a para (b) disposition of property (i.e., the creation of a trust) as well as a para (c) disposition. In cases where the power is not granted to trustees there may still be a disposition of property to or for the benefit of a trust where the granting of the power is effectively an indirect disposition of property to the trust. Finally, para (c) of the definition differs from para (e) in that the former deals with the creation of a power while the latter deals with the exercise of a power. Paragraph (e) of the definition is discussed below at paras 6.28 to 6.29.

(e) Paragraph (d): Releases, discharges, surrenders, forfeiture or abandonment

6.23 By para (d) of the "disposition of property" definition, a disposition of property occurs where there is a release, discharge, surrender, forfeiture, or abandonment of any debt, contract, or thing in action, or of any right, power, estate, or interest in or over any property. Two requirements must therefore be satisfied: first there must be a debt, contract, thing in action, right, power, estate or interest in existence; and second, there must be a release, discharge, surrender, forfeiture or abandonment of that interest. In language extending para (d) it is further provided that a debt or any other right, estate or interest is deemed to have been released when it has become irrecoverable or unenforceable by action or for any reason ceases to exist.

6.24 The expression "thing in action" is used to describe "all personal rights of property which can only be claimed or enforced by action, and not by taking physical possession": 6 *Halsbury's Laws of England* 4 ed para 1. Debts and rights under a contract, both specifically mentioned in para (d), and any other claim against a trust are things in action. Thus, there would be a disposition of property, for example, if a person surrendered a claim against a trust by agreeing not to pursue the claim.

6.25 The extension to para (d) differs from the corresponding provision in para (d) of the Estate and Gift Duties Act "disposition of property" definition. That latter provision is to the effect that the interests in question are deemed to have been released or surrendered when they become "irrecoverable or unenforceable by action through the lapse of time". In *Re Marshall (Deceased), CIR* v *Public Trustee* [1965] NZLR 851 it was held that the quoted words were not apt to describe a case where a right ceases to exist. Instead, they only deal with the situation where the right continues to exist but ceases to be recoverable or enforceable. Paragraph (d) of the s.226(1) definition of "disposition of property" overcomes this defect by specifically providing that the rights in question are deemed to have been released or surrendered when they cease to exist. It also encompasses the situation dealt with in para (d) of the Estate and Gift Duties Act definition (i.e., debts and other interests which become statute barred) by deeming debts and other interests which "become irrecoverable or unenforceable by action" to have been released or surrendered. Finally, because para (d) of the s.226(1) definition of "disposition of property" is not limited in its application to debts or other interests which become irrecoverable or unenforceable "through the lapse of time", it encompasses circumstances where a debt or other interest becomes irrecoverable or unenforceable through the lapse of time or for any other reason.

6.26 In *Re Marshall* the question was whether the failure by a person to claim interest under a mortgage from a trust in that person's favour, and fees due for the performance of services as a tustee of that trust, amounted to a disposition of property in terms of para (d) of the definition of that expression contained in s.2 of the Estate and Gift Duties Act 1968. Subject to the modification mentioned in the preceding paragraph, this provision is in the same terms as para (d) of the s.226(1) definition of "disposition of property". A majority of judges in the Court of Appeal held that the

right to make a demand for interest and remuneration was a thing in action. The failure to make a demand did not result in a "release, discharge, surrender...or abandonment" of the thing in action. Therefore, the issue was whether there had been a "forfeiture" of the right to demand interest and remuneration or a deemed release or surrender of that right in terms of the extension to para (d). As mentioned in the preceding paragraph, the Court held that there was no deemed release or surrender because the right to claim interest and remuneration still existed. The Court further held that "forfeiture" implies the loss of something as a penalty resulting from the breach of an obligation, contract or condition, and that as there had been no such breach there was no forfeiture.

6.27 The result in *Re Marshall* was that the failure to demand interest and remuneration did not amount to a disposition of property and, therefore, did not constitute a gift. If this holding were not negated in the context of the new trust taxation regime an easy avenue would be available for avoiding settlor status while still transferring value to a trust. Consequently, the provision of on demand loans to trustees where the right to demand interest is not exercised has been specifically dealt with in s.226(2)(b). By that provision, financial assistance is deemed to have been provided at below market value, thus rendering the person providing such assistance a settlor, if amounts payable in relation to the financial assistance are payable on demand and the right to demand payment is not exercised. This rule applies whether or not the specified rate of interest payable on demand would otherwise be considered to be a market rate of interest.

(f) Paragraph (e): Exercise of general power of appointment

Objective

6.28 By para (e) of the "disposition of property" definition, the exercise of a general power of appointment in favour of any person other than the holder of the power constitutes a disposition of property. The objective of this provision is to bring within the definition the exercise of powers over property in circumstances where the person exercising the power does not actually own the property but is still able to obtain it or dispose of it for that person's own benefit. The exercise of such a power in favour of a person other than the holder of the power is equivalent to the holder of the power exercising it in that person's own favour to acquire the property and then disposing of the property to the trust. Consequently, it is necessary to include the exercise of general powers of appointment within the disposition of property definition.

6.29 By way of example, if a person has a power to dispose of property as he or she thinks fit, including the power to dispose of the property for the person's own benefit, and this power is exercised in favour of trustees of a trust, this would constitute the exercise of a general power of appointment. In terms of para (e) of the "disposition of property" definition, the exercise would be in favour of a person other than the holder of the power and there would be a disposition of property. The disposition of property would constitute a settlement if made at below market value.

General power of appointment

6.30 By s.226(1), a "general power of appointment" is defined as including any power or authority conferred by will, settlement inter vivos, or in any other manner which enables the holder of the power or authority, or which would enable the holder if the holder was of full capacity, to obtain, appoint or dispose of any property or to charge any sum of money upon any property for the holder's own benefit.

6.31 The definition of "general power of appointment" serves to extend the common law concept of a "general power of appointment". Thus, for the purpose of para (e) of the "disposition of property" definition both the s.226(1) and the common law definitions of a general power of appointment are relevant.

6.32 At common law powers of appointment are categorised into general and special powers. A general power of appointment is "a power that the donee may exercise in favour of such person or persons as he pleases, including himself or his executors or administrators." (36 *Halsbury's Laws of England* 4ed para 806). A special power of appointment is one which "may be exercised only in favour of certain specified persons or classes..." (*Halsbury* para 806). Therefore, at common law a power to appoint to a defined class including the holder of the power would be a special power of appointment rather than a general power of appointment. However, by virtue of the s.226(1) definition of "general power of appointment" such a power would be treated as a general power of appointment. Thus, for example, the power considered in *In re Penrose, Penrose* v *Penrose* [1933] All ER 796, where a husband was given the power to appoint to a defined class which included himself, would be a general power of appointment in terms of the s.226(1) definition.

6.33 The "general power of appointment definition" encompasses any power or authority conferred by will or by inter vivos settlement or created in any other manner. The power or author-

ity must enable the holder to obtain, appoint or dispose of property, or to charge any sum or money on any property, as the holder thinks fit for the holder's own benefit. If the person does not have such a power or authority because he or she is not of full legal capacity, the person is treated as having a power or authority to obtain, appoint, or dispose of property, or to charge any sum or money on property, if in the absence of the incapacity he or she would have had such a power or authority. Thus, for the purpose of the s.226(1) definition powers purportedly exercisable by incapacitated persons are treated as powers of appointment.

6.34 The manner of exercise of the power of appointment is irrelevant. Powers exercisable orally, by instrument inter vivos, by will or in any other manner are within the ambit of the definition. Any power or authority which is exercisable by a person in a fiduciary capacity under a disposition not made by that person or exercisable as a mortgagee are specifically excluded from the definition. The first exception excludes most situations where a trustee has the power to appoint property in favour of beneficiaries. The second exception excludes powers exercisable by a mortgagee in relation to property over which the mortgagee holds a mortgage.

Exercise of the general power of appointment

6.35 Paragraph (e) of the "disposition of property" definition requires the exercise of the general power of appointment in favour of a person other than the holder of the power. Thus, there is only a disposition of property, first, if there is an exercise of the general power of appointment and, second, if the exercise is not in favour of the holder of the power.

(g) Concluding language of the definition

6.36 The concluding language of the "disposition of property" definition provides that dispositions by will or intestacy which would otherwise fall within the definition are treated as dispositions of property. It is further provided that a disclaimer of an interest under a disposition made inter vivos or of an interest under a will or of an interest under an intestacy is excluded from the definition.

6.37 A disclaimer of a beneficial interest under a trust would constitute a surrender or abandonment of a thing in action in terms of para (d) of the "disposition of property" definition. However, by virtue of the concluding language to the definition such a disclaimer is specifically precluded from being a disposition of property.

**Settlements where property is made available to trustees**

Requirements

6.38 By s.226(2)(b), any person who makes, continues to make, or has at any time made, property available to or for the benefit of a trust for less than market value is a settlor for the purpose of the trust regime. The provision of financial assistance to a trust is treated as the making available of property to the trust. If financial assistance is provided at below market rates the financial assistance is deemed to have been provided to the trust at below market value.

6.39 The objective of s.226(2)(b) is to treat as settlors persons who retain ownership of property while making it available to a trust at a below market rate of return and to specifically deal with the situation where financial assistance is provided to a trust. Transactions of this nature clearly result in a transfer of value to the trust to the extent that the value provided by the trustees for the use of the property or the provision of financial assistance is less than the market value of the use of the property or the financial assistance. It is therefore appropriate to treat as a settlor any person who makes property available to a trust, or who provides financial assistance to a trust, at below market value.

Timing of transaction

6.40 A person is a settlor in relation to a trust if that person "makes, continues to make, or has at any time made" property available to a trust at below market value. Thus, a person will be a settlor of a trust, if the other requirements of the provision are met, where the person has made property available to a trust at any time, whether before or after the application of the new trust regime.

Financial assistance

6.41 The provision of financial assistance to a trust is specifically treated as the making available of property to the trust. "Financial assistance" is expressed to encompass financial assistance provided "by way of a loan, guarantee, the provision of security, or otherwise". Thus, persons who guarantee loans made to a trust, or who provide security for such loans, will be treated as making property available to the trust. For example, if a person guarantees a loan made by a bank to a trust at a market rate of interest, and the consideration provided by the trust for the guarantee is below the market value of the guarantee, the person will be a settlor of the trust.

6.42 Section 226(2)(b) also provides that where financial assistance is provided to or for the benefit of a trust at below market rates the financial assistance is deemed to have been provided for less than market value. The person providing such financial assistance is thus deemed to be a settlor. Persons who lend to trusts at below market rates of interest, or who provide guarantees or security for loans made to trusts at below market rates, will be settlors in relation to such trusts.

6.43 Section 226(2)(b) also deals specifically with the situation where financial assistance is provided to or for the benefit of a trust and amounts payable in relation to the financial assistance are payable on demand and the right to demand payment is not exercised or is deferred. In these circumstances also the financial assistance is deemed to have been provided to or for the benefit of the trust at below market value. This overcomes the holding in *Re Marshall (Deceased), CIR* v *Public Trustee* [1965] NZLR 851 that an on demand loan where the right to demand payment is not exercised does not give rise to a disposition of property and ensures that such loans cannot be used to circumvent the "settlor" definition.

**Provision of services as a settlement**

6.44 By s.226(2)(c), any person who provides, continues to provide or has at any time provided any service to or for the benefit of a trust for less than market value is a settlor of the trust. A person can be a settlor by virtue of this provision if the person provided services to or for the benefit of the trust at any time, whether or not those services are still being provided in the income year in question.

6.45 Section 226(2)(c) applies to any services provided to or for the benefit of a trust. For example, it would encompass investment advisory services, legal and accounting services, and services relating to any business carried on by the trustees of the trust.

**Trust property used or acquired, or services provided by the trustees, at above market value**

6.46 By s.226(2)(d), a person who acquires or obtains the use of property of a trust, or who obtains any service from the trustees of the trust, for greater than market value is a settlor in relation to the trust. In these circumstances by acquiring or obtaining the use of property of a trust, or in receiving services from the trustees of a trust, for value which exceeds the market value of the property or services the person is transferring value to the trust. For example, if a person purchases an asset from a trust for $10,000 where the market value of the asset is only $1,000 the person has transferred value of $9,000 to the trust. Similarly, if services provided by the trustees have a market value of $1,000 but the person pays $10,000 the person has again transferred $9,000 of value to the trust.

6.47 Given the ease with which it would be possible to transfer value to a trust by paying an inflated amount for property or services provided by the trust, it is necessary to treat any person paying such an inflated amount as a settlor.

**Section 226(2) concluding language**

Description

6.48 In terms of the concluding language of the s.226(2) definition of "settlor", a person is a settlor in two situations: first, if the person acts or abstains from acting and the effect of the action or abstention is that the intent and application of the settlor definition is defeated; second, if the person directly or indirectly enters into a transaction or series of transactions with or in relation to a trust with the effect of defeating the intent and application of the "settlor" definition.

Objective

6.49 The objective of the concluding language of the s.226(2) definition of "settlor" is threefold. First, it is intended to ensure that transactions of the type described in para (f) of the Estate and Gift Duties Act 1968 definition of "disposition of property" fall within the "settlor" definition. Second, it is intended to ensure that actions and transactions falling outside para (f) because of a defect in that provision fall within the settlor definition. Third, it is intended to provide an anti-avoidance rule which buttresses the specific provisions of the "settlor" definition.

6.50 Paragraph (f) of the Estate and Gift Duties Act definition of "disposition of property" treats as a disposition of property transactions entered into by a person with the intention of diminishing the value of that person's estate and increasing the value of the estate of any other person. It also provides that the passing by a company of a resolution which, by the extinguishment or alteration of rights attaching to shares or debentures of the company, results in the estate of a shareholder or debenture holder being increased in value at the expense of the estate of any other shareholder or debenture holder is deemed to be a transaction entered into by that other shareholder or debenture holder if that person could have prevented the passing of the resolution.

6.51 There are two main defects in para (f) of the Estate and Gift Duties Act definition of "disposition of property". The first is that it is limited to "transactions". In *Grimwade* v *FCT* (1949) 78 CLR 199 HC it was held that a transaction was something between persons rather than an action by one person. This distinction may be important, for example, in cases involving the transfer of value between classes of shares. The facts in *Robertson* v *CIR* [1959] NZLR 492 provide a good example. There, resolutions were passed at a general meeting of a company increasing its nominal capital by the creation of new shares which ranked equally with the existing shares. A parcel of the new shares was issued to trustees of a trust which had been established by a shareholder in the company. The shares issued to the trustees represented the shares which would otherwise have been issued to the shareholder. The effect of the new issue was to dilute the value of the existing shares in the company. Consequently, because the shares which would otherwise have been issued to the shareholder were issued to the trustees the value of the shareholder's shares was diminished, and this diminution was matched by an increase in the value of the trust's assets.

6.52 Although it was held that this arrangement constituted a transaction falling within para (f), it can be argued that this decision was not correct: see Adams and Richardson *Law of Estate and Gift Duties* (5 ed, Butterworths 1978) para 2/68. There were two steps in the arrangement in question. The first involved arrangements concerning the passing of resolutions between the shareholder and other members of the company. The second involved the passing of the resolutions by the company in general meeting which resulted in the creation of new shares and the allocation to the trustees. Although the first step involved a transaction it did not involve a reduction in the value of the shareholder's estate and an increase in the value of the trust's estate. Conversely, although the second step did result in a transfer of value it did not involve a transaction but rather a unilateral act of the company. When the facts are analysed in this manner there was no transaction falling within the terms of para (f).

6.53 The second defect in para (f) is that the extension to that paragraph dealing with company resolutions applies only where the change in value of the shares or debentures is attributable to an "extinguishment or alteration of the rights attaching" to the shares or debentures. Therefore, it does not deal with the situation illustrated in *Robertson* where the company issues new shares or debentures as opposed to altering the rights attaching to existing shares or debentures. The issuing of the new shares may affect the value of the existing shares but it does not extinguish or alter the rights attaching to those shares.

6.54 The concluding language of s.226(2) deals with both defects in para (f) of the Estate and Gift Duties Act definition of "disposition of property". By that language, actions or the failure to act are taken into account in addition to transactions. Further, in cases involving shares in companies the concluding language will apply whether there is an alteration or extinguishment of rights attaching to shares or debentures or a transfer in value between parcels of shares held by different persons.

Effect of the concluding language

6.55 A person is a settlor by virtue of the concluding language of s.226(2) if that person acts or abstains from acting and the effect is to defeat the intent and application of the settlor definition. Transfers of value to a trust by using a corporate intermediary may be caught by this language, for example, in the following circumstances:

(i) an arrangement of the type evidenced in *Robertson* whereby value was transferred to a trust by way of a company resolution to issue additional shares. Such an arrangement may result in a transfer of value because the shareholder in question votes in favour of the resolution or because the shareholder abstains from voting against the resolution;

(ii) informal influence or persuasion exercised by a minority shareholder the effect of which is that majority shareholders vote in favour of a resolution which results in a transfer of value to a trust at the expense of shares held by the minority shareholder;

(iii) arrangements where the value of shares issued to a person and to a trust is altered to increase the value of the shares held by the trust at the expense of the shares held by the person;

(iv) arrangements of the type described in *FCT* v *St Helens Farm (ACT) Pty Ltd* (1981) 11 ATR 544 and *Gorton* v *FCT* (1965) 113 CLR 604 where a person transfers property to a company in return for shares in the company, additional shares are issued to a trust and the effect of issuing the additional shares is to reduce the value of the shares held by the person who transferred the property to the trust and to transfer

value to the trust. In this situation the person transferring the property to the company will be a settlor if the transfer is at less than market value. The company may also be a settlor by virtue of para (a) of the "disposition of property" definition and s.226(2)(a);

(v) the renouncement by a person of an entitlement to receive additional shares in a company in consequence of which additional shares are issued to trustees of a trust: see, for example, *Birks* v *CofT* 10 ATD 266 (1953);

(vi) the redemption by a company of shares held by one person where this results in an increase in the value of shares held by a trust.

6.56 These arrangements involve transfers of value to shares held by a trust. The concluding language may also apply where a company settles property on a trust if the settlement resulted from an action of a person holding an interest in the company or from the failure of such a person to act in relation to the company. For example, if a company settled income on a trust rather than distributing it to its shareholders, and the shareholders abstained from voting against the settlement, the shareholders may be settlors of the trust by virtue of the concluding language of s.226(2).

6.57 The concluding language of s.226(2) also includes as a settlor a person who enters into a transaction or a series of transactions with or in relation to the trust with the effect of defeating the intent and application of the "settlor" definition. The meaning of "transaction" is discussed below.

6.58 For the concluding language to apply the action, abstention or the transaction must have the effect of defeating the intent and application of the "settlor" definition. The intent of the "settlor" definition is to treat as a settlor any person who transfers value to a trust. This is clear from the list of transactions contained in paras (a) to (d) of the s.226(2) "settlor" definition. Each of those transactions involves a transfer of value to the trust, either because property is transferred to, or is used by, a trust, or services are provided to a trust, at less than market value, or because property is transferred by or is made available by the trust, or services are provided by the trustees, at above market value. The concluding language thus brings within the definition persons who act or who fail to act, or who enter into transactions, in circumstances where they fall outside the terms of the specific transactions listed in the definition but where value is transferred by the person, directly or indirectly, to the trust.

6.59 The intention of the person who acts, abstains from acting or enters into the transactions is not relevant in applying the concluding language to the definition. The focus of the language is on the effect of the action or transaction or of the failure by the person to act.

**Section 226(2) proviso: value provided by beneficiaries**

6.60 By the proviso to s.226(2), the fact that a person is or will become a beneficiary of a trust does not constitute the giving or receiving of any value. This ensures that beneficiaries of trusts who transfer property to a trust or provide services to trustees cannot argue that the fact that they remain or become beneficiaries constitutes value provided by the trustees in return for the property or services.

**Transaction or series of transactions**

6.61 By s.226(2), a person is a settlor if "whether by one transaction or by a series of transactions" the person does any of the things specified in paras (a) to (d) of s.226(2). Further, the concluding language of s.226(2) treats as a settlor any person who "enters into a transaction or a series of transactions" with or in relation to the trust with the effect of defeating the intent and application of the settlor definition.

6.62 The word "transaction" was narrowly construed in *Grimwade* v *FCT* (1949) 78 CLR 199 to mean something done with another person as opposed to a unilateral act. A broader construction was given in *Robertson* v *CIR* [1959] NZLR 492. There, it was held that a series of connected events or steps with a common objective constituted a transaction although taken individually any one of the steps may not have been a transaction. Moreover, in *Gorton* v *FCT* (1965) 113 CLR 604 voting by a person at shareholders' meetings was sufficient to constitute a transaction. Consistently with these broader interpretations, "transaction" can be taken to mean acts which affect persons other than the actor even if they are not with other persons: Adams and Richardson *Law of Estate and Gift Duties* (5 ed, Butterworths 1978) para 2/61. But even if this broader construction is not correct, and an activity must involve at least two persons to constitute a transaction, the concluding language of s.226(2) applies to acts as well as to transactions. Thus, an act falling within the terms of the concluding language will be sufficient to render a person a settlor.

6.63 The transaction or series of transactions need not directly involve the trustees of the trust in relation to which the transaction is undertaken. There are three features of the legislation which

support this view. First, if the term "transaction" can be taken to include acts which affect persons other than the actor then a unilateral act by a person in relation to a trust that does not directly involve the trustees is nevertheless a transaction for the purposes of the section. Second, the introductory and the concluding language of s.226(2) provides that a "transaction" may be undertaken indirectly. Third, the concluding language of s.226(2) provides that the transaction specified there may be entered into "with or in relation to" the the trust.

6.64 From *Robertson* it is apparent that a series of related steps may be treated as a transaction. Section 226(2) also applies where there is a "series of transactions". There will be a series of transactions if there are a number of transactions which together effect a disposition of property or any of the other things specified in s.226(2).

Indirect transactions

Objective

6.65 In terms of the introductory language of s.226(2) a person is a settlor if that person "directly or indirectly" undertakes any of the transactions specified in paras (a) to (d). Further, a person is a settlor by virtue of the concluding language of s.226(2) if that person "directly or indirectly" enters into a transaction with the effect of defeating the intent and application of the "settlor" definition. The inclusion of indirect transactions reduces opportunities for avoiding settlor status by indirectly transferring value to a trust.

Indirect dispositions of property

6.66 A person makes an indirect disposition of property, for example, where the disposition is made through an intermediary. This may occur in a number of ways. In a simple case A may transfer property to B, and pursuant to an agreement or understanding with A, B may then transfer the property to a trust. The interposition of B means that the disposition of property is not a direct one. However, A effectively transfers property to the trust indirectly through the intermediary, B. An indirect disposition may also occur where A pays B to acquire property on the basis that B transfers the property to a trust.

6.67 In some cases where there is a disposition of property through an intermediary the intermediary may be a nominee. If so, s.226(3) will apply to treat as a settlor the person on whose behalf the nominee acts. If the intermediary is not a nominee the person using the intermediary may be a settlor on the grounds that the person has made an indirect disposition of property to the trust.

6.68 An indirect disposition of property may also be made through an associated person. For example, if a resident gifts property to a non-resident associate and the non-resident associate disposes of the property to a trust the resident may have made an indirect disposition of property.

6.69 An indirect disposition of property may also occur where property is transferred to an entity owned or controlled by a trust. In these circumstances the disposition of property to the entity may have been made indirectly for the benefit of the trust. For example, if a person transfers property to a company and the issued shares of the company are owned by a trust, the person will have made an indirect disposition of property for the benefit of the trust. If the disposition of property was at below market value the transferor will be a settlor in relation to the trust. Value is effectively transferred to the trust in these circumstances because the value of the trust's shareholding will increase to reflect the below market value transfer of the asset to the company. The result would be the same where a company allotted shares to another company at less than market value if the shares in that other company were owned by a trust.

6.70 Other categories of transaction described in the "disposition of property" definition may also constitute indirect dispositions of property for the benefit of a trust when entered into with an entity owned or controlled by a trust. For example, if a person forgives a debt owed by a company which is owned or controlled by a trust the forgiveness may constitute a disposition of property to or for the benefit of the trust. If the transaction is at less than market value the person will be a settlor of the trust. Similarly, if a person exercises a general power of appointment in favour of a company which is owned or controlled by a trust, and the company does not pay a market value amount to the person in return for the property appointed to the company, there will be a disposition of property for the benefit of the trust.

Indirectly making property available to a trust

6.71 Property will be made available indirectly to or for the benefit of a trust when it is made available through an intermediary. For example, if A lends money to B at below market rates and B lends the amount borrowed from A to a trust at below market rates A will have made the financial assistance available to the trust indirectly. Similarly, if B borrows money at market rates for on-lending to a trust at below market rates, and A pays B the difference between market rates and the rate paid by the trust together with a fee, A

will have provided financial assistance to the trust indirectly. B may be a nominee in these circumstances, in which case s.226(3) will render A a settlor. If it cannot be established that B is a nominee, A will be a settlor by reason of making the financial assistance available to the trust indirectly.

6.72 Property will also be made available indirectly to or for the benefit of a trust if it is made available to an entity which the trust owns or controls. For example, if a person lends money to a company controlled by a trust, and the company lends the money to the trust, the person will have made the financial assistance available to or for the benefit of the trust indirectly. If the financial assistance is provided at below market rates the person will be a settlor of the trust.

Indirect provision of services to a trust

6.73 A person provides services to a trust indirectly if that person pays another person to provide services to the trust. If the trust does not provide a market value consideration for the services the person will be a settlor of the trust in terms of s.226(2)(c). A person may also provide services indirectly to or for the benefit of a trust by providing the services to an entity owned or controlled by the trust.

Indirect acquisition, or use of, property of the trust or indirect provision of services by the trustees

6.74 A person may indirectly acquire property of the trust where it is provided to the person by the trust through an intermediary. For example, if the trustees of a trust sell property to A and A sells the property to B then B will have indirectly acquired the property from the trust. If the consideration provided by B is greater than the market value of the property this may result in B being a settlor of the trust in terms of s.226(2)(d). However, this will not necessarily be the result. If the effect of the transaction is not to transfer value to the trust, either through A passing the consideration on to the trust or through A accumulating the consideration for the benefit of the trust, then B will not be a settlor.

6.75 Property may be made available to a person indirectly by a trust, or services may be provided indirectly by trustees, through similar use of intermediaries.

**Market value**

Significance

6.76 The transactions specified in paras (a) to (d) of the settlor definition only result in a person being a settlor if, in the case of the transactions specified in paras (a) to (c), they are effected at below market value or, in the case of the transactions specified in para (d), they are effected at above market value. The concept of market value is also relevant in the context of the definition of "corpus" and the definition of "distribution" in s.226(1).

Market value compared with "fully adequate consideration"

6.77 The concept of market value is used in relation to the "settlor" definition contained in s.226(2) to overcome two defects in the "fully adequate consideration" concept used in the Estate and Gift Duties Act definition of "gift". The first of these defects is that it has been suggested that the question of whether fully adequate consideration has been provided can be determined by looking at the "nature of the transaction" and by considering whether what is given is a "fair equivalent" for what is received: *CIR* v *New Zealand Insurance Co Ltd* [1958] NZLR 1077, 1088. This approach is less precise than placing a value on the property or services which passes on one side and comparing this with the value of the consideration provided on the other. The adoption of "market value" indicates that the "fair equivalent" test does not apply in the context of the "settlor" definition and that the question of whether a person is a settlor is determined by placing a value on the consideration flowing between the person and the trust.

6.78 The second problem with the fully adequate consideration concept, also suggested by the *New Zealand Insurance Co* case, is that the intention or purpose of the parties is relevant in determining whether consideration is adequate. This could give rise to arguments under the fully adequate consideration test that if the only purpose for which a person disposes of property to a trust is to receive consideration from the trust the consideration from the trust must be fully adequate. This argument could not be made under the market value test. The market value test is an objective one and that the intention or purpose of the parties is not a relevant consideration.

General principles

6.79 The method of valuing transactions with or in relation to trusts and of valuing property settled on trust will vary considerably from transaction to transaction. It is not possible in the context of this bulletin to give precise guidance on how particular categories of transactions are to be valued. However, some principles of general application are clear from cases decided in similar contexts.

6.80 In general terms, the market value of property or services is determined by assuming that the property is sold to a person, or the services are provided to another person, in a hypothetical transaction. This allows an objective judgment to be made as to whether the transaction was effected at market value. Applying this hypothetical transaction approach, the market value of property or services is the amount at which a reasonable and willing vendor will sell the property or provide the services to a willing, well informed and prudent purchaser where:

(i) the vendor or person providing the services is assumed to be honest and reasonable, and therefore willing to provide prospective purchasers with all of the information which the vendor or person providing the services is entitled to provide: *Lynall* v *IRC* [1971] 3 All ER 914;

(ii) special circumstances surrounding the disposition of property or the provision of services - for example, that the person disposing of the property was in financial difficulty - can be taken into account: *Edge* v *CIR* [1958] NZLR 42;

(iii) if the transaction involves the disposition or use of property, any special characteristics of the property must be taken into account: *Lynall;*

(iv) the purchaser in the hypothetical transaction is assumed to be prudent, and therefore the price which the purchaser would pay would be a reasonable one in view of the information which can be assumed to be available: *Public Trustee for NSW* v *CIR* [1966] NZLR 257; *Lynall;*

(v) all potential purchasers are considered but the price which a purchaser would pay for special reasons does not represent the market value unless there are sufficient special purchasers to indicate that the higher price is in fact the market value: *HMR Properties* v *CIR* 5 ATR 797 (1975); *CIR* v *Crossman* [1936] 1 All ER 762; *Robinson Brothers (Brewers) Ltd* v *Houghton Assessment Committee* [1938] 2 All ER 534.

6.81 The hypothetical purchaser is assumed to be well informed so that all available information can be taken into consideration in determining whether the transaction was effected at market value. All information which the person disposing of the property or providing the property or services is entitled to disclose, whether or not there is an obligation to disclose the information, is taken into consideration.

6.82 Any special circumstances surrounding the transaction may be considered. For example, if the vendor of property is desperate to sell because of financial difficulties, and is therefore willing to accept a lower price, that fact will be relevant in determining whether the property was disposed of at market value. If there are no special circumstances surrounding the transaction it is not appropriate to assume special circumstances in determining whether the transaction was at market value.

6.83 In cases involving the disposition or making available of property, any special characteristics of the property may be considered in valuing the transaction. For example, if shares in a private company which are subject to a right of pre-emption are disposed of it is necessary to assume that the hypothetical purchaser of the shares would acquire them subject to that right of pre-emption: see the *Lynall* case cited above. Similarly, if the transaction involved land and there were restrictions on the use of the land it would be necessary to consider those restrictions in valuing the land.

6.84 As a general rule, a price which, for special reasons, a particular person would be prepared to pay for property or services will not represent the market value of the property or services. Thus if a property developer would be prepared to pay a high price for a piece of land in order to establish itself in a particular area the price which the developer would pay would not be determinative in establishing whether the price paid on the sale of the property to a trust represented the market value of the property: see the *HMR Properties* case cited above. However, if there are a number of special purchasers willing to pay a special price that may indicate that the higher price represents the market value.

6.85 If the market selling value method of valuing trading stock for the purpose of s.85 of the Income Tax Act is adopted by a person, the correct approach is to ascertain the amount at which the person would be willing to sell the trading stock in the ordinary course of business at the relevant date: *Sharkey* v *Wernher* [1956] AC 58. The ordinary course of business approach does not differ significantly from the willing buyer - willing seller approach discussed above. Thus, in cases involving the disposition of property, or the provision of property or services, by a person who is in the business of disposing of property or providing property or services of the type in question, the market value of the property or services can be determined by establishing whether the amount charged is the amount which would be charged in the ordinary course of the person's business.

6.86 In determining whether a transaction results in a person being classified as a settlor by virtue of s.226(2) all value provided in relation to the transaction, whether in cash or in kind, is taken into account. However, as discussed above, the proviso to s.226(2) provides that the fact that a person is or will become a beneficiary does not constitute the giving or receiving of value.

Services provided by professional advisers

6.87 In some cases professional advisers provide services free of charge with the purpose of encouraging the person to whom the services are provided to become a longer term client. In other cases services may be provided free of charge to an existing client in order to encourage the person to remain a client, and on the basis that the services are relatively minor in the context of the overall services provided to the person. If services are rendered by a professional adviser to trustees of a trust for these types of reasons the question arises whether the adviser is a settlor of the trust.

6.88 Applying the willing seller - willing buyer approach, it would be clear that where services are provided free of charge in the circumstances described a well informed and prudent person receiving the benefit of the adviser's services would not pay for the services. Consequently, the provision of services would be at market value. Applying the ordinary course of business approach, if the adviser provided services free of charge in the described circumstances then the provision of the services free of charge will be at market value. In this context, the question is not whether the adviser ordinarily provides services to the trustees free of charge but rather whether in the circumstances in which the services are provided to the trustees the adviser would ordinarily provide the services free of charge to the adviser's other clients.

Services provided by trustees

6.89 As a matter of law trustees are generally prohibited from charging for services provided in relation to the trust. One exception to this rule is where the trust deed allows trustees to charge for services. The question arises whether a trustee who provides services free of charge in relation to a trust is thereby a settlor of the trust in terms of s.226(2).

6.90 If the trustee is not legally entitled to charge for the trustee's services this will be a special circumstance to consider in terms of the discussion above of the willing buyer - willing seller approach. Given the inability to charge for services, a willing buyer would not pay for the services. Consequently, in these circumstances the trustee will not be a settlor of the trust. However, the trustee may be a settlor if the trustee is able to charge for services but does not do so.

Forgiveness of debt

6.91 If a person forgives a debt owing by a trust the forgiveness will constitute a "disposition of property" by virtue of para (d) of the definition of that term. If the debt is forgiven at less than market value the person forgiving the debt will be a settlor of the trust. Where the trust and the trustees are insolvent the debt will have little or no value. Consequently, a forgiveness of the debt for no consideration will not result in the lender being classified as a settlor. However, if the trust and the trustees are not insolvent and the debt is forgiven at below market value the lender will be a settlor of the trust.

**Nominee and nominal settlors: s.226(3)**

Significance

6.92 Section 226(3) provides that where any person has made a settlement to or for the benefit of a trust or on the terms of a trust as a nominee for another person, or if the settlement is made at the request of another person and is of a nominal amount, the other person is deemed to be the settlor of the trust rather than the person actually making the settlement.

6.93 The objective of this provision is to ensure that persons acting as nominees, or who do not act as nominees but who settle a nominal amount on trust on instructions from another person, are not treated as settlors. Often professional advisers or relatives will assist in establishing a trust by settling a nominal sum on trust on behalf of another person. In these circumstances it is not appropriate to expose the professional adviser or relative to a potential tax liability under s.228. The professional adviser or relative is not the real settlor of the trust but is in effect only an intermediary or facilitator. The real settlor is the person on whose behalf the professional adviser or relative acted in making the settlement. Thus, s.226(3) treats the person for whom the nominee or the nominal settlor acted as the settlor rather than the nominee or nominal settlor.

6.94 Section 226(3) also makes it clear that a person cannot avoid settlor status by using nominees or nominal settlors to establish trusts. This is also apparent from s.226(2) as that provision includes as settlors persons who carry out indirectly the transactions described in that provision.

Requirements

6.95 The term "nominee" is not defined for the purpose of s.226(3). It will thus have the meaning which it normally has in the context of the Income Tax Act: i.e., a person who acts on the instructions of another person. The nominee exception applies where any "settlement" is made by a nominee. By s.226(6) a settlement is any action or failure to act on the part or any person, or any transaction entered into by a person, which has the effect of making that person a settlor.

6.96 The question of whether a settlement is of a nominal amount is determined by considering the amount of the settlement in isolation rather than by comparing the amount of the settlement with the eventual value of the trust's assets. It is not possible to establish a fixed amount as being nominal. However, it would generally be the case that a settlement involving an amount less than $100 would be a nominal settlement. In contrast to the nominee settlor exception the nominal settlor exception is limited to settlements of "amounts". This is understood to mean amounts of money. Thus, the nominal settlor exception applies only to settlements of money. The exception would not apply, for example, in cases where the settlement involved the provision of services or the transfer of property other than money. This is because in practice the transactions which the exception is targeted at - the establishment of trusts by professional advisers and relatives at the request of another person - only involve the settlement of small cash sums.

6.97 The nominal settlor exception applies only where the settlement was made at the request of another person. Thus, if a person settles a nominal amount on trust on that person's own initiative the person will remain a settlor in terms of s.226(2). Although it is not stated explicitly, it is implicit in the nominee concept that the nominee exception applies where the person who is acting as a nominee in making the settlement does so at the direction of another person.

Disclosure

6.98 Although s.226(3) excludes nominee and nominal settlors from being settlors for the purpose of the trust regime, persons in this category may still have an obligation under s.231(3) to make a disclosure. By s.231(3), a person is required to make a disclosure to the Commissioner if -

(i) the person was resident in New Zealand at the time of a settlement on or to or for the benefit of a trust on or after 17 December 1987; and

(ii) the person would otherwise be treated as a settlor of the trust but by virtue of the application of s.226(3) the person is not treated as a settlor of the trust; and

(iii) at the time of the settlement there was no trustee of the trust resident in New Zealand.

6.99 If these conditions are satisfied the person is required to disclose to the Commissioner the fact of the settlement, the name and address of the person who is deemed to be the settlor pursuant to s.226(3) and any further details which may be required. The disclosure must be made within three months of the date of settlement or, if later, by 31 May 1989. The deemed settlor may also have a disclosure obligation in relation to the settlement because, for example, there is no resident trustee of the trust at the time of settlement: s.231(2).

**Settlements by closely held companies: s.226(4)**

Objective

6.100 Section 226(4) provides that where a controlled foreign company, or a company which would be a controlled foreign company if it were a foreign company, settles a trust or is deemed to be a settlor of a trust any person who at the time of settlement held a control interest in any category of control interest (as defined in s.245C) in the company of 10 percent or greater is a settlor of the trust.

6.101 The objective of this provision is to limit opportunities for avoiding the trust regime by using a company to establish a trust and then winding the company up. The provision also recognises that where a closely held company is used to settle a trust the company is being used as a vehicle for the settlement and it is thus appropriate to look through the company to the real settlor.

Application of s.226(4)

(a) Conditions to satisfy

6.102 Section 226(4) provides that a person who holds an interest in a company which settles a trust is a settlor of the trust if the following conditions are met:

(i) the company settles a trust or is deemed to be a settlor of the trust by virtue of s.226;

(ii) at the time of the settlement the company was a controlled foreign company (CFC) as defined in s.245C or, if it was not a CFC,

it was a company which would have been a CFC if it were a foreign company;

(iii) at the time of the settlement the person held a control interest in any of the categories of control interest specified in s.245C of 10 percent or more or, if the company was not a CFC, the person held an interest in the company which would have been a control interest of 10 percent or more in a CFC if the company were a foreign company.

(b) Settlement by company

6.103 For s.226(4) to apply the company must settle a trust or it must be deemed by virtue of s.226 to be a settlor of a trust. A company will have settled a trust if it undertakes any of the transactions or actions which result in a person being a settlor by virtue of s.226(2) or if the company is a settlor by virtue of s.226(4) or s.226(5).

6.104 In this context it is important to appreciate that a company will be regarded as having settled a trust not only if it undertakes an action or transaction specified in s.226(2) but also if it is a settlor by virtue of any of the other provisions of s.226, or by virtue of s.226(4) itself. For example, if a New Zealand resident company which holds a control interest of 10 percent or more in a CFC is by virtue of s.226(4) a settlor of a trust settled by the CFC then the New Zealand resident company will be treated as being a settlor of the trust. Consequently, if the New Zealand resident company would have been a CFC if it were a foreign company any person who held a control interest of 10 percent or more in the New Zealand resident company at the time of settlement by the CFC will also be a settlor of the trust by virtue of s.226(4). This is because s.226(4) applies where a company "settles a trust or is deemed by virtue of this section" to be a settlor of a trust and in the example the New Zealand resident company settles the trust, or is deemed to be a settlor of the trust, in terms of s.226. Therefore, any person who held control interest of 10 percent or more in the New Zealand resident company at the time of settlement by the CFC will be a settlor of the trust.

6.105 Section 226(4) applies where the person has a "control interest" of 10 percent or more in a company. In terms of s.245C "control interests" encompass direct and indirect control interests. An indirect control interest is a control interest held through a CFC. In the context of s.226(4) indirect control interests taken into account will be those held through CFCs or through companies that would be CFCs if they were foreign companies. Thus, where a lower tier CFC (or company which would be a CFC if it were a foreign company) settles a trust any person with an indirect control interest of 10 percent or more in the CFC (or company which would be a CFC if it were a foreign company) at the time of settlement will be a settlor of the trust.

6.106 A company may be deemed to be a settlor of a trust by virtue of s.226(3) or s.226(7). Thus, if a trust was settled by a nominee of a company the company would be deemed to be a settlor of the trust by s.226(3). Similarly, if a company acquired any rights or powers in relation to a trustee or settlor of an existing trust, and that acquisition had the purpose or effect of enabling the person to require the trustee to treat the company or any other person nominated by the company as a beneficiary of the trust, the company would be deemed to be a settlor of the trust by s.226(7). In both cases s.226(4) could be applied if the company was a CFC, or a company which would be a CFC if it were a foreign company, to treat any person holding a control interest in the company of 10 percent or more as a settlor of the trust which the company is deemed to have settled by virtue of s.226(3) or s.226(7).

(c) Nature of the company

6.107 For s.226(4) to apply the company which settled the trust, or which is deemed to have been a settlor of the trust, must have been a CFC, or a company which would have been a CFC if it was a foreign company, at the time of settlement.

6.108 The CFC legislation will be discussed in detail in a later bulletin. Briefly, a foreign company is a CFC in relation to an accounting period if at any time during that accounting period the control interests in any of the categories of control interest listed in s.245C(4) of five or fewer New Zealand residents in the foreign company is at any time during the accounting period 50 percent or greater: s.245C(1). By s.245C(3), the control interest of a person in a foreign company in any of the categories of control interest listed in s.245C(4) is calculated by aggregating with respect to each category of interest the person's direct control interest and indirect control interest and the direct control interest and indirect control interest held by persons associated with the person. By s.245C(4), a person holds direct control interests in a foreign company at any time equal to each percentage of the following things which the person holds or is entitled to acquire at that time:

(i) the percentage of the total paid up capital of the foreign company;

(ii) the percentage of the total nominal capital of the foreign company;

(iii) the percentage of the rights to vote or participate in decision making concerning distributions, the constitution of the company, variation of the capital of the company, or the appointment or election of directors;

(iv) the percentage of the income of the foreign company which the person would be entitled to receive if the income earned by the company was distributed on the last day of its accounting period and the entitlement of the person to receive income were the same at all other times during the company's accounting period;

(v) the percentage of the value of the net assets of the foreign company which the person would be entitled to receive in the event of distribution of all of the company's assets.

6.109 Indirect control interests are determined under s.245C(5). Broadly, that provision allocates direct control interests held by a CFC, or by an associate of a CFC, in another foreign company to persons holding control interests in the CFC. The question of whether persons are associated is determined under s.245B. Control interests are calculated on four measurement days (31 March, 30 June, 30 September, and 31 December) and the control interests held on those particular days are deemed to be held from the preceding measurement day up to and including that measurement day: s.245A(2)(e). Alternatively, an election may be made to calculate control interests on a daily basis.

6.110 The control test is applied on a category of interest by category of interest basis. That is, a foreign company will be a CFC if the control test is satisfied in any one of the categories of interest listed in s.245C(4). For example, if five or fewer residents hold direct and indirect control interests in the foreign company in the paid up capital category of 50 percent or more the company will be a CFC even if the aggregate interests held by the residents in the other categories are less than 50 percent.

6.111 Section 226(4) applies in relation to both foreign companies which are CFCs and companies which are not foreign companies but which would be CFCs if they were foreign companies. This means that s.226(4) applies with respect to all companies, whether resident in New Zealand or not, which satisfy the control test contained in s.245C which applies with respect to foreign companies.

6.112 The control interest concept encompasses both direct and indirect control interests. Thus, if a CFC holds a direct control interest in another foreign company residents holding control interests in the CFC will have control interests in that other foreign company. If the other foreign company is a CFC and it settles a trust, any resident who holds a control interest in the foreign company of 10 percent or more at the time of settlement will be a settlor of the trust.

(d) Interests in the company

6.113 Section 226(4) applies with respect to any person who, at the time of the settlement by the company, held a control interest of 10 percent or more in the company in any of the categories of control interest listed in s.245C. The calculation of control interests in a foreign company has been discussed briefly above. Control interests are broader than "income interests" (calculated under s.245D) in that control interests include interests held by associated persons and entitlements to acquire interests. Also, a person may have control interests in each of the categories of control interest listed in s.245C(4) while an income interest is calculated as the highest of the interests listed in s.245D(2). Finally, there are different rules for calculating indirect control interests and indirect income interests.

6.114 The effect of s.226(4) is that persons holding control interests of more than 10 percent at the time of settlement or deemed settlement are settlors of the trust. If the company is subsequently wound up, or the person's interest in the company is subsequently disposed of, the person will remain a settlor. Conversely, a person who acquires an interest in the company after the date of settlement will not be a settlor of the trust. This result is consistent with the objective of limiting opportunities for avoidance of settlor status by using closely held companies to settle trusts and with the objective of looking through closely held companies which settle trusts to establish the real settlor of the trust.

Effect on the company

6.115 Section 226(4) is a look through rule. It operates by defining as a settlor a person who holds an interest in a closely held company which settles a trust. However, the application of s.226(4) does not prevent the company from also being a settlor. Thus, if a resident company settles a trust it will be a settlor of the trust. Additionally, if the requirements of s.226(4) are satisfied any person who holds an interest in the company may also be a settlor of the trust.

Examples

Example 6

Facts: NZco holds control interests in CFC of 100 percent in each of the categories of control interest specified in s.245C at the time CFC settles a trust. A and B each hold control interests in NZco of 40 percent in each category of control interest at the time CFC settles the trust and C holds control interests of 20 percent in each category. NZco is not a foreign company and A, B and C are resident in New Zealand.

Result:

(i) At the time of settlement NZco held control interests of more than 50 percent in CFC in each of the categories of control interest listed in s.245C. NZco thus satisfies s.226(4) in that at the time of settlement it held a control interest of more than 10 percent in any of the categories of control interest listed in s.245C. NZ co is therefore a settlor of the trust settled by CFC by virtue of s.226(4).

(ii) NZco is a settlor of the trust and is thus treated as having made a settlement on the trust: s.226(6). At the time of settlement NZco is a company which would have been a CFC if it had been a foreign company because A, B and C together have control interests in the categories listed in s.245C of 50 percent or more. As A, B and C each have control interests in NZco (which by s.226(4) is a settlor of the trust) of 10 percent or more at the time of settlement they are also settlors of the trust by virtue of s.226(4). There are thus four resident settlors of the trust: NZco, A, B and C.

Example 7

Facts: NZco2 settles property on Trust1 on 1 April 1989 and on 1 June 1989 the trustees of Trust1 settle property on Trust2. On both 1 April 1989 and 1 June 1989 A, a New Zealand resident individual, holds control interests of 100 percent in each category of interest in NZco1 and NZco1 holds control interests of 100 percent in each category of interest in NZco2. NZco1 and NZco2 are both New Zealand resident companies which are not foreign companies.

Result:

(i) At the time of settlement of Trust1 by NZco2, NZco2 is a company which would be a CFC if it were a foreign company. A's control interests in NZco2 are calculated under the indirect control interest rules contained in s.245C(5) because A does not hold a direct interest in NZco2 but rather an interest in NZco1 which in turn holds an interest in NZco2. By application of those rules A has control interests in each of the categories of interest in NZco2 of 100 percent. Therefore, both NZco2 and A are settlors of Trust1. NZco1 is also a settlor of Trust1 because it has control interests of 10 percent or more in NZco2 at the time of settlement.

(ii) When the trustees of Trust1 settle property on Trust2 any person who is a settlor of Trust1 is treated as a settlor of Trust2: s.226(5). Therefore, NZco2 is a settlor of Trust2 by virtue of settling Trust1 and A and NZco1 are settlors of Trust2 by virtue of being settlors of Trust1 under s.226(4).

Settlor status and the CFC regime

6.116 By s.226(4), where a CFC settles a trust any person holding a control interest of 10 percent or more in the CFC at the time of settlement is a settlor of the trust. The worldwide trustee income derived by the trustees of the trust is therefore liable to tax in New Zealand by virtue of s.228 because there will be a resident settlor of the trust. If there are no resident trustees of the trust the settlor may be liable for tax on the trustee income. By s.245J(1), the branch equivalent income or loss of a CFC is calculated, generally, as if the CFC were a company resident in New Zealand. If a resident company settles a trust and there are no resident trustees the company may be liable for tax on the trustee income. Therefore, if a CFC settles a trust, the question arises whether the branch equivalent income or loss of the CFC is calculated by including the trustee income of the trust.

6.117 If trustee income were taken into account in calculating branch equivalent income or loss double taxation of trustee income could arise if such income were directly assessable to resident settlors as well as being attributed to settlors on a pro-rata basis under the CFC regime. Further, problems could arise if persons who held control interests in a CFC at the time of settlement subsequently disposed of those interests to other residents. In these circumstances the persons originally holding the interests would remain settlors and might be liable for tax on trustee income while the persons acquiring the interests would be liable for tax on their pro-rata share of the trustee income under the CFC regime.

6.118 However, these problems do not arise because trustee income is not taken into account in calculating branch equivalent income or loss. The scheme of the trust legislation is to tax trustee income either to the trustee or to the settlor. The objective of the extended "settlor" definition in s.226 is to ensure that if a New Zealand resident settles a trust indirectly the trustee income derived by the trustees does not escape New Zealand tax. To require attribution of trustee income under the CFC regime would be inconsistent with the broad thrust of the settlor definition. It is therefore considered that because there is a specific regime governing the taxation of trustee income the more general provisions of the CFC regime cannot be used to tax such income.

Section 226(4) and indirect settlements

6.119 Section 226(4) is expressed to apply "without limiting the situations in which a person is a settlor by reason of that person indirectly undertaking any of the transactions specified in subsection (2) of this section". This is taken to mean that s.226(4) is not exhaustive of the situations in which a settlement made by a company is treated as also being a settlement made by persons holding interests in the company. Thus, in some circumstances settlements made by a company which is not a CFC, or which is not a company which would be a CFC if it were a foreign company, may also be treated as being made by a person holding an interest in such a company. For example, if a non-resident person used a closely held company to settle a trust before becoming resident in New Zealand, s.226(4) would not apply but the person using the company may be a settlor because the person made an indirect settlement on the trust.

**Settlements by trustees: s.226(5)**

Objective

6.120 Section 226(5) provides that if a trustee of a trust settles another trust or makes a distribution to or on the terms of another trust any person who is a settlor of the trust making the settlement or distribution is a settlor of the trust on which the settlement is made or to which the distribution is made. The objective of s.226(5) is to ensure that settlor status cannot be avoided by using trusts to settle other trusts or to make distributions to other trusts. In the absence of this rule it may not be possible to establish that a settlor of a trust is a settlor of another trust settled by that trust.

Application

6.121 Section 226(5) applies if:

(i) there is a settlement or distribution by a "trustee of a trust";

(ii) the trustee "settles a trust or makes any distribution to or on the terms of another trust";

(iii) there is a settlor of the trust making the settlement or distribution.

6.122 In this context, the definition of "trustee" in s.2 is relevant. Among other things, that definition provides that "in relation to any trust, a reference in this Act to a trustee of that trust means that trustee only in the capacity as trustee of that trust". Therefore, settlements or distributions made by trustees on or to other trusts are only relevant in applying s.226(5) if they are made by the trustee in the trustee's capacity as trustee of that trust. Consequently, if the trust from which the settlement is made is wound up the trustees of that trust will cease to be settlors of the resettled trust because the trustees were settlors of the resettled trust in their capacity as trustees of the trust from which the settlement was made rather than in a personal capacity. If the original trust is wound up the trustees lose their status as trustees of that trust and, because their status as settlors of the resettled trust depends solely on their status as trustees of the original trust, it follows that they also lose their status as settlors of the resettled trust. However, any person who was a settlor of the resettled trust by virtue of s.226(5) will remain a settlor of that trust even if the original trust is wound up.

6.123 The second requirement is that the trustee must settle a trust or make a distribution to or on the terms of another trust. The use of the present tense is taken to indicate that the rule only applies with respect to settlements or distributions made by trustees after the new trust regime came into effect: i.e., after the beginning of the income year commencing on 1 April 1988. The trustee will be considered to have settled a trust if the trustee is a settlor of the trust in terms of s.226. In determining whether the trustee has made a distribution to another trust the definition of "distribution" in s.226(1) will apply.

6.124 The third requirement is that there must be a settlor of the trust which makes the settlement. Section 226(5) provides that the term "settlor" in relation to the trust on which the settlement is made "includes any person who is a settlor of the first trust, and includes any person who is a settlor of the first trust by the operation of this subsection". Thus, a person will be a settlor of the trust making the settlement (i.e., the "first trust") if the person is a settlor of that trust by virtue of any of

the provisions of s.226, including s.226(5). For example, if A settles Trust 1, the trustees of Trust 1 settle Trust 2, and the trustees of Trust 2 settle Trust 3, A will be a settlor of all three trusts. A is a settlor of Trust 2 by operation of s.226(5) because A is a settlor of Trust 1. A will also be a settlor of Trust 3 by virtue of s.226(5) because A is a settlor of Trust 2 by virtue of s.226(5).

6.125 Section 226(5) applies where the trustees of a trust settle another trust or make a distribution to another trust after the beginning of the income year commencing on 1 April 1988, the date on which the new trust regime came into effect. However, the person who is a settlor of the trust from which the settlement or distribution is made (i.e., the "first trust") need not necessarily have undertaken the transaction or action which rendered that person a settlor of the first trust after the effective date. If the person is a settlor of the first trust by virtue of s.226(2) it is clear that the transaction or action giving rise to that settlor status may have been undertaken at any time, whether before or after the commencement of the new trust regime.

6.126 However, if the first trust was settled before the commencement date and the trustees of that trust settled another trust before the commencement date the settlor of the first trust would not be a settlor of the second trust by virtue of s.226(5). Unlike s.226(2), s.226(5) only applies to make a person a settlor of a trust where the transaction or action takes place after the commencement date of the new trust regime. Thus, the settlor of the first trust would only be a settlor of the second trust if the settlement on the second trust was an indirect settlement by the settlor of the first trust or if the trustees of the second trust were acting as nominees for the settlor of the first trust in making the settlement.

6.127 By way of example, assume that on 1 February 1986 A made a disposition of property to a trust at below market value, and on 1 February 1989 the trustees of the trust made a disposition of property to another trust at below market value. A would be a settlor of the first trust in terms of s.226(2) even though the disposition of property to that trust took place before the commencement date of the new trust regime. By virtue of s.226(5), A would also be a settlor of the second trust because the disposition of property to the second trust took place after the commencement date of the new trust regime. However, if the disposition of property to the second trust was made before the commencement date of the new trust regime s.226(5) would not apply to render A a settlor of the second trust, although A would be a settlor of the first trust and the trustees of the first trust would be settlors of the second trust.

Settlement definition: s.226(6)

6.128 Section 226(6) provides that the term "settlement" means any action or failure to act on the part of any person, or any transaction or series of transactions entered into by any person, which has the effect of making that person a settlor. The term "settlement" is used in a number of contexts: see, for example, para (d) of the definition of "distribution", the definition of "foreign trust", the definition of "qualifying trust", s.226(3), s.226(4), s.226(12), s.227A, s.228(4), s.228(5), s.228(6) and s.231.

**Acquisition of rights or powers in relation to settlor or trustee: s.226(7)**

Objective

6.129 Section 226(7) provides that if any person has acquired rights or powers in relation to a trustee or settlor of an existing trust, and the acquisition has the purpose or effect of enabling the person to require the trustee of the trust to treat the person or any other person nominated by the person as a beneficiary of the trust, the person is deemed to be a settlor of the trust.

6.130 In the absence of this provision it would be possible to avoid settlor status by acquiring rights or powers in relation to an existing trust rather than by establishing a new trust. For example, if a Hong Kong resident settles $990,000 on trust where the trustee is a company owned by the Hong Kong resident, and a New Zealand resident acquires the trustee for $1 million, the New Zealand resident would not be a settlor of the trust under the other provisions of s.226. However, by acquiring the trustee the New Zealand resident may be able to nominate beneficiaries of the trust and exercise control over the $990,000 trust fund. Effectively, the person acquiring the trustee in these circumstances is in the same position as if that person had established the trust. Thus, by s.226(7) the person acquiring the trustee will be deemed to be a settlor of the trust if the acquisition has the purpose or effect of enabling the person to require the trustee to treat nominated persons as beneficiaries of the trust.

Application

6.131 Section 226(7) applies if:

(i) a person acquired rights or powers in relation to a trustee or settlor of an existing trust; and

(ii) the acquisition was made directly or indirectly; and

(iii) the acquisition had the purpose or effect of enabling the person to require the trustee to treat the person or any other nominated person as a beneficiary of the trust.

6.132 Section 226(7) applies where rights or powers are acquired in relation to either the trustee or the settlor of an existing trust. Rights in relation to a trustee or settlor may be acquired, or example, if the trustee or settlor is a company and the person acquires shares in the company. The acquisition of the shares may enable the person to require the trustee to treat the person or any nominated person as a beneficiary of the trust. In the case of trusts established outside New Zealand persons are often appointed in relation to the trust to ensure that the trustee's decisions are in accordance with the settlor's wishes. These persons are often referred to as "protectors" but other terminology may be used. It may thus be possible to acquire powers in relation to a trustee, for example, by being appointed a protector of the trust or by being appointed to a position with the same function as a protector, by acquiring the protector or other person who performs the function of a protector, or by acquiring the settlor and using the settlor's influence or control over the protector or other person performing the function of a protector.

6.133 The acquisition may have been made directly or indirectly. The important consideration is therefore whether a person has acquired rights or powers in relation to a trustee rather than how those powers or rights were obtained.

6.134 The purpose or effect of the acquisition must be to enable the person to require the trustee to treat the person or any other person nominated by the person as a beneficiary of the trust. This will be determined by establishing whether the person can in fact require the trustee to treat the person or another nominated person as a beneficiary of the trust. If the person can require the trustee to treat the person or another nominated person as a beneficiary the person will be a settlor even if the legal documentation establishing the trust does not indicate that the person has this power. For example, it is often the case in relation to trusts established in tax havens that settlors exercise informal control over trustees; the control being informal in the sense that it is not disclosed in the documents establishing the trust. A person who acquires rights or powers in relation to a settlor of such a trust will be a settlor of the trust if the purpose or effect of the acquisition is to enable the person to utilise the settlor's informal control over the trustees in order to have the person or a nominated person to be treated as a beneficiary of the trust.

6.135 Section 226(7) applies if the acquisition has the purpose or effect of "enabling" the person to require the trustee to treat the person or a nominated person as a beneficiary. Therefore, it is not necessary that the person actually require the trustee to treat the person or a nominated person as a beneficiary. The provision is satisfied if the person is able to require the trustee to behave in that manner. Consequently, if in year 1 a person acquires rights or powers of the type described in s.226(7) and those rights or powers are not exercised until year 3, the person will be a settlor of the trust in years 1 to 3 inclusive. In these circumstances the person effectively has a power of disposition over the income derived by the trustees and it is thus appropriate to treat the person as a settlor from the outset.

**Settlements by employers: s.226(12)**

Objective

6.136 Section 226(12) provides that a person is deemed not to be a settlor of a trust if the person makes a settlement as an employer for the benefit of employees on a trust established principally for the purpose of providing retirement benefits to natural persons. This provision does not apply if the trust is a foreign superannuation scheme as defined in s.245R or if it is a superannuation fund (as defined in s.2).

6.137 The objective of this provision is to ensure that New Zealand subsidiaries of multinational companies are not treated as settlors of superannuation schemes established by their non-resident parent companies where they make contributions to such schemes in relation to their employees. In the absence of this rule a New Zealand subsidiary of, say, a United States multinational company could be treated as a settlor of the superannuation scheme established by the United States parent company and could be liable for tax on the worldwide trustee income of the scheme in terms of s.228.

Application

6.138 For s.226(12) to apply the settlement must be made by an employer on the terms of a trust established principally for the purpose of providing retirement benefits for natural persons. Section 226(12) does not apply if the trust is a foreign superannuation scheme as defined in s.245R. These schemes will be unit trusts and by virtue of s.226(10) will therefore fall outside the scope of the trust regime.

6.139 Section 226(12) also does not apply if the trust is a superannuation fund. By s.2, the expres-

sion "superannuation fund" is defined as meaning superannuation category 1 and 2 schemes and superannuation schemes which are registered under the Superannuation Schemes Act 1989. Superannuation schemes constituted outside New Zealand which have been classified by the Government Actuary under the Superannuation Schemes Regulations 1983 are excluded from the definition.

## PART 7: TRUSTS SETTLED BY PERSONS BEFORE BECOMING RESIDENT

### Overview

7.1 Section 226A applies where a settlor of a trust becomes resident in New Zealand after 17 December 1987 and, if a distribution had been made from the trust on the day immediately preceding the day on which the settlor became resident, the trust would have been a foreign trust in relation to the distribution. In these circumstances any settlor, trustee or beneficiary of the trust may elect to pay tax on the trustee income derived by the trustee within 12 months of the later of 31 May 1989 or the day on which the settlor became resident.

7.2 In many cases trusts settled by non-residents will have been established in ignorance of the New Zealand trust taxation regime. Consequently, it is not appropriate to automatically expose settlors of such trusts who subsequently become resident in New Zealand to taxation on trustee income in accordance with s.228. However, to be consistent with the policy underlying the trust regime, if a settlor of the trust is resident in New Zealand it is appropriate either to subject the trustee income to tax or to tax resident beneficiaries deriving distributions of amounts other than beneficiary income at a higher rate to compensate for the deferral advantage they enjoy. Thus, rather than automatically exposing the trustee income of such trusts to taxation s.226A gives settlors, trustees and beneficiaries an option to elect to pay tax on such income. However, if an election is not made resident beneficiaries are taxed at a higher rate on distributions of income and capital gains to compensate for the deferral of New Zealand tax enjoyed on the trustee income as it is accumulated.

7.3 The effect of an election is that the elector is liable to pay income tax on trustee income. Therefore, if an election is made the legislation treats the trust as a qualifying trust in relation to distributions of income, capital profits and capital gains derived by the trustees after the date on which the election is made. Distributions of such amounts, other than distributions of beneficiary income, are thus not assessable for income tax to the beneficiary: s.227(6). The trust remains a foreign trust in relation to distributions of income, capital profits or capital gains derived before the date on which the election was made. Thus, distributions of income derived by the trustees before the election was made are assessable, subject to the application of the proviso to s.9 of the Income Tax Amendment Act (No 5) 1988 (see Part 3 of this bulletin for a discussion of s.9). Where the obligation to pay tax on trustee income ceases to be satisfied in any income year distributions made in that income year, and in succeeding income years, are treated as distributions from a non-qualifying trust except to the extent that they consist of distributions of amounts derived before the election to pay tax on trustee income was made.

7.4 If an election is not made, and no further settlements are made on the trust after the settlor becomes resident in New Zealand, the settlor is not liable for tax on the trustee income: s.228(4) in relation to trusts settled on or before 17 December 1987; s.228(5)(b) in relation to trusts on which a settlement has been made after 17 December 1987. Further, if the trustee is resident outside New Zealand at all times during the income year the trustee will not be liable for tax on the trustee income: s.228(6). Consequently, as the trustee income is not taxed as it is derived distributions of income, other than of beneficiary income, and capital gains derived after the expiry of the period for making the election are taxed at a higher rate to compensate for the deferral advantage enjoyed by the beneficiary. This is achieved by treating the trust as a non-qualifying trust in relation to such distributions: s.226A(3). The trust remains a foreign trust in relation to distributions of income, other than beneficiary income, and capital gains derived before the expiry of the 12 month period for making the election. That is, such distributions are assessable to the extent that they consist of income derived by the trustees, subject to the proviso to s.9 of the Income Tax Amendment Act (No 5) 1988.

Elections: s.226A(1)

Requirements

7.5 Section 226A(1) applies if:

(i) a "settlor" of a trust becomes resident in New Zealand;

(ii) the settlor of a trust becomes resident in New Zealand after 17 December 1987; and

(iii) the settlor is a natural person; and

(iv) if a distribution had been made from the trust on the day immediately preceding the day on which the settlor became resident the trust would have been a foreign trust in relation to the distribution.

7.6 In these circumstances any settlor, trustee or beneficiary of the trust can elect, pursuant to s.228(7), to pay tax on the trustee income derived by the trustees. This election must be made within 12 months of the later of 31 May 1989 or the day on which the settlor became resident in New Zealand.

Conditions for s.226A to apply

(a) Settlor

7.7 Section 226A applies where a "settlor" of a trust becomes resident in New Zealand. In this context, the broad definition of "settlor" contained in s.226, and discussed in Part 6 of this bulletin, applies.

(b) Settlor becomes resident after 17 December 1987

7.8 Section 226A applies where the settlor becomes resident in New Zealand after 17 December 1987. If the trust was settled before 17 December 1987, and the settlor became resident on or before 17 December 1987, an election to pay tax on trustee income could have been made before 31 May 1989 in terms of s.227A.

(c) Settlor a natural person

7.9 Section 226A applies only where the settlor who becomes resident in New Zealand is a natural person. If the settlor is a company the special rules in s.226A will not apply. Consequently, if a settlement has been made on the trust by a company after 17 December 1987 the corporate settlor will be liable to tax on trustee income in terms of s.228(4), subject only to the exceptions contained in s.228(5). In this context, the most significant of these exceptions is that the corporate settlor will not be liable to tax on trustee income if a trustee of the trust is resident in New Zealand for the entire income year during which the settlor is resident: s.228(5)(a).

(d) Trust a foreign trust

7.10 The final pre-condition for s.226A to apply is that the trust would have been a foreign trust in relation to a distribution made on the day before the day on which the settlor became resident in New Zealand. This requirement will be satisfied if there was no settlor of the trust resident in New Zealand from the later of 17 December 1987 or the date on which the trust was first settled until the date of deemed distribution (i.e., the day before the day on which the settlor became resident). Thus, s.226A would not apply, for example, if a settlor who had been resident in New Zealand after 17 December 1987 ceased to be resident and then later became resident again. As a settlor of the trust had been resident in New Zealand after 17 December 1987, the trust would not be a foreign trust in relation to a distribution made on the day preceding the day on which the settlor again became resident in New Zealand. However, the result would be different if a person who had been resident in New Zealand after 17 December 1987 first settled a trust after ceasing to be resident. If the person subsequently became resident in New Zealand again s.226A could apply because no settlor of the trust had been resident in New Zealand from the date on which the trust was first settled until the date on which the settlor became resident in New Zealand again.

7.11 For the trust to be a foreign trust in relation to an assumed distribution made on the day before the settlor became resident in New Zealand it is necessary that no settlor of the trust had been resident from the later of 17 December 1987 or the date of first settlement of the trust until the date of assumed distribution (i.e., the day before the day on which the settlor becomes resident in New Zealand). Thus, if there are two settlors of a trust, A and B, and A had been resident in New Zealand subsequent to the date on which the trust was first settled - the date of first settlement being after 17 December 1987 - s.226A and s.228(5)(b) will not apply if B later becomes resident in New Zealand. Instead, the provisions in s.228 governing settlor liability to tax on trustee income will apply.

Election

7.12 The election to pay tax on trustee income may be made by any settlor, trustee or beneficiary of the trust. Thus, the settlor who becomes resident in New Zealand may elect to pay tax on trustee income. Alternatively, any other settlor of the trust, or any trustee or beneficiary, may make an election. Also, any combination of settlors, trustees or beneficiaries may make a joint election.

7.13 If a trustee of the trust is resident in New Zealand at any time during the income year in which the settlor becomes resident in New Zealand, the trustee will be liable for tax on New Zealand and foreign source trustee income under s.228(2) and s.228(3) whether or not an election is made to pay tax on trustee income. However, to secure the benefit of s.226A it is still necessary that an election be made to pay tax on trustee income.

If no election is made the trust will be a non-qualifying trust in relation to distributions of amounts derived after the expiry of the period for making an election, even if the trustee has paid tax on trustee income in terms of s.228. To ensure that elections to pay tax on trustee income can be made by any settlor, trustee or beneficiary s.226A provides that the election is made pursuant to s.228(7), and s.228(7) provides that any settlor, trustee or beneficiary may make an election. Prior to amendment by the Income Tax Amendment Act 1989, s.228(7) permitted only settlors, trustees and beneficiaries who were not otherwise liable to tax on trustee income to make an election. The amendment was intended to ensure that settlors, trustees and beneficiaries could make an election even if they were otherwise liable to pay tax on trustee income.

Example 8

Facts: A settled property on trust on 1 June 1986 when A was resident in Australia. There are two trustees of the trust, one being A's spouse and the other being an Australian resident solicitor. The trust property earns Australian source income. A and her spouse become resident in New Zealand on 1 October 1990.

Result:

(i) A is not liable to tax on trustee income because the trust was settled before 17 December 1987: s.228(4). (If the trust had been settled after 17 December 1987 s.228(5)(b) would provide that A would not be liable to tax on trustee income).

(ii) Section 226A will apply because A became resident in New Zealand after 17 December 1987, A is a natural person, and if a distribution had been made from the trust on the day before the day on which A became resident in New Zealand the trust would have been a foreign trust in relation to the distribution. The trust would have been a foreign trust because no settlor of the trust was resident in New Zealand from the later of 17 December 1987 or the date of first settlement until the day before the day on which the settlor became resident.

(iii) A's spouse, as trustee of the trust, is liable to pay tax on the trustee income of the trust derived from outside New Zealand from the income year commencing on 1 April 1990 because a settlor of the trust, A, is resident in New Zealand for a part of that income year: s.228(3). The exceptions in s.228(6) do not apply because A's spouse is not resident outside New Zealand at all times during the income year.

(iv) If an election is not made in terms of s.226A(1) and s.228(7), the trust will be a non-qualifying trust in relation to distributions of amounts derived by the trustees after the expiry of 12 months from the date on which A became resident in New Zealand: i.e., after 1 October 1991.

(v) Although A's spouse is already liable to pay tax on trustee income he can make an election in accordance with s.226A(1) and s.228(7). If an election is made, either by A, by A's spouse, by the Australian trustee or by any beneficiary, the trust will be a qualifying trust in relation to distributions of amounts derived by the trustees after the date on which the election was made provided that the trustee's obligations in relation to the trustee income continue to be satisfied.

7.14 The election must be made within 12 months of the later of the day on which the settlor became resident in New Zealand or 31 May 1989. Thus, a reasonable transitional period is provided for settlors, trustees and beneficiaries associated with such trusts to decide whether to make an election to pay tax on trustee income.

7.15 If the requirements of s.226A are satisfied, and a settlor, trustee or beneficiary wishes to make an election, the election is made under s.228(7). Where the election is made in terms of s.226A, s.228(7) provides that the election must be made within the period specified in s.226A and that the effect of the election is that the elector is assessable and liable to income tax on trustee income from the date of election.

Liability to tax on trustee income derived, and treatment of distributions made, before election

7.16 When an election to pay tax on trustee income is not made immediately after the settlor becomes resident in New Zealand the treatment of the trustee income derived between the date on which the settlor became resident and the date on which the election is made is determined in accordance with s.228. The fact that provision is made for settlors, trustees and beneficiaries to elect to pay tax on trustee income does not suspend the operation of s. 228. Thus, any trustee income derived from New Zealand during the period before the election is made will continue to be liable to income tax: s.228(2).

7.17 Also, if a settlement is made by the settlor after the settlor becomes resident in New Zealand the settlor and trustee of the trust will be liable to tax on trustee income derived from outside New Zealand from the beginning of the income year in which the settlement was made. In this context, the broad definition of "settlor" set out in s.226, and discussed in Part 6 of this bulletin, applies. That definition is broad in its scope, and includes a wide range of direct and indirect transactions entered into with or in relation to a trust.

7.18 If a distribution is made to a resident beneficiary during the period before an election is made it may technically constitute a distribution from a non-qualifying trust. However, once the election has been made the effect will be that the distribution will be treated as a distribution from a foreign trust.

**Consequence of election: s.228(7), s.226A(2)**

Trustee income

7.19 Section 228(7) provides that where a person elects to pay tax on trustee income in the circumstances specified in s.226A the person is liable to income tax on trustee income from the date of the election, and the election applies from the date of the election and in respect of all succeeding income years. The liability of any other person to tax on trustee income remains unaffected by the election. For example, if a resident settlor makes the election this will not affect the liability of any non-resident trustee to tax on trustee income derived from New Zealand. If the non-resident trustee later becomes resident in New Zealand the settlor will remain liable to tax on all trustee income because of the election and the trustee will become liable to tax on trustee income derived from outside New Zealand because the trustee is resident in New Zealand and a settlor of the trust is also resident in New Zealand: s.228(3).

7.20 No method is prescribed for determining the amount of trustee income derived on and after the day on which the election was made. The rules contained in s.226A(4) are relevant only for the purpose of determining the treatment of distributions from the trust. However, to be consistent with the treatment of distributions either a time based apportionment using the method prescribed in s.226A(4)(a) or a calculation based on income actually derived after the date of election will be accepted.

Distributions

(a) Treatment of distributions

7.21 Section 226A(2) provides that if an election is made in terms of s.226A(1) the trust is deemed to be a foreign trust for the purpose of the definition of "taxable distribution" in s.226 to the extent that any distribution from the trust consists of income, capital profits or capital gains derived by the trustee before the date of the election. Further, the trust is deemed to be a qualifying trust to the extent that any distribution consists of income, capital profits or capital gains derived by the trustee after the date of the election provided that the trustee's obligations in relation to the trustee income continue to be satisfied.

7.22 The rules contained in s.226A(2) apply for the purpose of the definition of "taxable distribution" in s.226. By categorising the trust in relation to separate components of a distribution, s.226A(2) thus determines the extent to which any distribution constitutes a taxable distribution. As the trust is deemed to be a foreign trust in relation to a distribution to the extent that the distribution consists of income, capital profits or capital gains derived before the date on which the election was made, the distribution will be a taxable distribution to the extent that it consists of a distribution of amounts other than corpus or of capital profits or capital gains derived by the trustee: s.226(1) "taxable distribution" definition. Also, as the trust is deemed to be a qualifying trust to the extent that the distribution consists of income, capital profits or capital gains derived by the trustee after the date on which the election was made, the distribution will not be assessable to the beneficiary because distributions from qualifying trusts of amounts which do not constitute beneficiary income are not assessable: s.227(6).

(b) Application of the proviso to s.9 of the Income Tax Amendment Act (No 5) 1988

7.23 By the proviso to s.9 of the Income Tax Amendment Act (No 5) 1988, distributions of income, capital profits or capital gains derived by trustees in income years commencing before 1 April 1988 are not assessable for income tax where the distribution is made after 1 April 1988. Section 226A(2) applies subject to s.9 of the Amendment Act. Therefore, although s.226A deems the trust to be a foreign trust to the extent that it consists of income, capital profits or capital gains derived before the election was made, the effect of the proviso to s.9 is that the distribution will be a taxable distribution only to the extent that it consists of income derived by the trustees in income years commencing on and after 1 April 1988. Section 9 is discussed in Part 3 of this bulletin.

(c) Satisfaction of trustee's obligations

7.24 Section 226A(2)(b) provides that where an election has been made the trust is a qualifying

trust to the extent that any distribution consists of income, capital profits or capital gains derived after the date on which the election was made if the trustee's obligations in relation to the trustee income have been satisfied. If the trustee's obligations are not satisfied in the income year in which the election is made or in any subsequent income year, the trust is deemed to be a non-qualifying trust in relation to any distribution made in that income year except to the extent that the distribution consists of amounts derived by the trustee before the date of election. The trust remains a foreign trust to the extent that the distribution consists of income, capital profits or capital gains derived by the trustee before the date on which the election was made.

7.25 If the trustee's obligations are not satisfied the trust is deemed to be a non-qualifying trust with respect to any distributions made in the income year in which the obligations were not satisfied and in any subsequent year. Accordingly, the distribution is a taxable distribution to the extent that it consists of amounts other than beneficiary income or corpus. This is the case even if the amounts distributed were derived in income years during which the trustee's obligations were satisfied, thus providing an incentive to the elector or any other person who is liable to tax on trustee income to continue satisfying the trustee's obligations. There are two exceptions to this rule. First, the trust remains a foreign trust with respect to a distribution to the extent that it consists of income, capital profits or capital gains derived by the trustee before the date on which the election was made: s.226A(2)(b) language in parentheses. Second, the distribution will not be a taxable distribution to the extent that it consists of income, capital profits or capital gains derived by the trustees in income years commencing before 1 April 1988: proviso to s.9 Income Tax Amendment Act (No5) 1988.

7.26 The trust will remain a qualifying trust in terms of s.226A(2)(b) if the "trustee's obligations under this Act in respect of the trustee's liability to income tax in respect of the trustee income derived by the trustee have been satisfied". Thus, it is only necessary to establish that the trustee's obligations have been satisfied. It is not necessary that the obligations be satisfied by the trustee personally, by the settlor if the settlor is liable for tax under s.228, or by the person who makes the election in terms of s.226A and s.228(7).

(d) Application of s.230

7.27 Section 230(2)(d) provides that where the trust is one to which s.226A applies the ordering rules contained in s.230(1) do not apply to a distribution from the trust except where the trust is deemed to be a non-qualifying trust by s.226A(2)(b). Instead the distribution is deemed to consist of such amounts as reflect the terms of the trust or the terms of the discretion of the trustee.

7.28 Thus, in cases where s.226A(2) applies the constituent elements of a distribution are determined according to the terms of the trust or in terms of the exercise of the trustee's discretion. If the trustee distributes corpus to a beneficiary in exercise of the trustee's discretion, the distribution is treated as a distribution of corpus even if accumulated income remains available for distribution by the trustees. This rule does not permit trustees to argue that distributions of income, for example, are distributions of corpus if a distribution of corpus to a particular beneficiary is outside the terms of the trust or outside the terms of the trustee's discretion.

7.29 If the trustee's obligations are not satisfied, and the trust becomes a non-qualifying trust in terms of s.226A(2)(b), the ordering rules in s.230(1) will apply in relation to distributions made in the income year for which the trustee's obligations were first not satisfied and in subsequent years.

**Consequence of not making an election: s.226A(3), s.228**

Trustee income

7.30 If no election is made to pay tax on trustee income the trustee or settlor of the trust may still be liable to tax on trustee income by virtue of s.228. The rules in s.228 apply both during the period in which an election may be made in accordance with s.226A and after the expiry of that period. The application of s.228 is not suspended during the period that an election may be made in accordance with s.226A. The application of s.228 is discussed in Part 10 of this bulletin.

7.31 If a settlement is made by the settlor after the settlor becomes resident in New Zealand the settlor and trustee of the trust will be liable to tax on trustee income derived from outside New Zealand from the beginning of the income year in which the settlement was made. In this context, the broad definition of "settlor" set out in s.226, and discussed in Part 6 of this bulletin, applies.

7.32 For example, a person will have made a settlement on a trust after becoming resident in New Zealand if the trustees of a trust settled by the person before becoming resident (the first trust) themselves settle a further trust (in their capacity as trustees of the first trust) after the date on which the settlor became resident: s.226(5). This could occur, for example, if the first trust contained a provision for the trustees to settle

income on a subtrust in circumstances where the settlement does not constitute beneficiary income of a beneficiary. If, after the date on which the settlor became resident, the trustees of the first trust exercised the power to settle income on a subtrust the settlor of the first trust would be deemed to have made a settlement on the subtrust after the date on which the settlor became resident. Consequently, the settlor would be liable to tax on the trustee income of the subtrust in accordance with s.228 even though no election had been made to pay tax on trustee income.

Distributions

(a) Treatment of distributions

7.33 Section 226A(3) provides that if an election is not made in accordance with s.226A(1) the trust is deemed to be a foreign trust for the purpose of the definition of "taxable distribution" in s.226 to the extent that any distribution from the trust consists of income, capital profits or capital gains derived by the trustee before the "election expiry date". The election expiry date is 12 months from the later of 31 May 1989 or the day on which the settlor became resident in New Zealand. The trust is deemed to be a non-qualifying trust to the extent that the distribution consists of income, capital profits or capital gains derived by the trustee after the election expiry date.

7.34 As with s.226A(2), the rules in s.226A(3) apply for the purpose of the definition of "taxable distribution" in s.226. The rules are therefore relevant in determining the extent to which a distribution from a trust of the type described in s.226A is a taxable distribution if an election to pay tax on trustee income is not made in accordance with s.226A and s.228(7). The trust is deemed to be a foreign trust to the extent that the distribution consists of income, capital profits and capital gains derived by the trustee before the election expiry date: s.226A(3)(a). In the context of the "taxable distribution" definition, this means that the portion of the distribution in relation to which the trust is deemed by s.226A(3)(a) to be a foreign trust is a taxable distribution to the extent that it consists of amounts other than corpus, capital profits and capital gains and to the extent that it does not constitute beneficiary income.

7.35 Section 226A(3)(b) provides that the trust is deemed to be a non-qualifying trust to the extent to which any distribution from the trust consists of income, capital profits or capital gains derived by the trustee after the election expiry date. Thus, the portion of the distribution in relation to which the trust is deemed to be a non-qualifying trust is a taxable distribution to the extent that it consists of amounts other than corpus or beneficiary income.

(b) Application of the proviso to s.9 of the Income Tax Amendment Act (No5) 1988

7.36 As discussed in Part 3 of this bulletin, the proviso to s.9 of the Income Tax Amendment Act (No5) 1988 provides that distributions of income, capital profits or capital gains derived in income years commencing before 1 April 1988 are not assessable where the distribution is made after 1 April 1988. In the context of s.226A(3) this means that a distribution in relation to which the trust is deemed to be a foreign trust is not assessable to the extent that it consists of income, capital profits or capital gains derived in income years commencing before 1 April 1988.

(c) Application of s.230

7.37 If an election is not made in accordance with s.226A and s.228(7) the ordering rules in s.230(1) will generally apply to determine the constituent elements of a distribution from the trust. The exceptions to the application of s.230(1), set out in s.230(2), are discussed in Part 13 of this bulletin.

**Income derived before election or before election expiry date: s.226A(4)**

7.38 Where an election is made to pay tax on trustee income the trust is deemed to be a foreign trust to the extent that any distribution consists of income, capital profits or capital gains derived by the trustee before the date on which an election was made and a qualifying trust to the extent that the distribution consists of amounts derived by the trustee after that date: s.226A(2). If an election is not made the trust is deemed to be a foreign trust to the extent that any distribution consists of income, capital profits or capital gains derived by the trustees before the election expiry date and a non-qualifying trust to the extent that any distribution consists of amounts derived by the trustee after that date: s.226A(3). Thus, where an election is made during an income year, or where the election expiry date falls within an income year, it will be necessary to calculate the portion of the income, capital profits or capital gains derived by the trustees before the election or before the election expiry date. This calculation is governed by the rules in s.226A(4).

7.39 Section 226A(4) provides two methods for calculating the income, capital profits or capital gains derived by the trustees during the portion of the income year falling before the date of election or before the election expiry date. Any trustee, settlor or beneficiary who is liable to pay tax on the trustee income of the trust can choose which of these methods they wish to apply.

7.40 The first method is a time-based apportionment. Under this method the income, capital profits or capital gains derived during the entire income year are multiplied by a fraction, the numerator of which is the number of days in the income year falling before the date of election or before the election expiry date and the denominator of which is 365. In algebraic terms the income, capital profits or capital gains derived before the date of election or before the election expiry date is calculated as follows:

$$a \times \frac{b}{365}$$

where:

a is the income, capital profits or capital gains derived by the trustee during the income year in which the election is made or in which the election expiry date falls; and

b is the number of days in the income year falling before the day on which the election is made or before the election expiry date.

7.41 In using this method it is necessary to apply the formula separately to the income derived by the trustees and to the capital profits or capital gains derived by the trustees. For example, if during the relevant income year the trustees derived $10,000 income and $22,000 capital profits or capital gains, and there were 100 days in the income year before the election was made, the income and capital profits or gains would be calculated as follows:

(i) income

$$\$10{,}000 \times \frac{100}{365} = \$2{,}740$$

(ii) capital profits or capital gains

$$\$22{,}000 \times \frac{100}{365} = \$6{,}027$$

7.42 The second method is based on the income, capital profits or capital gains actually derived by the trustees. Under this method the trustee, settlor or beneficiary who is liable to tax on trustee income calculates the income, capital profits or capital gains which were actually derived by the trustees before the day on which the election was made or before the election expiry date.

### Section 227A elections

7.43 A further election procedure was provided by s.227A in relation to trusts first settled on or before 17 December 1987. If, on or before 31 May 1989, any settlor, trustee or beneficiary of such a trust made an election to pay tax on trustee income derived in income years commencing on and after 1 April 1988 all trustee income derived from outside New Zealand, or derived from New Zealand only as non-resident withholding income, in income years commencing before 1 April 1988 is deemed to have been liable to New Zealand income tax and the trustee's obligations in relation to that liability are deemed to have been satisfied. This means that the trust is likely to satisfy the requirements of the definition of "qualifying trust" in s.226, provided that the trustee's obligations in relation to New Zealand source income other than non-resident withholding income have been satisfied and that the trustee's obligations in relation to all trustee income derived after the income year commencing on 1 April 1988 have been satisfied.

7.44 A trust of the type described in s.226A may also fall within the terms of s.227A. Thus, if a settlor of a trust which was first settled on or before 17 December 1987 becomes resident in New Zealand after that date, and before 31 May 1989, an election could have been made under either s.226A or s.227A. (If the settlor becomes resident after 31 May 1989 it will be too late for any person associated with the trust to make a s.227A election). The effect of making a s.227A election as opposed to a s.226A election is as follows:

(i) trustee income

- s.227A election: elector liable for tax on trustee income derived in income years commencing on and after 1 April 1988;
- s.226A election: elector liable for tax on trustee income derived after the date of election (s.228(7));

(ii) distributions

- s.227A election: distributions which constitute beneficiary income assessable; distributions of amounts other than beneficiary income not assessable if all of the trustee's obligations in relation to the trustee income continue to be satisfied (s.227(6));
- s.226A election: distributions which constitute beneficiary income assessable; distributions of amounts other than beneficiary income assessable to the extent that the trust is a foreign trust in relation to the distribution and the distribution consists of amounts other than corpus or capital profits or gains derived by the trus-

tees in income years commencing before 1 April 1988 (s.9 Income Tax Amendment Act (No 5) 1988).

Examples

7.45 The following examples illustrate the application of s.226A to a given fact pattern in the three circumstances contemplated by that section: i.e., where an election is made to pay tax on trustee income and the trustee's obligations are satisfied; where an election is made but the trustee's obligations are not satisfied; and where no election is made. To simplify the examples it is assumed that the trust was first settled on 1 June 1988. This means that the trustees derived no income or capital profits or gains in income years ending before 1 April 1988. Consequently, the proviso to s.9 of the Income Tax Amendment Act (No 5) 1988 is not relevant to the examples.

Example 9: Election made and trustee's obligations satisfied

Facts:

(i) A settles $100,000 on trust on 1 June 1988 when A is resident in Hong Kong. The trustees are all resident in Hong Kong. Two members of A's family, B and C, are beneficiaries of the trust. The trustees have a discretion to pay income or capital to B and C. No further settlement is made on the trust after 1 June 1988.

(ii) A becomes resident in New Zealand on 1 May 1991. A had not previously been resident in New Zealand. B and C also become resident in New Zealand on 1 May 1991.

(iii) On 1 November 1991 A makes an election in accordance with s.226A and s.228(7) to pay tax on trustee income.

(iv) All of the income derived by the trustees is derived from outside New Zealand.

(v) The amounts derived and accumulated by the trustees are as follows:

| Year Ending | Income $ | Capital Gains $ |
|---|---|---|
| 31 March 1989 | 10,000 | 5,000 |
| 31 March 1990 | 11,000 | 5,000 |
| 31 March 1991 | 13,000 | 2,000 |
| 31 March 1992 | 8,000 | 3,000 |
| 31 March 1993 | 10,000 | 3,000 |

(vi) On 1 April 1993 the trustees make distributions to B of $50,000 and to C of $30,000. A had paid tax on the trustee income derived between the date of election and 1 April 1993. B and C were resident in New Zealand on 1 April 1993.

Result:

(a) entitlement to make election

A is entitled to make an election in accordance with s.226A and s.228(7) because A is a natural person who became resident in New Zealand after 17 December 1987 and the trust would have been a foreign trust in relation to a distribution made on 30 April 1991, the day before A became resident. The trust would have been a foreign trust in relation to such a distribution because no settlor of the trust had been resident in New Zealand from the date on which the trust was first settled, 1 June 1988, until 30 April 1991.

As beneficiaries of the trust, B and C are also entitled to make an election in accordance with s.226A and s.228(7). The Hong Kong trustees are also entitled to make an election.

The election must be made within 12 months of the later of the day on which the settlor became resident or 31 May 1989. A became resident on 1 May 1991. Thus the election may be made at any time on or before 1 May 1992. A's election on 1 November 1991 is therefore within time.

(b) Trustee income

Before A became resident in New Zealand the trustee income derived by the trustees was not liable to New Zealand tax because no settlor of the trust was resident here and the income was all derived from outside New Zealand: s.228. After A became resident A is not liable to tax on trustee income in the absence of a s.226A election by A because A was not resident in New Zealand when the settlement was made on the trust: s.228(5)(b). Further, the trustees are not liable for tax on the trustee income derived in the income year during which A became resident and in subsequent income years because the trustees are resident outside New Zealand at all times during those income years and the settlor was not resident in New Zealand at the time of settlement:s.228(6).

The effect of the election is that A is liable to pay tax on the trustee income derived from the date of election. No method is prescribed for calculating the income derived in the year of

election after the date on which the election is made. However, as indicated in paragraph 7.20 above either a time-based apportionment or a calculation based on income actually derived will be accepted. Assuming that a time-based apportionment is made the trustee income in respect of which A is liable for tax is as follows:

| Year ending | Trustee income |
|---|---|
| 31 March 1992 | $\$8,000 \times \frac{151}{365} = \$3,310$ |
| 31 March 1993 | - |

(note: the $10,000 income derived by the trustees in the income year ending 31 March 1993 is distributed to B as beneficiary income.)

(c) Distributions

The trust is a discretionary trust and an election to pay tax on trustee income has been made in accordance with s.226A and s.228(7). Consequently, by s.230(2) the ordering rules in s.230(1) do not apply in relation to the distributions to B and C and the distributions are deemed to reflect the terms of the exercise of the trustees' discretion.

If it is assumed that B is an income beneficiary (entitled only to distributions of income), that C is an income and capital beneficiary, and that the trustees exercised their discretion to pay capital to C, the treatment of the distributions is as follows:

- $50,000 distribution to B

The distribution is deemed to consist of a distribution of the income derived in the income years ending on 31 March 1989 to 31 March 1993. The treatment of the distribution is as follows:

| Amount | Source | Treatment |
|---|---|---|
| $32,000 (1) | Income years ending 31 March 1989, 1990 and 1991 | Assessable as a taxable distribution from a foreign trust: s. 226A(2)(a) |
| $ 8,000 | Income year ending March 1992 | Portion derived before 1 November 1991 election date assessable as taxable distribution from foreign trust:<br>i.e., $\$8,000 \times \frac{214}{365} = \$4,690$<br>remaining $3,310 not assessable as constitutes distribution of income from qualifying trust which does not constitute beneficiary income: s. 226A(2); s. 227(6) |
| $10,000 | Income year ending 31 March 1993 | Assessable as beneficiary income |

notes: (1) The $32,000 is the sum of the income derived in the income years ending 31 March 1991 and 1992 and $8,000 of the income derived in the income year ending 31 March 1989.

The distribution is thus assessable to B to the following extent:

| Assessable income | |
|---|---|
| - taxable distribution | $36,690 |
| - beneficiary income | 10,000 |
| Total | $46,690 |

The taxable distribution of $36,690 is from a foreign trust. Therefore, it is taxable at B's normal marginal rates.

- $30,000 distribution to C

The trustees exercise their discretion to distribute capital to C. The distribution thus consists of the $18,000 capital gains derived by the trustees in the income years from 31 March 1989 to 31 March 1993 and $12,000 corpus. The treatment of the distribution is as follows:

| Amount | Source | Treatment |
|---|---|---|
| $12,000 | Capital gains derived in income years ending 31 March 1989, 1990 and 1991 | Not assessable as constitutes a distribution of a capital profit or gain from a foreign trust |
| $ 3,000 | Capital gains derived in income year ending March 1992 | Portion derived before election not assessable: i.e.,$3,000 $\times \frac{214}{365}$ = $1,759 (Distribution of capital gain from a foreign trust); remaining $1,241 not assessable as constitutes a distribution from a qualifying trust of an amount other than beneficiary income |
| $ 3,000 | Capital gains derived in income year ending 31 March 1993 | Not assessable: distribution from a qualifying trust of an amount other than beneficiary income |
| $12,000 | *Corpus* | Not assessable: distributions of corpus not assessable |

The result is that no portion of the $30,000 distribution is taxable.

Example 10: Election made but trustee's obligations not satisfied

Facts: As in Example 9 , except that the trustee's obligations are not satisfied in the income year ending 31 March 1993.

Result:

(a) Trustee income

The trustee income derived in the income year ending 31 March 1992 remains liable for tax as in Example 9 . That is, there is no liability to tax in respect of the trustee income derived before the election to pay tax on trustee income was made (i.e., before 1 November 1991); but the settlor is liable to tax on trustee income derived after that date (i.e., $3,310). The settlor is liable to tax on trustee income derived in all subsequent income years.

(b) Distributions

By s.226A(2)(b), any distributions made in the income year in which the trustee's obligations are not satisfied and in any subsequent income year are treated as distributions from a non-qualifying trust except to the extent that they consist of amounts derived before the day on which the election was made to pay tax on trustee income. Further, by s.230(2)(d) the s.230 ordering rules apply in relation to any such distribution.

The distributions to B and C (made on 1 April 1993) are in an income year subsequent to the income year in which the trustee's obligations are not satisfied. Therefore, the trust is deemed to be a non-qualifying trust in relation to the distributions, except to the extent that they consist of amounts derived by the trustees before the election was made to pay tax on trustee income, and s.230(1) applies. The distributions are contemporaneous. No rules are provided as to how contemporaneous distributions are to be ordered in terms of s.230(1). Thus, the characterisation of contemporaneous distributions will generally be for the trustee to decide, subject to the rules in s.230 governing the order in which income, capital profits and corpus are deemed to be distributed. In this case it is assumed that the trustee decides to allocate $50,000 of the income to B. The remaining $2,000 of the income is allocated to C because s.230(1) treats all income as having been distributed before capital profits or gains are distributed.

The treatment of the distributions is as follows:

- $50,000 distribution to B

The trustee's discretion to pay out earlier years' income is overridden by s.230(1). Thus, in terms of s.230(1) current years' income must be paid out first and then preceding years' income. In this case none

of the income is derived in the income year in which the distribution is made. The treatment of the income is therefore determined according to s.230(1)(b). That provision does not specify that preceding years' income must be regarded as having been distributed in any particular order and it is assumed that the trustees distribute $50,000 of the income to B and the remaining $2,000 of the income to C. If the later years' income is distributed to B the distribution to B consists of:

| Amount | Source | Treatment |
|---|---|---|
| $32,000 | Income derived in income years ending 31 March 1989, 1990 and 1991 | Assessable as taxable distribution from foreign trust: s. 226A(2)(a) |
| $ 8,000 | Income derived in income year ending March 1992 | Portion derived before election assessable as taxable distribution from foreign trust: i.e.,$8,000 x $\frac{214}{365}$ = $4,690 remaining $3,310 assessable as a taxable distribution from a non-qualifying trust at 45%: s. 226A(2)(b), s. 227(4) |
| $10,000 | Income derived in income year ending 31 March 1993 | Assessable as beneficiary income as paid or applied within 6 months from end of income year |

The distribution is taxable as follows:

| | | |
|---|---|---|
| taxable distribution | | |
| - from foreign trust | $36,690 | (1) |
| - from non-qualifying trust | $3,310 | (2) |
| beneficiary income | $10,000 | |

notes:
(1) assessable at ordinary rates
(2) assessable at 45%

- $30,000 distribution to C

The distributions to B and C are contemporaneous. Therefore, the distribution to C cannot consist of amounts which are deemed to have been contemporaneously distributed to B. Consequently, C is deemed to receive $2,000 of the income derived in the income year ending 31 March 1989, the capital gains of $18,000 derived in the income years ending 31 March 1989 to 31 March 1993 and corpus of $10,000. The following treatment results:

| Amount | Source | Treatment |
|---|---|---|
| $ 2,000 | Income derived in income year ending 31 March 1989 | Assessable as taxable distribution from foreign trust |
| $12,000 | Capital gains derived in income years ending 31 March 1989, 1990 and 1991 | Not assessable as constitutes a distribution of capital gains from a foreign trust |
| $ 3,000 | Capital gain derived in income year ending 31 March 1992 | Not assessable to extent derived before election as constitutes distribution of capital gain from foreign trust i.e.,$3,000 x $\frac{214}{365}$ = $1,759 remaining $1,241 assessable as a taxable distribution from a non-qualifying trust at 45%: s 226A(2), s227(4) |
| $ 3,000 | Capital gain derived in income year ending 31 March 1993 | Assessable as taxable distribution from non-qualifying trust at 45% |
| $10,000 | Corpus settled on 1 June 1988 | Not assessable |

The distribution is thus taxable as follows:

taxable distribution
- from foreign trust $2,000 (1)
- from non-qualifying trust $4,241 (2)

Notes: (1) Assessable at ordinary rates
(2) Assessable at 45%

<u>Example 11: No election to pay tax on trustee income</u>

Facts: Same as Example 9 except that no election is made to pay tax on trustee income.

Result:

(a) Trustee income

As no election has been made the trustee income is not liable to tax. By s.228(6), the trustee is not liable for tax on trustee income because the trustee is resident outside New Zealand at all times during the income years in question and A, the settlor, was not resident in New Zealand at the time of any settlement on the trust. A is not liable for tax on trustee income because A was resident outside New Zealand when the trust was settled: s.228(5)(b).

(b) Distributions

By s.226A(3), the trust is deemed to be a foreign trust to the extent to which any distribution consists of income, capital profits or capital gains derived before the election expiry date (i.e., before 1 May 1992) and a non-qualifying trust to the extent that the distribution consists of income, capital profits and capital gains derived after that date. The ordering rules in s.230(1) apply in determining the constituent elements of the distribution.

The distributions to B and C are contemporaneous and it is assumed that the trustees treat $50,000 of the income as having been distributed to B and the remaining $2,000 as having been distributed to C.

- $50,000 Distribution to B

| Amount | Source | Treatment |
|---|---|---|
| $32,000 | Income derived in income years ending 31 March 1989, 1990 and 1991 | Assessable as taxable distribution from foreign trust: s 226A(3)(a) |
| $ 8,000(1) | Income derived in income year ending 31 March 1992 | Assessable as taxable distribution from foreign trust |
| $10,000(2) | Income derived in income year ending 31 March 1993 | Assessable as beneficiary income: paid or applied within 6 months after end of income year |

Notes:

(1) By s.226A(1) the election expiry date is 12 months from the later of 31 May 1989 or the date on which the settlor became resident in New Zealand. The settlor became resident in New Zealand on 1 May 1991. Thus, the election expiry date is 1 May 1992 and pursuant to s.226A(3) a distribution of income derived before the election expiry date is treated as a distribution from a foreign trust. The distribution of the $8,000 income derived in the income year ending 31 March 1992 is therefore a distribution from a foreign trust.

(2) The distribution of the $10,000 income derived in the income year ending 31 March 1993 is beneficiary income because it constitutes income paid or applied to the beneficiary within 6 months after the income year in which it was derived. If the distribution had been made after that 6 month period it would have been necessary to apportion the income to the periods falling before and after the election expiry date, 1 May 1992. To the extent that the distribution consisted of income derived before the election expiry date it would be a

taxable distribution from a foreign trust, and to the extent that it consisted of income derived after that date it would consist of a taxable distribution from a non-qualifying trust.

The tax treatment of the distribution is:

| | |
|---|---|
| Taxable distribution from foreign trust | $40,000 |
| Beneficiary income | $10,000 |

- $30,000 Distribution to C

| Amount | Source | Treatment |
|---|---|---|
| $ 2,000 | Income derived in income year ending 31 March 1989 | Assessable as taxable distribution from foreign trust: s 226A(3)(b) |
| $15,000 | Capital gains derived in income years ending 31 March 1989 to 1992 | Not assessable as distribution of capital gains from foreign trust |
| $ 3,000 | Capital gain derived in income year ending 31 March 1993 | Portion derived before election expiry date not assessable as distribution of capital gains from foreign trust: i.e.,$3,000 x $\frac{30}{365}$ = $246.57 Portion derived after election expiry date assessable as taxable distribution from non-qualifying trust: $3,000 - $246.57 = $2,753.43 |
| $10,000 | Corpus settled on 1 June 1988 | Not assessable |

The result is as follows:

| | | |
|---|---|---|
| Taxable distribution | | |
| - from foreign trust | $2,000 | (1) |
| - from non-qualifying trust | $2,753 | (2) |

Notes:
(1) Assessable at normal rates
(2) Assessable at 45%

## PART 8: INCOME ASSESSABLE TO BENEFICIARIES

**Overview of s.227**

8.1 In outline, s.227(1) requires beneficiaries to include beneficiary income and taxable distributions in their assessable income. By s.227(2), the trustee is liable to income tax as agent of the beneficiary in relation to the beneficiary income and taxable distributions derived by the beneficiary. An anti-avoidance rule, set out in s.227(3), provides that any person who becomes resident in New Zealand within 5 years of having ceased to be resident is deemed to have derived any beneficiary income and taxable distributions derived from a foreign or non-qualifying trust during the period of non-residence on the day on which that person again becomes resident in New Zealand. Section 227(4) sets out the treatment of taxable distributions from non-qualifying trusts. Another anti-avoidance rule is contained in s.227(5). This provision is aimed at arrangements whereby property or services are transferred or made available to a person other than a beneficiary in circumstances where the intent and application of s.227 is defeated. By s.227(6), distributions from a qualifying trust which do not consist of beneficiary income are not assessable for income tax. Finally, s.227(7) sets out the treatment of beneficiary income where a trustee furnishes a return of income under s.15 for an accounting year ending with an annual balance date other than 31 March.

**Assessable income: s.227(1)**

<u>Inclusion of beneficiary income and taxable distributions in assessable income</u>

(a) Amounts included in assessable income

8.2 Section 227(1) provides that the assessable income of any person in any income year includes any beneficiary income and any taxable distributions derived by that person in that income year. Income is beneficiary income where it vests absolutely in interest in the beneficiary during the same income year in which it is derived by the trustee or if it is paid or applied to or for the benefit of the beneficiary during that income year or within six months thereafter. In the case of a foreign trust, a distribution is a taxable distribution to the extent that it does not constitute beneficiary income and does not consist of capital profits or gains realised by the trustee or corpus (unless the capital profit or gain is generated in a transaction with an associated person: s.226(11)). In the case of a non-qualifying trust, a distribution is a taxable distribution to the extent that it does not constitute beneficiary income and does not consist of corpus.

(b) Derivation of beneficiary income and taxable distributions

8.3 Beneficiary income and taxable distributions are included in assessable income when "derived" by the beneficiary. Income is generally derived by a person when it has been received or when it has become due and payable. Section 75 extends the general concept of derivation. Pursuant to that section income is deemed to have been derived by a person if it has been "credited in account, or reinvested, or accumulated, or capitalised ... or otherwise dealt with in [the person's] interest or on [the person's] behalf" even if it has not been paid to or received by the person. Income which falls within the beneficiary income and taxable distribution definitions will be income "derived" by the beneficiary in accordance with the ordinary meaning of that term or in accordance with s.75.

(c) Dual derivation of beneficiary income

8.4 Under the previous trust taxation regime income derived by a trustee which was also derived by a beneficiary entitled in possession, or who was deemed to be entitled in possession, to the receipt of the income was assessable to the beneficiary and to the trustee as agent for the beneficiary. Income which was derived by the trustee which was not also income derived by a beneficiary entitled in possession, or who was deemed to be entitled in possession to the income, was assessable to the trustee as if the trustee were beneficially entitled to the receipt of the income. The scheme of the legislation was therefore that income derived by a trustee was assessable to the trustee as agent for the beneficiary or as if the trustee were beneficially entitled to the income, depending upon whether or not there was a beneficiary entitled in possession, or who was deemed to be entitled in possession, to the income. In cases where the income was derived by a trustee and there was a beneficiary who was entitled or who was deemed to be entitled in possession to the receipt of the income it was said that there was a dual derivation of the income by the trustee and the beneficiary.

8.5 The scheme of the legislation with respect to income derived by a trustee during an income year in circumstances that the beneficiary is also liable for tax on the income in respect of that income year is unchanged. All trust income is derived first by the trustee. If during the income year that the income is derived by the trustee the income vests absolutely in interest in the beneficiary, or during that income year or within six months thereafter the income is paid or applied to or for the benefit of the beneficiary, the income is derived by the beneficiary as beneficiary income. By s.227 the

beneficiary is liable for income tax in respect of that income and the trustee is liable for income tax in respect of that income as agent for the beneficiary. If the income derived by the beneficiary is not beneficiary income the trustee is liable for tax in respect of the income (referred to as "trustee income") as if the trustee were beneficially entitled to the income: s.228. The treatment of income derived by trustees in this context is therefore unchanged from the treatment under the previous trust regime: that is, there is dual derivation of beneficiary income by the trustee and beneficiary.

Characterisation of beneficiary income and taxable distributions

8.6 Section 227(1) provides that beneficiary income is included in assessable income. This could be taken to mean that beneficiary income is a category of assessable income which is separate from the other categories of assessable income listed in s.65(2). However, the correct interpretation is that the trust regime is silent on the question of characterisation of trustee income and beneficiary income and that income derived by trustees retains the character which it possessed on derivation by the trustees, whether the income is classified as trustee income or beneficiary income.

8.7 Authority for the proposition that income retains its character as it is passed through to the beneficiary is provided by *Archer-Shee* v *Baker* [1927] AC 844 and *Syme* v *Webb* [1914] AC 1013. Also, in general terms the scheme of the trust legislation is that there is only one trust income rather than a separate income for trustee and beneficiary. A change in the character of income could only be assumed if the income derived by the trustee and beneficiary was separate. It is also significant in this context that under the imputation and dividend withholding payment regimes it is assumed that dividends flow through to beneficiaries as dividends, and provision is made for imputation credits and dividend withholding payment credits to be allocated to such dividends: s.394ZD.

8.8 The only situation where the one income principle does not apply is in the case of a distribution of an amount which does not constitute beneficiary income from a foreign trust or a non-qualifying trust. With respect to these distributions the legislation does not assume that there is only one trust income and income derived by the trustee in one year may be treated as being derived by the beneficiary in a later year if distributed in the later year as a taxable distribution. As the one income principle does not apply in relation to taxable distributions such distributions constitute a separate category of income in the beneficiary's hands. Accordingly, taxable distributions are not characterised according to the character in the trustee's hands of the amounts from which the distributions are made.

Residence and source

8.9 Section 227(1) requires beneficiaries to include beneficiary income in their assessable income. This provision does not override the normal rules as to residence and source of income. Consequently, by s.242 resident beneficiaries are assessable for income tax on beneficiary income derived from both within and outside New Zealand and non-resident beneficiaries are assessable for income tax only on beneficiary income derived from New Zealand.

8.10 By s.243(2)(n) income derived by a beneficiary is derived from New Zealand so far as the "income of the trust fund is derived from New Zealand". This is taken to mean that beneficiary income is derived from New Zealand if the trustee derived the income which constitutes the beneficiary income from New Zealand. For example, if in a particular income year the trustee derives interest and dividends from New Zealand in terms of s.243(2)(m) and s.243(2)(g), and that income constitutes beneficiary income because it vests absolutely in interest in the beneficiary during that income year, then the beneficiary income will be derived from New Zealand. In effect, beneficiary income is sourced according to the source of the income when derived by the trustee.

8.11 In this context the discussion above of the dual derivation of beneficiary income is relevant. It has been argued that in contrast to the position under the previous trust regime there is no dual derivation of beneficiary income under the new trust regime and that therefore income derived by a beneficiary is not income of the trust fund in terms of s.243(2)(n). Consequently, it is argued, it can be inferred that beneficiary income derived by a non-resident beneficiary cannot be sourced in New Zealand pursuant to s.243(2)(n). This interpretation is based on the incorrect premise that there is no dual derivation of beneficiary income. It is quite clear from the beneficiary income definition that all trust income is first derived by the trustee and that such income is treated as being derived also by the beneficiary if it is beneficiary income. Therefore, beneficiary income does represent income of the trust fund in terms of s.243(2)(n) because it is income which has first been derived by the trustee. Even if this interpretation were incorrect beneficiary income could be sourced in New Zealand under the other paragraphs of s.243(2) because, as discussed above, income retains its character as it is passed through as beneficiary income.

8.12 Where a beneficiary who is not resident in New Zealand derives New Zealand source beneficiary income there will be a non-resident withholding tax liability if the income is non-resident withholding income as defined in s.310(2). By s.312 a liability to deduct non-resident withholding tax arises when a person makes a payment of non-resident withholding income. In this context it is considered that the definition of "payment" in s.309 is sufficiently wide to cover transactions which constitute the vesting or payment or application of income in terms of the beneficiary income definition.

8.13 Where a person makes a payment of non-resident withholding income to a non-resident trustee of a trust, and the income is beneficiary income in relation to the trust, the person will be required to deduct non-resident withholding tax. If a person makes a payment of interest, dividends or royalties to a resident trustee of a trust and the income is beneficiary income of a non-resident beneficiary, the resident trustee will be required to deduct non-resident withholding tax. However, in this latter situation it would also be proper for the trustee to arrange for the person paying the interest, dividends or royalties to make the payment directly to the beneficiary and to deduct non-resident withholding tax from the payment.

Income year

(a) Inclusion of amounts derived during the income year

8.14 Section 227(1) provides that the assessable income of any person in any "income year" includes any beneficiary income and any taxable distributions derived by that person "in that income year". The question arises as to how this requirement operates where, pursuant to s.15, the trustee or beneficiary furnishes returns to a balance date other than 31 March.

8.15 Section 15 provides that if instead of furnishing a return to a year ending with 31 March a taxpayer furnishes a return for the year ending with the annual balance date of the taxpayer's accounts the income derived during the year ending with the annual balance of the taxpayer's accounts is deemed to have been derived during the year ending with the 31 March nearest to the annual balance date. The effect of this rule is that if the taxpayer returns income to a balance date ending between 1 April and 30 September the income derived during the accounting year ending on the balance date is deemed to have been derived in the year ending on the preceding 31 March. On the other hand if the taxpayer returns income to a balance date ending after 30 September the income derived during the accounting year ending on the balance date is deemed to have been derived in the year ending on the next 31 March.

(b) Beneficiary returns income to balance date other than 31 March

8.16 There is no special rule governing the situation where a beneficiary returns income to a balance date other than 31 March. Beneficiary income and taxable distributions derived by the beneficiary during the accounting year ending with a balance date other than 31 March are therefore deemed to have been derived in the income year ending with either the preceding 31 March or the succeeding 31 March, depending on whether the balance date ends before or after 30 September. For example, if the beneficiary returns income to a balance date ending on 30 June the beneficiary income and taxable distributions derived during the accounting year ending 30 June are deemed to have been derived in the income year ending on the 31 March preceding the 30 June.

8.17 By s.226(1), beneficiary income is defined in relation to any person who is a beneficiary of a trust for any income year as being income derived during "that income year" by the trustee which during "that income year" vests absolutely in interest in the beneficiary or which is paid or applied to or for the benefit of the beneficiary during or within 6 months after the end of "that income year". The "income year" referred to in the definition is that of the trustee.

Thus, the question is whether the income vests absolutely in interest in the beneficiary in the income year in which it was derived by the trustee or is paid to or applied for the benefit of the beneficiary during or within six months after that income year. If this requirement is satisfied the income will be beneficiary income although it may not be assessable to the beneficiary in the same income year because the beneficiary returns income to a balance date other than 31 March.

8.18 Assume, for example, that the trustee returns income to the year ending 31 March while the beneficiary returns income to the year ending 31 October. If income derived by the trustee in the year ending 31 March 1990 vests absolutely in interest in the beneficiary on 31 March 1990 the effect of s.15 is that the income is deemed to have been derived by the beneficiary in the income year ending 31 March 1991, that being the closest 31 March to the beneficiary's 31 October 1990 balance date. From the trustee's perspective the income will be beneficiary income in relation to the income year ending 31 March 1990 because it vests

absolutely in the beneficiary in that income year. The income is thus beneficiary income of the beneficiary, although it is not assessable to the beneficiary until the following income year ending on 31 March 1991.

(c) Trustee returns income to balance date other than 31 March

8.19 Section 227(7) provides that if a trustee furnishes a return under s.15 for an accounting year ending with an annual balance date other than 31 March, and any income derived by the trustee in that accounting year is also beneficiary income during that accounting year, the beneficiary is deemed to have derived the beneficiary income during the same income year as that during which the trustee is deemed to have derived the income pursuant to s.15.

8.20 By way of example, if the trustee furnishes a return of income to an annual balance date of 31 October income derived by the trustee during the accounting period ending 31 October 1990 which is also income derived by the beneficiary during the period ending 31 October 1990 will be beneficiary income for the income year ending 31 March 1991. Similarly, if the trustee furnishes a return of income to an annual balance date of 31 July, income derived by the trustee during the accounting period ending 31 July 1990 which is also income derived by the beneficiary during the period ending 31 July 1990 will be beneficiary income for the income year ending 31 March 1990 because pursuant to s.15 the trustee is deemed to have derived the income during the year ending 31 March 1990.

8.21 The definition of "beneficiary income" in s.226(1) refers to income that vests absolutely in interest in the beneficiary during the "income year" in which it was derived by the trustee or that is paid or applied during that income year or within six months thereafter. Where pursuant to s.15 the trustee furnishes a return of income to a balance date other than 31 March the question arises whether the paid or applied limb of the beneficiary income definition is satisfied if the payment or application is made during or within six months after the income year or during or within six months after the trustee's accounting year. Although s.15 does not change the trustee's income year, but rather only deems income derived to the balance date of the trustee's accounting year to be derived in the income year ending on the preceding or the succeeding 31 March, it is considered that the paid or applied limb is satisfied if a payment or application is made up to six months from the end of the accounting year to which returns are furnished by the trustee in accordance with s.15. This interpretation is consistent with the intention of the six month rule in the "beneficiary income" definition and avoids anomalies which could arise if the rule only applied where the payment was made during or within six months after the end of the income year.

8.22 By way of example, if pursuant to s.15 the trustee furnishes a return to 31 October 1990 and a payment or application of income derived in the accounting year ending on 31 October 1990 is made to a beneficiary on 15 April 1991 the income thus paid or applied will be income derived by the beneficiary during the same accounting year in which it was derived by the trustee. Consequently, pursuant to s.227(7) the income will be beneficiary income for the income year ending 31 March 1991. Similarly, if pursuant to s.15 the trustee furnishes a return to 31 July 1990 and a payment or application of income derived by the trustee during the accounting year ending 31 July 1990 is made to a beneficiary on 25 January 1991 the income will be derived by the beneficiary during the accounting year ending 31 July 1990. Therefore, in terms of s.227(7) the income will be derived by the beneficiary in the income year ending 31 March 1990.

<u>Foreign tax credits</u>

(a) Beneficiary income

8.23 In cases where beneficiary income is derived from outside New Zealand tax may have been paid on the income to another country. Where the beneficiary is resident in New Zealand a credit may be allowed against New Zealand tax payable on the beneficiary income for the income tax paid to the other country on that income. There are no special rules governing credits for foreign taxes paid on beneficiary income. The question of whether such credits are allowed is determined under the general foreign tax credit provisions contained in Part VIII of the Income Tax Act.

8.24 Section 293(2) provides that where a person who is resident in New Zealand derives income from a country or territory outside New Zealand income tax paid in that country or territory on the income is allowed as a credit against income tax payable in New Zealand on that income. The credit is allowed for "income tax" paid to the other country or territory.

8.25 To satisfy s.293(2) the tax paid to the foreign country or territory must be an income tax. "Income tax" in relation to a country or territory outside New Zealand is defined in s.293(1) as meaning "any tax (whether imposed by a central, state or local government) which, in the opinion of the Commissioner, is substantially of the same

nature as income tax imposed under Part IV of this Act or as non-resident withholding tax imposed under Part IX of this Act..." Additional tax for late payment of tax, and any interest, penalty or additional tax imposed under the penal provisions of the law of the other country or territory, are excluded from the definition of income tax. Amounts deducted from dividends which the person deriving the dividend was not personally liable to pay - that is, taxes other than withholding taxes that are paid in respect of a dividend - are also excluded from the income tax definition.

8.26 A credit is allowed under s.293(2) only if income tax has been "paid" to the other country or territory in respect of the income. Tax which is payable but which has not been paid is not creditable. However, s.301 allows a credit in relation to an income year if within four years after the income year in which the income was derived an application is made to the Commissioner for the credit and all information necessary to determine the amount of the credit is supplied. At the Commissioner's discretion an application may be made within a further period beyond the four year period but that further period may not exceed two years. Section 301 thus allows foreign taxes which had not been paid when the New Zealand tax liability in relation to the income arose to be credited later against the New Zealand tax that was paid on the income. For example, assume that a beneficiary derives $100 beneficiary income from Australia in year one, that New Zealand tax of $33 is paid in respect of that income and that income tax which converts to NZ$25 is paid in Australia in respect of the income in year three. In these circumstances s.301 allows the beneficiary to claim a credit against the New Zealand tax paid in year one for the Australian tax paid in year three. To give effect to the claim an amendment to the assessment made in respect of year one will be made in terms of s.23 and s.25.

8.27 Section 293(2) provides that the foreign tax is credited against the income tax payable in New Zealand in respect of the income. The amount of New Zealand tax payable in respect of the foreign source beneficiary income is determined in accordance with s.306. By s.306(2) the calculation is made by apportioning to the foreign source beneficiary income the portion of the income tax payable on the taxable income of the beneficiary which represents the same proportion that the foreign source beneficiary income from a particular source bears to the beneficiary's total assessable income.

For example, if during the income year ending 31 March 1990 an individual derives a $50,000 salary from New Zealand and $5,000 beneficiary income from Australia the New Zealand income tax payable in respect of the beneficiary income is calculated as follows:

- tax on $55,000

$30,875 x 24% = $7,410
$24,125 x 33% = $7,961
$15,371

- tax on $5,000 beneficiary income

$$\$15{,}371 \times \frac{5{,}000}{55{,}000} = \$1{,}397$$

8.28 If Australian income tax which converts to NZ$1,250 was paid in respect of the $5,000 beneficiary income the beneficiary would be allowed to credit the $1,250 against the New Zealand tax of $1,397 paid in respect of the beneficiary income. In this context it should be noted that by s.304 the amount of the credit is limited to the amount of the New Zealand tax payable in respect of the income. Therefore, if in the example the Australian tax was NZ$1,500 the credit would have been limited to $1,397.

(b) Taxable distributions

8.29 Section 293(2B) provides that where a resident beneficiary derives a taxable distribution a credit against New Zealand income tax payable in respect of the taxable distribution is allowed only for tax paid on the taxable distribution that is of substantially the same nature as non-resident withholding tax imposed under Part IX of the Income Tax Act. That is, a credit is allowed only for non-resident withholding taxes paid in relation to the taxable distribution. A credit is not allowed for tax paid on the income and capital gains from which the taxable distribution is made. For example, if the trustee of a non-qualifying trust derived income in year 1 of $100 and paid $10 income tax on the income, and in year 3 the trustee distributed the net income of $90 to a resident beneficiary, no credit would be allowed to the beneficiary for the $10 tax paid in respect of the income from which the distribution was made.

8.30 The amount of the credit against income tax payable in relation to the taxable distribution is calculated in accordance with the following formula:

$$a \times \frac{b}{c}$$

where -

a is the tax that qualifies for a credit under s.293(2B) (i.e., the tax paid in respect of the taxable distribution that is of substantially the same nature as non-resident withholding tax imposed under Part IX);

b is the amount of the taxable distribution including the tax that qualifies for a credit under s.293(2B);

c is the total amount of the distribution (as defined in s.226) including the tax that qualifies for a credit under s.293(2B).

8.31 The objective of the formula is to ensure that foreign withholding tax paid in relation to a non-taxable portion of a distribution is not creditable. For example, if a distribution of $100 is made from a foreign trust and in terms of s.230(1) the distribution consists of $80 income derived by the trustee in prior years while $20 consists of capital gains derived by the trustee, and if a withholding tax of $30 is paid on the distribution, the entire $30 should not be creditable because a portion will have been paid in relation to the non-taxable capital gains component of the distribution. By operation of the s.293(2B) formula, the amount which is creditable is calculated as:

$$\$30 \times \frac{\$80}{100} = \$24$$

If the New Zealand tax payable on the taxable distribution is $26.40 (i.e., $80 x 33%) the net New Zealand tax payable after allowance of the credit is: $26.40 - $24 = $2.40.

(c) Taxable distributions derived by controlled foreign companies from non-qualifying trusts

8.32 Where a taxable distribution is derived by a controlled foreign company (CFC) from a non-qualifying trust the taxable distribution is attributed to any person resident in New Zealand with an income interest of 10 percent or greater in the CFC separately from other income derived by the CFC: s.245J(24), s.245G(5). The amount thus attributed is subject to tax at the rate applying to taxable distributions from non-qualifying trusts. Section 245K(6)(a) sets out the rules governing credits for foreign taxes in these circumstances.

8.33 Section 245K(6)(a) provides that a credit is permitted against New Zealand income tax payable on the income attributed under s.245G(5) only for tax paid on that income which is substantially of the same nature as non-resident withholding tax imposed under Part IX of the Income Tax Act. The creditable taxes are thus the same as where a taxable distribution is derived directly by a person resident in New Zealand.

8.34 Where the entire distribution to a CFC is not a taxable distribution, for example because a portion of the distribution constitutes corpus, s.245K(6)(b) limits the amount of the foreign non-resident withholding tax that is available for crediting to the portion which is attributable to the taxable distribution component of the distribution. The formula prescribed for this purpose is essentially the same as the formula set out in s.293(2B) that was discussed above.

8.35 The amount of the foreign tax paid in respect of the taxable distribution that is creditable to the person holding an income interest of 10 percent or greater in the CFC is finally determined by s.245K(6)(c). This provides that the credit is calculated by multiplying the creditable tax determined under s.245K(6)(b) by the income interest of the person in the CFC.

Losses

(a) Losses and calculation of beneficiary income and trustee income

8.36 Where the expenses incurred by a person and the allowances permitted to a person exceed the income derived during an income year the person sustains a loss for income tax purposes. In the context of the trust regime the question arises whether such a loss can be passed through to a beneficiary to be deducted from income derived from other sources and whether it can be carried forward to succeeding income years.

(b) Pass through of loss to beneficiary

8.37 There are two possible ways in which a loss could arguably be passed through to a beneficiary and deducted from income derived from other sources. The first is if income and expenses were passed through separately to the beneficiary, with the deductible items being offset against the income at the beneficiary level. However, there is no provision in the legislation for deductible items and income to be passed through separately to the beneficiary. The only provision is for "income" to be vested in or paid or applied to the beneficiary, and "income" is a positive amount. Also, expenditure and allowances of the trustee are not deductible by the beneficiary because the expenditure is not incurred by the beneficiary and the beneficiary does not carry out the activities that give rise to the deductible expenses and allowances: *Doherty* v *FCT* (1933) 48 CLR 1; *CIR* v *Dasent* [1956] NZLR 959.

8.38 The second method by which losses could arguably be passed through to the beneficiary is by the trustee deducting the deductible items from the income and then passing through the net loss to the beneficiary. However, again the legislation makes provision only for "income" to be passed

through to the beneficiary and "income" is a positive amount. Moreover, it is not possible to vest or to pay or apply negative amounts.

8.39 Consequently, losses may not be passed through to a beneficiary and offset against income derived by the beneficiary from other sources. However, losses may be carried forward and deducted from income derived by the trustee in later income years as discussed below.

(c) Carry forward of losses

8.40 Where the trustee sustains a loss in an income year the loss may be carried forward to succeeding income years and deducted from income derived by the trustee in those income years: s.188. For income tax purposes the loss is available to be deducted from income derived in succeeding income years whether or not in terms of the trust losses are to be borne by income. Thus, s.188 overrides the common law rule that losses are borne by capital if it is clear from the trust or will that this is the intended treatment. This conclusion is not affected by *Rutherford* v *CIR* [1965] NZLR 444 because in that case it was assumed that the terms of the trust governed and the specific point of whether s.188 overrides the terms of a trust was not argued.

8.41 Where losses are able to be carried forward for offset against future income they are deducted from the income derived by the trustee in the succeeding income year. If after the deduction of such losses in the succeeding income year there is income remaining this income will be beneficiary income or trustee income, depending upon whether the income is vested in or paid or applied to or for the benefit of the beneficiary. Thus, the loss is not carried forward and deducted against beneficiary income or trustee income: rather, it is carried forward and deducted from income derived by the trustee in the succeeding income year in determining whether there is any income in that year which may be classified as beneficiary income or trustee income.

**Trustee liability for tax on beneficiary income: s.227(2)**

8.42 Section 227(2) provides that where any beneficiary derives beneficiary income or a taxable distribution during any income year the trustee is liable to income tax in respect of that income as agent of the beneficiary. This brings into play the agency provisions of Part VII of the Income Tax Act.

8.43 Section 266 requires every person who is an agent to make returns of the income in respect of which the person is an agent. Further, the agent is assessed on such income in the same manner as if the agent were principal. The trustee is thus liable for tax on beneficiary income as if the income were the trustee's income.

8.44 Section 267 deals with the rate and amount of tax payable. It provides that except where expressly provided otherwise the rate of tax for which an agent is assessable and liable is determined by reference to the total taxable income of the principal. However, tax is charged and payable only on the income in respect of which the agency exists and in the same proportion as that income bears to the total taxable income of the principal. In the context of s.227(2), this means first that the trustee must calculate the tax payable on the total taxable income of the beneficiary. Then the trustee must pay an amount of tax that represents the proportion of the total tax payable on the taxable income of the beneficiary that the beneficiary income and taxable distributions represent of the total taxable income of the beneficiary. For example, if during the income year ending 31 March 1990 a beneficiary who is a natural person derives beneficiary income of $5,000 and total taxable income, including the beneficiary income, of $50,000 the tax payable by the trustee in respect of the beneficiary income would be calculated as:

- tax payable on taxable income

  $30,875 x 24% = $ 7,410
  $19,125 x 33% = $ 6,311
  $13,721

- tax payable on beneficiary income

  $$13{,}721 \times \frac{\$5{,}000}{\$50{,}000} = \$1{,}372$$

8.45 Section 267 applies "except where otherwise provided" in the Income Tax Act. Where a beneficiary derives a taxable distribution from a non-qualifying trust the taxable distribution is assessable at the special rate of tax provided for in s.227(4) and in clause 9D of the First Schedule to the Act. Consequently, where a beneficiary derives a taxable distribution from a non-qualifying trust the amount of tax for which the trustee is liable as agent for the beneficiary is calculated according to s.227(4) rather than according to s.267.

8.46 Section 268 provides that the liability of the agent does not release the principal from liability to make returns and to be assessed and chargeable with tax. Further, any assessment of the agent for tax does not preclude an assessment of the principal for the same tax and any assessment of the principal does not preclude an assessment of the agent for the same tax. The trustee and beneficiary

are thus jointly and severally liable for tax on beneficiary income and on taxable distributions. Therefore, the beneficiary remains liable to furnish returns and to assessment for tax on beneficiary income and taxable distributions.

8.47 In practical terms, where the trustee has paid tax on the beneficiary income or on the taxable distribution in full the beneficiary will not be required to pay tax on that income. If the trustee pays tax on the beneficiary income or taxable distribution but the amount paid is less than the correct amount that is payable the beneficiary will be required to pay the difference between the amount that the trustee paid and the correct amount that is payable. If the trustee has not paid tax on the beneficiary income or taxable distribution the Commissioner may seek to enforce the liability against the trustee and the beneficiary.

8.48 By s.269, when an agent pays tax the agent may recover the amount so paid from the principal, or the agent may deduct the amount from any money in the agent's hands which belongs to the principal. The trustee thus has a right of indemnity against the beneficiary for any tax paid as agent for the beneficiary. Section 270 provides that an agent may retain out of money belonging or payable to the principal an amount which it may reasonably be considered is sufficient to pay the tax for which the agent is or may become liable. Thus, where the trustee has not yet paid tax on beneficiary income or on a taxable distribution the trustee may deduct from money belonging or payable to the beneficiary an amount which will be sufficient to meet the tax liability on that income or distribution.

8.49 By s.272, a person is personally liable for tax on the income in respect of which the person is an agent. The trustee is therefore personally liable for tax on beneficiary income and on taxable distributions.

8.50 The residence of the trustee is not relevant for the purposes of s.227(2). The trustee is liable for tax as agent on beneficiary income and taxable distributions whether the trustee is resident or non-resident. The trustee's liability extends only as far as the beneficiary's liability. Thus, if the beneficiary is not resident in New Zealand the trustee is liable as agent for tax on beneficiary income from sources within New Zealand only.

**Beneficiaries temporarily ceasing to be resident: s.227(3)**

8.51 Section 227(3) applies where any person who is resident in New Zealand ceases to be resident for a period of less than five years and during the period of non-residence the person derived beneficiary income or any taxable distribution from a foreign trust or from a non-qualifying trust. In these circumstances the person is deemed to have derived the beneficiary income or taxable distribution on the day on which the person again becomes resident in New Zealand.

8.52 This provision is an anti-avoidance rule which is designed to limit opportunities for making tax-free distributions of amounts accumulated in foreign or non-qualifying trusts by making the distribution when the beneficiary is temporarily resident outside New Zealand. The rule applies with respect to distributions from foreign trusts and non-qualifying trusts only because income will not have been accumulated free of New Zealand tax if the trust is a qualifying trust.

8.53 Section 227(3) applies where a person derives beneficiary income or taxable distributions while temporarily non-resident. It is not necessary that the person was a beneficiary of the trust when the person ceased to be resident or when the person again becomes resident. Section 227(3) would therefore apply where a person having ceased to be resident becomes a beneficiary of a foreign trust or non-qualifying trust and derives beneficiary income or a taxable distribution while non-resident. The provision would apply whether or not the person was still a beneficiary of the trust when the person again became resident in New Zealand.

8.54 Section 227(3) affects amounts that would have been assessable as beneficiary income from a foreign trust or a non-qualifying trust or as a taxable distribution had the recipient been resident in New Zealand when the sums in question were derived. If such amounts are derived by a person when non-resident they are deemed to have been derived by the person on the day on which the person becomes resident in New Zealand again. Such amounts must therefore be included in assessable income in the income year in which the person again becomes resident in New Zealand. Where the person becomes resident again during an income year no apportionment of the income is made between the part of the year for which the person was resident and the part of the year for which the person was non-resident: the entire amount is included in assessable income. The normal rules discussed in this bulletin which apply to beneficiary income and taxable distributions will then apply to the amounts which are deemed to have been derived.

8.55 The proviso to s.227(3) provides that s.227(3) does not apply to beneficiary income or taxable distributions derived by the person prior to the date on which the Income Tax Amendment Act (No 5) 1988 received the Royal assent. That Act received the Royal assent on 16 December 1988.

**Taxable distributions from non-qualifying trusts: s.227(4)**

Special rate of tax

8.56 Section 227(4) provides that where any person derives a taxable distribution from a trust which is a non-qualifying trust in relation to the distribution the taxable distribution is not included in the person's assessable income but instead the person is liable for tax in respect of the taxable distribution at the rate specified in the First Schedule to the Income Tax Act. The rate currently specified in clause 9D of the First Schedule, which applied from the beginning of the income year commencing on 1 April 1988, is 45 cents for every $1 of the taxable distribution.

8.57 Taxable distributions from non-qualifying trusts are thus less favourably treated than other categories of distribution in three respects: they are subjected to a higher rate of tax; they include distributions of capital gains in addition to distributions of income; and, as with taxable distributions from foreign trusts, a credit is allowed for non-resident withholding tax paid on the distribution but not for tax paid on amounts out of which the distribution is paid. There are two reasons for this unfavourable treatment. The first is to encourage such trusts to be brought within the New Zealand tax system through the election mechanisms prescribed in s.226A and s.227A. If an election is not made tax may not be paid on trustee income as it is derived, but the beneficiary may be taxed in a comparatively unfavourable manner on distribution. The second reason is that as income other than New Zealand source income is not taxed in New Zealand as it is derived the beneficiary has the advantage of deferring liability to tax in respect of the income until it is distributed. The unfavourable treatment on distribution thus serves to compensate for the deferral advantage received by the beneficiary in relation to the income derived by the trustee.

8.58 In this context, the proviso to s.9 of the Income Tax Amendment Act (No 5) 1988 is relevant. The effect of that provision is that a distribution from a non-qualifying trust is not a taxable distribution to the extent that it consists of amounts derived by the trustee in income years commencing before 1 April 1988. Section 9 is discussed in Part 3 of this bulletin.

Taxable distributions derived by controlled foreign companies

8.59 Under the controlled foreign company (CFC) regime contained in Part IVA of the Income Tax Act income derived and losses incurred by a CFC are attributed to residents holding income interests in the CFC of 10 percent or greater. The amount of income or loss attributed to a resident is determined first by calculating the branch equivalent income or loss of the CFC and then by multiplying that income or loss by the person's income interest in the CFC: s.245J; s.245G. Where a CFC derives a taxable distribution from a non-qualifying trust the taxable distribution is attributed to residents holding an income interest in the CFC of 10 percent or greater. The amount thus attributed is taxed separately from other income derived by the CFC. This rule ensures that it is not possible to convert a taxable distribution which by s.227(4) would be taxable at a higher rate to an amount which is taxable at normal rates simply by passing the taxable distribution through a CFC.

8.60 The separate attribution of taxable distributions from non-qualifying trusts through CFCs is achieved by s.245J(24) and s.245G(5). By s.245J(24), if a CFC receives a taxable distribution to which s.227(4) would apply if the CFC were a taxpayer the taxable distribution is not taken into account in calculating the branch equivalent income or loss of the CFC and s.245G(5) applies with respect to the taxable distribution. Section 245G(5) provides that where pursuant to s.245J(24) a taxable distribution is not taken into account in calculating the branch equivalent income or loss of any person in relation to a CFC, the attributed foreign income of that person in relation to the taxable distribution is calculated separately by multiplying the taxable distribution by the income interest of the person in the CFC for the accounting period of the CFC during which the taxable distribution was received. The person is liable to tax in respect of the amount thus calculated at the rate which would apply by virtue of s.227(4) if the person had received the taxable distribution as a beneficiary of the trust from which the taxable distribution was made. A credit for foreign non-resident withholding tax paid on the taxable distribution is allowed in accordance with s.245K(6). That provision is discussed above at paragraphs 8.33 to 8.35.

**Derivation of taxable distribution and losses**

8.61 The proviso to s.227(4) provides that if in the income year during which the person derives a taxable distribution from a non-qualifying trust the person has a loss or a loss carried forward to which s.188 would apply the person may claim as a deduction from the taxable distribution an amount calculated in accordance with the following formula:

$$a \times \frac{b}{c}$$

where -

- a is the part of the loss or loss carried forward that the person claims to be taken into account under the proviso;

b is the minimum rate specified in the First Schedule for income tax on income derived by trustees, the rate being expressed as a decimal;

c is the rate specified in the First Schedule for income tax in respect of taxable distributions from non-qualifying trusts, the rate being expressed as a decimal.

8.62 The effect of the proviso is to allow a loss which is available for carry forward under s.188 to be deducted from a taxable distribution derived from a non-qualifying trust, but only if the amount of the loss thus deducted is reduced by application of the formula to reflect the fact that the taxable distribution is taxable at a higher rate than assessable income against which the loss would otherwise be offset.

8.63 The proviso applies where the person has a loss or loss carried forward to which relief would be given under s.188. The losses to which s.188 applies are global losses; that is, the result of a year's trading: *Grieve* v *CIR* [1984] 1 NZLR 101, 103. The proviso therefore applies where during the income year in which the taxable distribution is derived deductible expenses and allowances exceed income derived, thus resulting in a loss in that income year which may be available for carryforward to the succeeding income year, or where a global loss of this type has been carried forward from an income year prior to the income year during which the taxable distribution is derived. For the proviso to apply the loss must be one which can be carried forward pursuant to s.188. Therefore, if the person deriving the taxable distribution is a company the continuity of ownership requirements of s.188(7) must be satisfied. Also, if the person deriving the taxable distribution is a company the loss grouping provisions of s.191 may apply. If the company claims a deduction from a taxable distribution in accordance with the proviso to s.227(4) the amount of the loss available for carryforward under s.188, and for grouping under s.191, will be reduced by virtue of the proviso.

8.64 If the loss is one to which relief would be given under s.188 the taxpayer is entitled to claim a deduction from the taxable distribution of an amount calculated in accordance with the formula specified in the proviso. If a deduction is taken in accordance with the proviso the loss is not available for deduction or carry forward under s.188 to the extent that it is taken into account under the proviso. If the taxpayer claims a deduction it is necessary to also claim the portion of the loss which taken into account as item a of the formula. Therefore, there are two decisions to make: first, whether to claim a deduction from the taxable distribution; and second, if it is decided to claim a deduction, the amount of the loss which is to be taken into account in applying the formula in the proviso.

8.65 The following example illustrates the operation of the proviso to s.227(4):

<u>Example 12</u>

Facts:

(i) Xco is a New Zealand resident company. In the income year which commences on 1 April 1989 Xco derives a taxable distribution of $10,000 from a non-qualifying trust of which it is a beneficiary. (It is assumed that the distribution is made from income and capital gains derived during the income year commencing on 1 April 1988 and that the distribution of income is a taxable distribution rather than beneficiary income. As the distribution is from amounts derived during the income year commencing on 1 April 1988 the proviso to s.9 of the Income Tax Amendment Act (No 5) 1988 has no effect for the purpose of the example).

(ii) Xco has a global loss for the income year commencing 1 April 1989 of $50,000. This loss is available for carryforward to the succeeding income year in terms of s.188. Xco wishes to deduct from the taxable distribution the portion of the loss which will result in Xco having no tax to pay on the taxable distribution. This calculation is made by solving the equation:

$$y \times \frac{0.33}{0.45} = 10{,}000$$

where -

y is the amount of the loss needed to secure a deduction of $10,000 from the taxable distribution;

.33 is the rate of tax applying to trustee income in the income year commencing on 1 April 1989;

.45 is the rate of tax applying to taxable distributions from non-qualifying trusts in the income year commencing on 1 April 1989;

10,000 is the deduction which Xco wants to secure.

(This formula is not prescribed by the legislation but is provided in order to explain how

Xco calculates the amount of the loss it wishes to take into account) Solving the equation,item "y" has a value of $13,642. Xco thus claims to take into account $13,642 of its loss for the purposes of applying the s.227(4) formula.

Result:

(i) Xco has derived a taxable distribution from a non-qualifying trust. By s.227(4) this distribution is liable to tax at the rate of 45 percent. If the proviso to s.227(4) were not invoked Xco would be liable to tax in respect of the taxable distribution of $10,000 x 45% = $4,500.

(ii) The loss of $50,000 is one to which s.188 applies. Therefore, Xco is entitled to deduct an amount from the taxable distribution in accordance with s.227(4) proviso.

(iii) Xco claims to take into account $13,642 of the loss in calculating the deduction from the taxable distribution. On the basis of this claim the amount of the deduction from the taxable distribution is calculated as follows:

$$\$13,642 \times \frac{.33}{.45} = \$10,000$$

The multiplier in the formula is based on the rates of tax applying in the income year commencing on 1 April 1989.

(iv) Xco deducts the $10,000 calculated in accordance with the proviso to s.227(4) from the taxable distribution of $10,000 resulting in no tax liability in respect of the distribution.

(v) The portion of the loss taken into account for the purpose of the proviso to s.227(4), i.e., the $13,642, is no longer available for carry forward under s.188. The loss available for carry forward under s.188, or for grouping under s.191 if Xco is a member of a group of companies and the requirements of s.191 are satisfied, is reduced to $50,000 - 13,642 = $36,358.

**Arrangements to defeat the intent and application of s.227: s.227(5)**

8.66 Section 227(5) applies where in relation to any trust and any beneficiary an arrangement has been entered into pursuant to which property is transferred, or services or other benefits are provided, to a person other than the beneficiary and the effect of the arrangement in relation to the beneficiary is to defeat the intent and application of s.227. In these circumstances s.227(5) deems the property, services or benefits to have been received or enjoyed by the beneficiary.

8.67 The objective of s.227(5) is to limit opportunities for distributions to be made tax free to a person who is not a beneficiary of the trust in circumstances where a beneficiary of the trust benefits from the distribution. In many cases transactions of this type will constitute an "application" of income or property of the trust for the benefit of a beneficiary in terms of the "beneficiary income" and "taxable distribution" definitions. Thus, s.227(5) effectively operates to buttress the "beneficiary income" and "distribution" definitions in situations where a transaction does not constitute an application of trust income or property for the benefit of a beneficiary but where the beneficiary nevertheless benefits from the transaction.

8.68 The intent of s.227 is to require beneficiaries to include beneficiary income and taxable distributions in their assessable income. An arrangement will defeat the intent and application of s.227 if the beneficiary derives a benefit as a result of the property being transferred, or the services or other benefits being provided, to another person and the beneficiary directly or indirectly benefits from that transfer of property or provision of services or benefits.

8.69 Section 227(5) applies where the arrangement has been entered into in relation to any trust and any beneficiary. There is no specification as to who must have entered into the arrangement and, in particular, it is not necessary for the beneficiary to be a party to the arrangement. In this context, the term "arrangement" is defined in broad terms in s.226(1).

8 70 If s.227(5) applies the property, services or benefits are deemed to be received or enjoyed by the beneficiary. Consequently, the beneficiary may derive beneficiary income or a taxable distribution as a result of the application of s.227(5).

**Distributions from qualifying trusts: s.227(6)**

8.71 Section 227(6) provides that distributions derived by a beneficiary which are not beneficiary income in the hands of the beneficiary are not assessable for income tax if the trust is a qualifying trust in relation to the distribution. This ensures that the law as stated in Coft v Luttrell [1949] NZLR 823 is preserved in relation to qualifying trusts. That is, where income which is not beneficiary income is assessable to the trustee the income is not assessable to the beneficiary when it is later distributed. The legislation thus recognises in the context of qualifying trusts that the trustee pays

tax on trustee income as a representative of the beneficiary and that therefore it is not appropriate to tax the beneficiary on the income when the beneficiary actually receives it.

8.72 As indicated in the preceding paragraph, s.227(6) operates to exclude from the assessable income of a beneficiary of a qualifying trust amounts that have been subject to tax in the trustee's hands and that are later distributed to the beneficiary. Other types of distributions are also excluded from the beneficiary's assessable income by virtue of s.227(6). For example, distributions from qualifying trusts of the type described in paras (a) and (b) of the s.226(1) definition of "distribution" are not be assessable if they fall outside the s.226(1) definition of "beneficiary income". This is because in the case of such distributions there may be no derivation of income by the trustee which corresponds with the distribution to the beneficiary. If this is the case, there will be no beneficiary income, because only income which is first derived by the trustee can be beneficiary income, and the distribution will not be assessable by virtue of s.227(6).

8.73 Section 227(6) only applies in respect of a distribution from a trust that is a qualifying trust in relation to the distribution. Section 227(6) does not apply where the trust is a foreign trust or a non-qualifying trust in relation to the distribution.

### Trustee returns income to accounting year balance date: s.227(7)

8.74 Section 227(7) applies where a trustee furnishes a return of income under s.15 for an accounting year ending with a balance date other than 31 March. In these circumstances, any income derived by the trustee in the trustee's accounting year which is also beneficiary income during that accounting year is deemed to have been derived by the beneficiary during the income year in which the trustee is deemed to have derived the income under s.15. This provision is discussed above at paragraphs 8.19 to 8.22.

## PART 9: ELECTION FOR TRUSTS SETTLED BEFORE 17 DECEMBER 1987

### Section 227A election

9.1 Section 227A applies where a settlement was first made on the terms of a trust on or before 17 December 1987, whether or not further settlements were made on the trust on or after that date. It provides that any settlor, trustee or beneficiary could have made an election under s.228(7) on or before 31 May 1989 to pay tax on trustee income derived in income years commencing on or after 1 April 1988. If an election was made it is provided that for the purpose of determining the liability of any person for income tax in respect of a distribution from the trust all trustee income derived from outside New Zealand, or derived from New Zealand as non-resident withholding income if the obligations of all persons to pay income tax in respect of that non-resident withholding income have been satisfied, is deemed to have been liable to New Zealand income tax and the trustee's obligations in respect of the trustee's liability to such income tax are deemed to have been satisfied.

9.2 The objective of s.227A was to provide a mechanism for trusts which would otherwise be non-qualifying trusts in relation to distributions to become qualifying trusts. The trusts in question are those which were first settled on or before 17 December 1987 where the trustee income was not liable for tax in New Zealand or where such income was liable for New Zealand tax only as non-resident withholding income. The prime example of a trust in this category is one settled by a New Zealand resident on non-resident trustees. The foreign source trustee income of this trust would not have been liable to New Zealand income tax under the old trust taxation regime because the trustee was non-resident. Therefore, if an election were not made the trust would not be a qualifying trust in relation to distributions made from the trust. Instead, it would be a non-qualifying trust and taxable distributions to beneficiaries would be assessable at 45 percent.

9.3 Section 227A is not limited by its terms to trusts which are non-qualifying trusts. Consequently, it would have been possible for a settlor, trustee or beneficiary of a foreign trust first settled on or before 17 December 1987 to have made an election in accordance with s.227A.

### Requirements

9.4 Section 227A applies where a settlement was first made on the terms of a trust on or before 17 December 1987 whether or not further settlements were made to or for the benefit of the trust or on the terms of the trust after that date. The significance of 17 December 1987 is that where a settlement has been made on a trust after that date any settlor of the trust who is resident in New Zealand is liable to tax on trustee income derived by the trustee in income years commencing on or after 1 April 1988: s.228(4). Consequently, in cases where a trust was first settled by a resident after 17 December 1987 all of the trustee income will be liable for tax in New Zealand and the trust will be a qualifying trust if the trustee's obligations in relation to that liability are satisfied. In these cases it is therefore not necessary to provide an election procedure.

9.5 However, if a trust was first settled on or before 17 December 1987 the foreign source trustee income derived in income years commencing before 1 April 1988 will not have been liable to New Zealand tax if the trustee was non-resident, and if the New Zealand source trustee income was non-resident withholding income it will only have been liable to non-resident withholding tax. Trustee income derived from outside New Zealand in income years commencing after 1 April 1988 will have been liable to New Zealand tax under s.228(3), although by virtue of the exceptions contained in s.228(5) and s.228(6) there may be no settlor or trustee liable to tax in respect of the trustee income. However, the trust will not be a qualifying trust unless the income derived in income years commencing before 1 April 1988 was liable to income tax. A trust in this category will therefore not satisfy the qualifying trust definition other than through the election procedure provided in s.227A.

### Election

9.6 An election under s.227A could have been made by any settlor, trustee or beneficiary or by any combination of settlors, trustees or beneficiaries, including a settlor or trustee who was already liable to tax on trustee income. For example, if a resident settled property on a trust with non-resident trustees on 1 June 1986, and the person made a further settlement on 1 October 1988, the settlor and trustee would be liable to pay tax on trustee income derived in income years commencing on and after 1 April 1988 because a settlement was made after 17 December 1987: s.228. However, the trust would not be a qualifying trust because the income derived in income years commencing before 1 April 1988 would not have been liable to income tax. Thus, the trustee or settlor might have considered it appropriate to make a s.227A election notwithstanding the fact that they were already liable to tax on trustee income.

9.7 The election had to be made on or before 31 May 1989. There was no provision for the Commissioner to extend the time for making an election in accordance with s.227A. An election to pay tax on trustee income can still be made under s.228(7) after 31 May 1989 but if such an election is made in relation to a trust which was first settled on or before 17 December 1987 the election will not convert the trust to a qualifying trust. This is because (except for the different times specified in s.226A and s.227A) a s.227(8) election only operates from the income year in which the election is made. Consequently, the income derived in income years commencing before the income year in which the election was made will not have been liable to New Zealand income tax and the election will not convert the trust to a qualifying trust.

### Effect of election

9.8 Where an election was made in accordance with s.227A it is provided that in determining the liability of any person for income tax on a distribution from the trust all trustee income derived by the trustee from outside New Zealand, or from within New Zealand as non-resident withholding income if the obligations of all persons to pay tax in relation to that income have been satisfied, is deemed to have been liable to income tax under the Income Tax Act other than only as non-resident withholding income. Further, it is provided that the trustee's obligations in relation to that liability are deemed to have been satisfied.

9.9 The language used in s.227A ties in with the language used in the s.226(1) definition of "qualifying trust". There are two essential elements to that definition:

(i) first, that all of the trustee income derived by the trustee commencing with the income year in which a settlement was first made on the trust and ending with the income year in which the distribution is made has been liable to New Zealand income tax other than only as non-resident withholding income; and

(ii) second, that the trustee's obligations in respect of the trustee's liability to New Zealand income tax have been satisfied.

9.10 The effect of a s.227A election is therefore that the requirements of the qualifying trust definition are deemed to have been satisfied in relation to trustee income derived from outside New Zealand, or derived from New Zealand as non-resident withholding income, in income years commencing before 1 April 1988.

9.11 A s.227A election does not affect income derived from New Zealand other than as non-resident withholding income. Consequently, if the trustee derived income from New Zealand other than as non-resident withholding income, and the trustee's obligations in relation to the trustee's liability to pay tax on such income have not been satisfied, the trust will not be a qualifying trust in relation to any distribution from the trust. Also, after a s.227A election has been made the person making the election must continue to satisfy the obligation to pay tax on the trustee income: s.228(7). If this obligation is not satisfied the trust will cease to be a qualifying trust in relation to distributions.

## PART 10: TAXATION OF TRUSTEE INCOME

### Overview of s.228

10.1 Section 228 sets out the rules governing the taxation treatment of trustee income. The broad scheme of s.228 is that the trustee is always liable to tax on New Zealand source trustee income and, subject to several exceptions, that the trustee is also liable for tax in respect of foreign source trustee income derived in any income year in three situations. The first is where any settlor of the trust is resident in New Zealand at any time during the income year. The second is where the trust is a superannuation fund (as defined in s.2). The third is where a trustee of the trust is resident in New Zealand at any time during the income year and a settlor of the trust died resident in New Zealand, either during that income year or during any other income year.

10.2 Where a settlement has been made on a trust after 17 December 1987 any settlor of the trust who is resident in New Zealand at any time during an income year is, subject to several exceptions, liable to tax on trustee income derived during that income year as agent of the trustee. The most significant exceptions are where a trustee of the trust is resident in New Zealand at all times during the income year, where the trust is a superannuation fund, and where the settlor was not resident in New Zealand at the time of any settlement made by that settlor or was not resident in New Zealand at the time of any other settlement made after 17 December 1987.

10.3 In outline, s.228(1) provides that, subject to s.228, a trustee is assessable and liable for income tax on trustee income as if the trustee were an individual beneficially entitled to the trustee income. Section 228(2) provides that the trustee is liable to income tax on trustee income derived from New Zealand, and s.228(3) establishes the rules governing the taxation of trustee income derived from outside New Zealand. By s.228(2A) and s.228(2B) special rules are provided for calculating the assessable income derived by trustees of superannuation funds. Section 228(4) provides that where a settlement has been made on a trust after 17 December 1987 any settlor of the trust who is resident in New Zealand at any time during an income year is liable for tax on trustee income derived during that income year as agent for the trustee. Section 228(5) contains a number of exceptions to this rule. Section 228(6) contains several exceptions to the rule that trustees are liable for tax in respect of income derived from outside New Zealand in cases where a settlor of the trust is resident in New Zealand during an income year. Section 228(7) contains a procedure whereby any settlor, trustee or beneficiary of a trust can elect to pay tax on trustee income.

### Liability for tax on trustee income: s.228(1)

10.4 Section 228(1) provides that, subject to s.228, a trustee is assessable and liable for income tax on trustee income as if the trustee were an individual beneficially entitled thereto. This rule is qualified in that the rate of tax is calculated by reference to the trustee income alone, the trustee is not entitled to any rebate of income tax or to any deduction by way of special exemption, and the trustee is not entitled to be a cash basis holder for the purpose of s.64B to s.64M (the accruals rules).

10.5 Section 228(1) applies subject to the other provisions of s.228. Thus, the trustee is only liable for tax in respect of trustee income derived from outside New Zealand if s.228(3) applies and if none of the exceptions in s.228(6) apply.

10.6 The trustee is liable for income tax on trustee income as if the trustee were an "individual beneficially entitled thereto". One consequence of this language is that if the trustee is a company that fact is ignored in determining the amount of tax for which the trustee is liable. Thus, if at any time company rates of taxation differ from the rates applying with respect to trustee income it cannot be argued in cases where the trustee is a company that the trustee income is taxable at the company rate. With respect to the income year ending 31 March 1990 the rates of tax on income derived by resident companies and by trustees is the same.

10.7 Paragraph (a) of s.228(1) provides that the rate of tax is calculated by reference to the trustee income alone. This reflects the principle discussed in Part 5 of this bulletin that trustees are assessable for income tax on trustee income as representatives of the beneficiaries of the trust. Thus, income derived by the trustee in a capacity other than as trustee of the trust is not taken into account in determining the amount of tax on the trustee income and the rates of tax applying to the trustee income are not affected by the rates applying to other income derived by the trustee.

10.8 Paragraph (b) of s.228(2) provides that the trustee is not entitled to any rebate of income tax or to any deduction by way of special exemption. Together with paragraph (a) this also reflects the principle that trustees are liable for income tax on trustee income as representatives for the beneficiaries of the trust.

10.9 Paragraph (c) of s.228(3) provides that the trustee is not entitled to be a cash basis holder pursuant to s.64D. Consequently, the cash basis holder exception to the accruals rules contained in s.64C(5)(a) does not apply and the trustee is required to accrue income derived in respect of financial arrangements in accordance with the rules contained in s.64C. This ensures that individuals who do not otherwise qualify for the cash basis holder exemption and companies cannot take advantage of that exemption by placing financial arrangements in a number of trusts.

**New Zealand source trustee income: s.228(2)**

10.10 Section 228(2) provides that a trustee is liable for income tax on all trustee income derived from New Zealand. This is the case whether or not the trustee or settlor of the trust is resident in New Zealand. The question of whether income is derived from New Zealand is determined in accordance with s.243.

10.11 Where the trustee is resident outside New Zealand and the New Zealand source trustee income is non-resident withholding income as defined under s.310, there will be a liability to pay non-resident withholding tax in relation to the income. If the trustee income is liable for tax only as non-resident withholding income the trust will not be a qualifying trust in relation to distributions to beneficiaries: s.226(1) "qualifying trust" definition. Consequently, distributions from the trust which do not constitute beneficiary income may be assessable to resident beneficiaries as taxable distributions from a foreign trust or from a non-qualifying trust.

**Superannuation regime: s.228(2A), s.228(2B)**

10.12 Section 228(2A) provides that, notwithstanding s.106(1)(a) but subject to the other provisions of the Act, in calculating the assessable income derived in any income year by a trustee of a superannuation fund a deduction is allowed for expenditure incurred by the superannuation fund to the extent to which it is incurred in respect of developing, marketing, selling, promoting, and advertising for members to the fund. In the absence of this provision such expenditure may be precluded from deduction by s.106(1)(a). Section 228(2A) does not apply to expenditure incurred in acquiring any plant, machinery, equipment, land, or building or expenditure which is not income in the hands of the recipient.

10.13 Section 228(2B) provides that where any funds of a superannuation fund are invested in another superannuation fund or in a policy of life insurance issued in New Zealand, any income, gain or benefit arising from that investment is deemed not to be assessable income derived by the trustee of the superannuation fund. This avoids the double taxation of income in the hands of both superannuation funds or in the hands of the superannuation fund and in the hands of the life insurance office.

**Trustee income derived from outside New Zealand: s.228(3)**

Overview

10.14 Section 228(3) sets out the rules governing the liability to income tax of trustee income derived from outside New Zealand. It provides that a trustee is liable to income tax on trustee income derived from outside New Zealand in any income year during which any settlor of the trust is at any time resident in New Zealand, during which the trust is at any time a superannuation fund, or during which any trustee was at any time resident in New Zealand if any settlor of the trust died resident in New Zealand, whether during that income year or during any prior income year.

10.15 Therefore, except in the case of superannuation funds, the residence of the settlor is the important connecting factor in determining whether trustee income from outside New Zealand is liable for income tax. This differs from the previous trust regime where the residence of the trustee was the relevant connecting factor. Trustee residence was not chosen as the basis for taxing trustee income from outside New Zealand because it was considered that it would be too easy to avoid tax on such income by appointing non-resident trustees. Further, it was considered that in economic terms the residence of the settlor provided a more appropriate basis for taxing foreign source trustee income than did the residence of the trustee. In the case of superannuation funds, the residence of the settlor is not relevant in determining whether trustee income from outside New Zealand is liable to income tax. Trustee income derived by superannuation funds is always liable to income tax.

Settlor resident in New Zealand

10.16 By s.228(3)(a), a trustee is liable to income tax on trustee income derived from outside New Zealand in any income year during which any settlor of the trust is resident at any time in New Zealand.

10.17 The liability to tax on trustee income derived from outside New Zealand arises where any settlor of the trust is resident in New Zealand. Thus, if there is more than one settlor s.228(3)(a) applies if

any one of the settlors is resident in New Zealand at any time during the income year. Further, it is not necessary for the settlor to be resident in New Zealand at all times during the income year. The liability will arise if the settlor is resident at any time during the income year.

10.18 In cases where a settlor of the trust is resident in New Zealand at any time during the income year the trustee will be liable for tax on trustee income derived from outside New Zealand whether or not the trustee is resident in New Zealand. The one exception to this rule, discussed below at paragraphs 10.74 to 10.84, is contained in s.228(6). Where the trustee is resident outside New Zealand it is provided that the trustee is liable to income tax "as if the trustee were resident in New Zealand". This ensures that if a settlor of the trust is resident in New Zealand it cannot be argued that foreign source trustee income is not liable to income tax if the trustee is not resident.

Superannuation funds

10.19 By s.228(3)(aa), a trustee of a trust is liable to income tax on trustee income derived from outside New Zealand in any income year during which the trust is at any time a superannuation fund. This provision was inserted by the Income Tax Amendment Act 1989 as part of the legislation implementing the new superannuation taxation regime. The superannuation taxation regime has been integrated with the trust taxation regime and s.228(3)(aa) ensures that trustees of superannuation funds are assessable for income tax on the worldwide income of the fund.

Settlor died resident in New Zealand

10.20 By s.228(3)(b), a trustee is liable for income tax on trustee income derived from outside New Zealand in any income year during which any trustee of the trust was at any time resident in New Zealand and the trust is a testamentary trust or an inter vivos trust where, in either case, any settlor of the trust died resident in New Zealand. The provision applies whether the settlor died during the income year in which the income in question was derived or during any prior income year.

10.30 Section 228(3)(b) applies in relation to trustee income derived in an income year when any trustee of the trust is resident in New Zealand at any time during the income year. If there is more than one trustee it is sufficient that any one of the trustees is resident in New Zealand. Thus, s.228(3)(b) may apply to render a non-resident trustee liable for tax on trustee income derived from outside New Zealand if another trustee is resident in New Zealand at any time during the relevant income year. The liability arises if the trustee is resident at any time during the income year. It is not necessary that the trustee should be resident at all times during the income year.

10.40 Section 228(3)(b) applies where the trust is a testamentary trust or an inter vivos trust and, in either case, the settlor died resident in New Zealand. Thus, the trust may be one which was created on the death of the settlor or during the life of the settlor. The provision applies if the settlor died resident in New Zealand during the income year in which the relevant trustee income was derived or during any other income year. For example, if the settlor died resident in the 1990 income year, and a trustee of the trust was resident during the 1992 income year, the trustee income derived from outside New Zealand in the 1992 income year would be liable to New Zealand income tax.

10.41 In some cases a non-resident trustee may be liable under s.228(3)(b) for tax on trustee income derived from outside New Zealand. For example, the trustee may be resident for only part of the income year but will be liable for tax on trustee income derived from outside New Zealand during the whole income year. Or, the trustee may be non-resident for the entire income year but there may be another trustee who is resident in New Zealand during all or part of the income year. In these circumstances the trustee is liable to income tax in respect of trustee income derived from outside New Zealand as if the trustee were resident in New Zealand.

Liability of trustee resident outside New Zealand

10.42 The introductory language of s.228(3) provides that in the circumstances specified in paras (a) to (b) of that subsection the trustee is liable to tax on trustee income derived from outside New Zealand. If the trustee is resident outside New Zealand the language in parentheses states that the trustee is liable to tax "as if the trustee were resident in New Zealand". This language ensures that, in the circumstances specified in paras (a) to (b) of s.228(3), the provisions which normally apply to persons resident in New Zealand who derive income from outside New Zealand apply to trustees who are not resident in New Zealand. Read together with s.228(1), which provides that trustees are liable for tax on trustee income as if they were individuals beneficially entitled to the income, the effect of the language in parentheses is that non-resident trustees are liable to tax on income derived from outside New Zealand calculated in the same manner as for individuals who are resident in New Zealand. The liability to tax of trustees as individuals is subject to the three exceptions contained in paras (a) to (c)

of s.228(1). These provisions are discussed above at paragraphs 10.4 to 10.9.

10.43 Section 228(3) provides that the non-resident trustee is liable to tax on trustee income derived from outside New Zealand as if the trustee were an individual resident in New Zealand. Thus, to the extent that it applies to income derived from outside New Zealand, s.242(a) applies to make the trustee assessable for income tax on trustee income derived from outside New Zealand. Other provisions relating to the taxation of income derived from outside New Zealand will operate as follows:

(i) The trustee will be assumed to be resident in New Zealand for the purposes of calculating the credit for foreign taxes to which the trustee will be entitled under s.293.

(ii) The exception from the accruals taxation regime provided by s.64M(e) for non-residents will not apply in calculating trustee income derived from outside New Zealand.

(iii) Section 245R(11), which provides that any person who is resident outside New Zealand during an income year does not derive foreign investment fund income or incur a foreign investment fund loss, does not apply to the trustee. Thus, if the trust assets include an interest in a foreign investment fund the trustee will be required to take into account foreign investment fund income and foreign investment fund losses in calculating trustee income.

(iv) Section 245F(1), which provides that any person who is resident outside New Zealand at all times during an income year is not required to calculate attributed foreign income or attributed foreign loss in respect of an interest in a controlled foreign company (CFC), does not apply. Thus, if the trust assets include an "income interest of 10 percent or greater" (as defined in s.245A) the trustee will be required to take into account attributed foreign income and attributed foreign losses (where attribution is required under Part IVA of the Income Tax Act) in calculating trustee income.

(iv) Non-resident trustees who are liable to tax on trustee income derived from outside New Zealand by virtue of s.228(3) are permitted to elect to maintain a branch equivalent tax account (BETA) in accordance with s.394ZZS (s.394ZZS applies rather than s.394ZZN because the trustee is liable to tax as an individual). The non-resident trustee is permitted to maintain a BETA because the trustee is liable to tax in respect of trustee income derived from outside New Zealand on the same basis as if the trustee were resident in New Zealand. Thus, all provisions which affect the liability to tax of a person resident in New Zealand in respect of income derived from outside New Zealand apply to the non-resident trustee. A BETA is relevant in calculating the liability of a person resident in New Zealand to tax on dividends derived from foreign companies. Consequently, the non-resident trustee is permitted to maintain a BETA.

Relevance of settlor liability

10.44 The liability of a trustee to income tax on trustee income derived from outside New Zealand does not depend upon the liability of the settlor to income tax with respect to that income. Thus, subject to the exceptions contained in s.228(6), if s.228(3) is satisfied a trustee will be liable to income tax on trustee income derived from outside New Zealand whether or not any resident settlor of the trust is liable to income tax in respect of that income. For the purpose of s.228(3) settlor residence is relevant not settlor liability.

Trustee not otherwise liable

10.45 The concluding language of s.228(3) provides that a trustee is not otherwise assessable to income tax on trustee income derived from outside New Zealand. For example, if during the relevant income year no settlor of the trust was at any time resident in New Zealand the trustee is not liable for tax on trustee income derived from outside New Zealand unless the trustee elects to pay tax on trustee income in accordance with s.228(7). This is the case even if the trustee is resident in New Zealand and even if the settlor has been resident in New Zealand in prior years.

**Settlor liability in respect of trustee income: s.228(4)**

Overview

10.46 Section 228(4) sets out the general rule as to when a settlor is liable to income tax on trustee income. It applies in relation to trusts other than charitable trusts where a settlement was made to or for the benefit of a trust or on the terms of a trust after 17 December 1987. In these circumstances, subject to s.228(5), if a trustee of the trust derives trustee income in any income year any settlor of the trust who is resident in New Zealand at any time during that income year is assessable

and liable to income tax on that trustee income as agent of the trustee. Where there is more than one such settlor it is provided that they are jointly and severally liable for tax on that income.

Exceptions to settlor liability

10.47 Section 228(4) creates a general rule that a settlor of a trust is liable for tax in respect of trustee income as agent for the trustee. There are a number of exceptions to this rule. First, s.228(4) applies subject to s.228(5). Section 228(5) contains several significant exceptions to the rule that settlors are liable to income tax on trustee income. These are discussed below at paragraphs 10.55 to 10.73.

10.48 Second, s.228(4) does not apply in relation to charitable trusts. The expression "charitable trust" is defined in s.226(8) and s.226(9). Those provisions are discussed in Part 4 of this bulletin at paragraphs 4.108 to 4.123.

10.49 The third exception to settlor liability is that s.228(4) applies only where a settlement has been made to or for the benefit of the trust or on the terms of the trust after 17 December 1987. The significance of 17 December 1987 is that the Government's Consultative Document on International Tax Reform was released on that day. Prior to the publication of that document there was no indication that persons making settlements on trusts would be liable to income tax in respect of the trustee income derived by the trustee. Consequently, if a trust was settled before 17 December 1987, and no settlement has been made on the trust since that date, the settlor is not liable for tax on trustee income unless the settlor elects to pay tax on trustee income in accordance with s.228(7). However, if a settlement was made on the trust after 17 December 1987, whether or not the trust was first settled on or before 17 December 1987, the person making the settlement is taken as being on notice that one consequence of making the settlement is that the person may be liable for tax in respect of trustee income.

10.50 Section 228(4) provides that any settlor of the trust who is resident in New Zealand at any time during an income year is liable to income tax in respect of trustee income if a settlement was made to or for the benefit of the trust or on the terms of the trust by any person after 17 December 1987. Therefore, it is not necessary that the settlement made after 17 December 1987 was made by the settlor who is resident in New Zealand during the relevant income year. For example, if a resident individual, A, settled a trust on 1 June 1986 and a non-resident individual, B, made an additional settlement to or for the benefit of the trust on 1 May 1989, A would be liable for income tax on trustee income (subject to s.228(5)) derived in the income year commencing on 1 April 1989 and in subsequent income years in which A was at any time resident in New Zealand.

Application and effect of s.228(4)

10.51 Where a settlement has been made on the terms of a trust or to or for the benefit of a trust after 17 December 1987 and during any income year the trustee of the trust derives trustee income, s. 228(4) provides that 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 as agent of the trustee. Section 228(4) applies where the settlor is resident at any time during the income year. If the settlor is resident at any time during the income year the settlor is liable for income tax on trustee income derived during the entire income year.

10.52 The effect of s.228(4) is that the settlor is liable to income tax on trustee income as agent of the trustee. The agency provisions contained in Part VII of the Income Tax Act therefore apply. One object of treating the settlor as agent of the trustee is to give the settlor a right of indemnity against the trustee for any tax paid by the settlor on trustee income: Report of the Consultative Committee on International Tax Reform and Full Imputation, Part 2 p 89. This right of indemnity is provided for in s.269.

10.53 By s.266, every agent is required to make returns of the income in respect of which the agent is an agent. Further, the agent is assessable on such income in the same manner as if the agent were the principal. Therefore, in the context of s.228(3) it is permissible for the Commissioner to assess the settlor for income tax on trustee income whether or not the Commissioner also assesses the trustee for income tax on such income. There is no requirement for the Commissioner to assess the trustee on the trustee income and to attempt to collect the tax from the trustee before an assessment can be made on the settlor. Where an assessment is made of the settlor, s.268 provides that this does not preclude an assessment being made of the trustee. Further, by virtue of s.268 if an assessment is made of the settlor this does not release the trustee from the liability to make returns and to be assessed and charged with tax.

10.54 If there is more than one settlor liable to income tax under s.228(4) it is provided that they are jointly and severally assessable and liable to income tax in respect of the trustee income. Settlors are thus jointly liable for tax on the entire trustee income and it is for the settlors to apportion liability among themselves. An exception to this

general rule is provided in s.228(5)(c). By virtue of that provision an apportionment of the liability of a settlor can be made where the settlor can satisfy the Commissioner that the settlor's liability to tax exceeds the liability which the settlor should bear having regard to the settlements made by that settlor and the settlements made by other settlors. This exception is discussed further below at paragraphs 10.64 to 10.71..

**Exceptions to settlor liability: s.228(5)**

Overview

10.55 Section 228(5) provides several exceptions to the rule contained in s.228(4) that a settlor of a trust is liable to income tax on trustee income if a settlement has been made on the trust after 17 December 1987. By s.228(5)(a), a settlor is not liable to income tax on trustee income if at all times during that income year a trustee of the trust is resident in New Zealand. Section 228(5)(aa) excludes settlors of superannuation funds from liability. Section 228(5)(b) provides that a settlor of a trust who was not resident in New Zealand at the time when the settlor made a settlement on the trust, and who was not resident in New Zealand at the time of any settlement since 17 December 1987, is not liable to tax on trustee income. Section 228(5)(c) contains a rule for limiting the liability of settlors in circumstances where there is more than one settlor of the trust. By s.228(5)(d), a settlor is not liable for tax on trustee income to the extent that the trustee income is derived by virtue of the application of s.64B to s.64M to amounts remitted by the settlor under any financial arrangement.

Trustee resident: s.228(5)(a)

10.56 Section 228(5)(a) provides that s.228(4) does not apply to any settlor of a trust in any income year where at all times during that income year, or, where the trust was first settled during the income year, at all times from the date of first settlement until the end of the income year, a trustee of the trust is resident in New Zealand.

10.57 In these circumstances liability is not imposed on the settlor because there is a resident trustee who 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. Therefore, in that situation s.228(5)(a) does not apply and the settlor is liable for tax on trustee income in accordance with s.228(4) (subject to any other relevant exceptions) if a settlement has been made on the trust after 17 December 1987.

10.58 The language in parentheses in s.228(5)(a) deals with the situation where a trust is first settled during the income year. In those circumstances s.228(5)(a) will operate where a trustee has been resident in New Zealand at all times from the date of first settlement until the end of the income year.

Superannuation funds: s.228(5)(aa)

10.59 Section 228(5)(aa) provides that settlors of superannuation funds are not liable for tax on trustee income. The trustees of superannuation funds are liable to tax on trustee income derived from New Zealand (s.228(2)) and from outside New Zealand (s.228(3)(aa)).

Non-resident settlors: s.228(5)(b)

10.60 Section 228(5)(b) provides that 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 pursuant to s.228(7).

10.61 Section 228(5)(b) ties in with s.226A, the provision which applies where a settlor of a foreign trust becomes resident in New Zealand. Read together, the effect of these two provisions is that settlors of foreign trusts who become resident in New Zealand are not liable to income tax in respect of trustee income unless they elect to pay tax on such income. Persons who settled trusts before becoming resident in New Zealand may have made the settlement in ignorance of the New Zealand trust taxation regime. Therefore, it is appropriate that they not be liable automatically to income tax on trustee income on becoming resident. In this regard, settlors of such trusts are treated in a similar manner to resident settlors who settled trusts before 17 December 1987.

10.62 For s.228(5)(b) to apply the settlor must be a natural person. The exception does not apply if the settlor is a company. This is consistent with s.226A which also applies with respect to natural persons only. The settlor must not have been resident in New Zealand at the time of any settlement by the settlor. Further, the settlor must not have been resident at the time of any other settlement (that is, any settlement made by any other person) made after 17 December 1987.

10.63 Section 228(5)(b) does not apply where the settlor elects to pay tax on trustee income pursuant to s.228(7). Several categories of election are covered by the s.228(7) procedure including elections which can be made in the circumstances specified in s.226A. Thus, the s.228(5)(b) exception will not apply where a settlor of a foreign trust who becomes resident in New Zealand elects to

pay tax on trustee income in accordance with s.226A and s.228(7). Elections under s.228(7) to pay tax on trustee income can be made by the settlor, trustee or beneficiary. When the election is made by the trustee or beneficiary, and not by the settlor, the settlor will continue to be exempted from liability for tax on trustee income if the terms of s.228(5)(b) are satisfied.

Limitation of liability: s.228(5)(c)

(a) Requirements and application

10.64 Section 228(5)(c) may 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 that the settlor can establish to the satisfaction of the Commissioner that the liability of that settlor exceeds the liability which that settlor should bear in comparison with other persons who have made a settlement on the trust. In determining whether liability should be limited the Commissioner is required to have regard to settlements made on the trust by all settlors.

10.65 Section 228(5)(c) 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.228(4). 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.

10.66 The relief granted by s.228(5)(c) applies only to the extent that the settlor can establish to the satisfaction of the Commissioner that the liability to income tax of that settlor exceeds the liability which that settlor should bear in comparison with other settlors. For s.228(5)(c) to apply the settlor must make full disclosure of all relevant facts. 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. Such a comparison may be relatively simple if the settlements in question result from dispositions of property to the trust. In those circumstances the settlor's liability can be limited by applying either of the two following methods:

(i) by determining, at the time of the settlement by the settlor, the proportion which the market value of the property settled by the settlor on the trust bears to the market value of the trust's net assets. The relevant proportion is determined at the time of the settlement and remains unchanged until a further settlement is made on the trust. When a further settlement is made on the trust 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.

(ii) by tracing the income attributable to the property settled on the trust by the settlor.

10.67 To illustrate the first method, assume that A and B each transfer property with a market value of $10,000 to a trust in year 1 and that in year 4 B transfers further property with a market value of $5,000 to the trust. Assume further that in year 4 the property transferred by A and B in year 1 has a market value of $15,000 (i.e., the value of the trust property prior to the further settlement by B is $30,000). In these circumstances, the liability of A and B for tax on trustee income in years 1 to 3 is calculated in each of those income years as -

$$\text{Trustee Income} \times \frac{\$10{,}000}{\$20{,}000}$$

In year 4 the respective proportions of trustee income for which A and B are liable are recalculated by revaluing the property originally contributed by A and B and by taking into account the additional settlement made by B. The proportion of trustee income in respect of which A would be liable to income tax would be -

$$\frac{\$15{,}000}{\$35{,}000} = .43 \text{ (i.e., } 43\%)$$

B would be liable to income tax in respect of the remaining 57% of the trustee income.

10.68 Where persons settle different types of property producing different returns the tracing approach may be more appropriate. This approach could be used, for example, if one settlor transferred shares to the trust while another transferred land. In these circumstances it may be feasible to determine the liability of the settlors by allocating the income derived from the shares to the person who transferred the shares to the trust and by allocating the income derived from the land to the settlor who contributed the land to the trust.

10.69 The examples discussed above assume quite simple fact patterns. In more complex cases where, for example, property settled by one settlor has been disposed of by the trustee, or where settlements have arisen by virtue of the contribution of property and the provision of services, it may not be possible to make a sensible comparison of the settlements for the purpose of s.228(5)(c). If this is the case s.228(5)(c) will not apply. The question of whether s.228(5)(c) can be applied will depend on the facts of each case.

(b) Limitation of liability and qualifying trust definition: s.228(5) proviso

10.70 The proviso to s.228(5) provides that s.228(5)(c) does not apply in determining the nature and extent of the obligations of the trustee of the trust and whether those obligations have been satisfied for the purposes of the definition of "qualifying trust" in s.226(1) and for the purposes of the application of that definition.

10.71 Therefore, for the purpose of the "qualifying trust" definition if during any income year a settlor of the trust is resident in New Zealand the trustee will be liable for tax on the New Zealand and foreign source trustee income in terms of s.228(2) and s.228(3). If tax is not paid on the entire trustee income because the resident settlor's liability to tax is limited by s.228(5)(c) the trust will not be a qualifying trust in relation to any distribution made from it.

Trustee income arising from remittance of debt: s.228(5)(d)

10.72 By s.228(5)(d), a settlor is not liable to income tax on trustee income to the extent that the trustee income is derived by virtue of the application of s.64B to s.64M to amounts remitted by the settlor under any financial arrangement where s.64F or s.64FA applies.

10.73 In terms of the accruals legislation the remittance of a financial arrangement will generally give rise to income in the hands of the issuer of the financial arrangement. Where the remittance of a financial arrangement gives rise to trustee income s.228(5)(d) exempts the settlor from liability to tax in respect of the trustee income thus arising. However, the trustee will remain liable to tax in respect of the trustee income arising from the remittance and if the trustee's obligations in relation to that liability are not satisfied the trust will not be a qualifying trust for distribution purposes.

**Exceptions to trustee liability: s.228(6)**

Overview

10.74 Section 228(6) contains two exceptions to the rule in s.228(3) that, in the circumstances specified in s.228(3), a trustee is liable to income tax in respect of trustee income derived from outside New Zealand. The first exception is where the trustee is resident outside New Zealand at all times during the income year and no settlement has been made on the trust after 17 December 1987. The second exception is where the trustee is resident outside New Zealand at all times during the income year and the only settlements made on the trust have been made by settlors who at the time of settlement were not resident in New Zealand and who had not been resident since 17 December 1987. Neither exception applies where an election to pay tax on trustee income has been made by the trustee. Further, by the first proviso to s.228(6) nothing in s.228(6) affects the liability for income tax of any settlor of a trust, and by the second proviso to s.228(6) the trustee income remains liable to income tax for the purpose of determining whether the trust is a qualifying trust.

No settlement after 17 December 1987

10.75 Section 228(6) provides that where in any income year a trustee would be liable to income tax pursuant to s.228(3) in respect of trustee income derived from outside New Zealand the trustee is not so liable if no settlement has been made to or for the benefit of the trust or on the terms of the trust since 17 December 1987.

10.76 The exception applies only with respect to income derived from outside New Zealand. The trustee remains liable to income tax on trustee income derived from New Zealand. The exception ties in with s.228(4). Section 228(4) imposes a liability to income tax on a settlor of a trust only if a settlement has been made on the trust since 17 December 1987. Thus, where no settlement has been made on a trust since 17 December 1987 the settlor of the trust is not liable to income tax on the trustee income and any non-resident trustee is not liable to income tax on trustee income derived from outside New Zealand.

10.77 The exception does not apply where the trustee is resident in New Zealand at any time during the relevant income year. In these circumstances it is more likely that the tax will be collected from the trustee and it is not appropriate to exempt the trustee from liability.

10.78 The exception does not apply where an election has been made by the trustee to pay income tax on trustee income. An election to pay income tax on trustee income can be made by any settlor, trustee or beneficiary of the trust. Thus, where the election is made by a settlor or by a beneficiary, and not by the trustee, the exemption provided for trustees by s.228(6) will still apply.

Settlements made when settlor non-resident

10.79 Section 228(6) also provides that a trustee is not liable to tax on trustee income derived from outside New Zealand where the only settlements made on the trust have been made by settlors who

at the time of settlement were not resident in New Zealand and who had not been resident in New Zealand at any time since 17 December 1987.

10.80 This exception ties in with the exception from liability to tax on trustee income afforded by s.228(5)(b) to settlors of foreign trusts who become resident in New Zealand. Thus, where settlements have been made on the trust by non-residents any settlor who becomes resident in New Zealand only is not liable to income tax on trustee income and any trustee is not liable to income tax on trustee income derived from outside New Zealand.

10.81 As with the exception applying to trusts where no settlements have been made after 17 December 1987, the exception with respect to trusts settled by non-residents only applies if the trustee is resident outside New Zealand at all times during the income year. Further, the exception does not apply if the trustee makes an election to pay income tax on trustee income.

Limitations on application of s.228(6): s.228(6) provisos

10.82 The application of the exceptions in s.228(6) is limited by two provisos. The first proviso states that s.228(6) does not affect the liability to income tax of any settlor of the trust. Thus, for example, if a settlor of a trust on which no settlement has been made after 17 December 1987 elects in accordance with s.227A to pay tax on trustee income the liability of the settlor to pay tax on trustee income is not affected by the fact that pursuant to s.228(6) the trustee may not be liable for tax on trustee income derived from outside New Zealand.

10.83 The second proviso states that for the purpose of determining whether a trust is a qualifying trust the trustee income of the trust remains liable to income tax and s.228(6) does not apply in determining whether the trustee's obligations in relation to that liability have been satisfied. Thus, where the trustee is exempted from income tax on trustee income derived from outside New Zealand by virtue of s.228(6) that exemption is irrelevant in determining whether the trust is a qualifying trust in relation to distributions made from the trust.

10.84 Consequently, where a settlor of a trust is resident in New Zealand at any time during an income year and no settlements have been made on the trust after 17 December 1987, or settlements were made when the settlor was resident outside New Zealand, the trust will be a non-qualifying trust in relation to distributions unless tax is paid on the trustee income. As the settlor will not be liable to income tax in respect of the trustee income by virtue of s.228(5), and the trustee will not be liable to income tax on trustee income derived from outside New Zealand by virtue of s.228(6), the trust will only be a qualifying trust in relation to distributions if an election to pay tax on trustee income is made in accordance with s.228(7) and if the obligations to pay tax on the trustee income are subsequently satisfied.

**Elections to pay tax on trustee income: s.228(7)**

Overview

10.85 Section 228(7) provides that any trustee, settlor or beneficiary of a trust may, in relation to any income year, furnish to the Commissioner within the prescribed period for furnishing an annual return of income for that income year, or within such other period as may be specified in s.226A and s.227A, an election to pay tax on trustee income for that income year or from the date of the election. If an election is made, the person making the election is assessable and liable to income tax on the trustee income and the election applies in respect of the income year in relation to which the election is made or from the date of the election, and in respect of all succeeding income years.

Application

10.86 Elections to pay tax on trustee income may be made under s.228(7) in three situations. The first is where a settlor of a trust becomes resident in New Zealand and the trust would have been a foreign trust in relation to a distribution made from the trust on the day immediately preceding the day on which the settlor became resident. In these circumstances any trustee, settlor or beneficiary of the trust may, by virtue of s.226A, elect in accordance with s.228(7) to pay tax on trustee income within 12 months of the later of 31 May 1989 or the day on which the settlor became resident (s.226A is discussed in Part 7 of this bulletin).

10.87 The second situation where an election may be made under s.228(7) is where a trust was first settled on or before 17 December 1987. In these circumstances s.227A empowers any trustee, settlor or beneficiary to elect in accordance with s.228(7) to pay tax on trustee income before 31 May 1989 (s.227A is discussed in Part 9 of this bulletin).

10.88 Finally, s.228(7) permits any trustee, settlor or beneficiary of a trust to elect to pay tax on trustee income in any other situation where the trustee, settlor or beneficiary considers it appropriate to make an election. For example, if a person who settled a trust while resident in New Zealand ceases to be resident trustee income derived from outside New Zealand ceases to be liable to income

tax from the income year in which the settlor is not at any time resident in New Zealand. The trust will therefore cease to be a qualifying trust from that income year because a portion of the trustee income ceases to be liable to income tax. To avoid that consequence the trustee, settlor or beneficiary may consider it appropriate to elect to pay tax on trustee income from the income year in which the settlor is first not resident in New Zealand at any time.

Persons who may make s.228(7) election

10.89 Section 228(7) permits any trustee, settlor or beneficiary of a trust to elect to pay tax on trustee income. Elections may be made individually by trustees, settlors or beneficiaries or they may be made jointly by any combination of trustees, settlors or beneficiaries.

10.90 An election may be made under s.228(7) whether or not the person making the election is otherwise liable to income tax on the trustee income. For example, if a settlor of a trust that is a foreign trust in relation to distributions becomes resident in New Zealand, and there is a trustee of the trust resident in New Zealand, the trustee may make a s.228(7) election although the trustee is already liable to pay tax on trustee income under s.228(2) and s.228(3). In this situation, if the trust is to be treated as a qualifying trust in relation to distributions of income and capital gains derived after the expiry of twelve months from the date on which the settlor became resident in New Zealand an election must be made in accordance with s.226A and s.228(7) to pay tax on trustee income. If the resident trustee makes the election this relieves the settlor and the beneficiary of the decision as to whether to make the election themselves. At the same time, it satisfies the requirement of s.226A that an election must be made if the trust is to be treated as a qualifying trust in relation to distributions of income and gains derived after the final date for an election.

Time for making an election

10.91 An election under s.228(7) must be made within the prescribed period for furnishing an annual return of income for the income year in relation to which the election is first made or within such other period as may be specified in s.226A and s.227A.

10.92 The period specified for making an election in accordance with s.226A is twelve months from the later of 31 May 1989 or the day on which the settlor first became resident in New Zealand. The period specified for making an election in accordance with s.227A is the period falling on and before 31 May 1989.

10.93 Where a s.228(7) election is not made for the purposes of s.226A or s.227A it must be made within the prescribed period for furnishing a return of income for the income year in relation to which the election is first made. For example, if the settlor ceases to be resident in New Zealand during the income year ending 31 March 1990, and the trustee wants to ensure that the trust remains a qualifying trust by electing to pay tax on trustee income, the trustee would be required to furnish a s.228(7) election to the Commissioner within the period for furnishing a return of income for the income year ending 31 March 1991. It would not be necessary to make an election in relation to the income year ending 31 March 1990 because the trustee income would in any event be liable to New Zealand tax by virtue of the settlor being resident for a part of that income year.

Effect of election

10.94 The effect of a s.228(7) election is that the elector is liable to income tax on the trustee income derived by the trustee and the election applies in respect of the income year for which the election was made, or from the date of the election, and in respect of all succeeding income years.

10.95 The person making the election will be liable to income tax in respect of the trustee income from the date of the election where the election is made in accordance with s.226A or s.227A. In other cases where a s.228(7) election is made the elector will be liable to tax in respect of the trustee income derived in the entire income year to which the election relates.

10.96 An election under s.228(7) applies in respect of the income year for which the election was made, or from the date of the election, and in respect of all succeeding income years. There is no provision for an election to be revoked. Once an election has been made the elector thereafter remains liable to income tax in respect of the trustee income. If the obligations to pay tax on the trustee income are not satisfied in a later income year the trust will cease to be a qualifying trust for distribution purposes.

## PART 11: TRUSTS BECOMING SUBJECT TO TAX

### Overview of s.228A

11.1 In a number of instances the trustee income derived by the trustees of a trust will become subject to New Zealand income tax some time after the trust was first established. This will occur, for example, if the trust was settled by a person who was not resident in New Zealand at the time

of settlement where an election to pay tax on trustee income is made in accordance with s.226A and s.228(7) when the settlor subsequently becomes resident in New Zealand. Similarly, it will occur if property was settled by a resident on the terms of a trust with non-resident trustees before 17 December 1987 where an election to pay tax on trustee income is made in accordance with s.227A and s.228(7). In these circumstances, it is necessary for New Zealand tax purposes to establish opening values for trading stock and depreciable assets owned by the trust, and to ensure that income or expenses which would have been accrued in relation to financial arrangements held or issued by the trust if the trustee income had been liable to New Zealand income tax are not accrued after the trustee income becomes liable to income tax. This is achieved by the rules contained in s.228A.

**Application of s.228A(1)**

11.2 Section 228A(1) applies where, in relation to any trust and any income year, the trustee income of the trust becomes liable at any date to New Zealand income tax and immediately before that date the trustee income was not liable to New Zealand income tax other than as non-resident withholding income.

11.3 Section 228A(1) also applies where the trustee income of the trust was previously liable to New Zealand income tax as non-resident withholding income and subsequently becomes liable to New Zealand income tax other than as non-resident withholding income. For example, if the trustee income of a trust settled by a non-resident included interest paid by a New Zealand resident company the interest would cease to be liable to income tax as non-resident withholding income if the settlor and trustee became resident in New Zealand and an election was made in accordance with s.226A and s.228(7) to pay tax on trustee income.

11.4 Section 228A will apply also where a portion of the trustee income was previously liable to New Zealand income tax while another portion was not, and the portion of income which was not previously liable to income tax becomes liable. In this situation, s.228A will apply only in relation to the assets and financial arrangements employed in producing the income which was not previously liable to income tax. For example, if the trustee of a trust settled by a non-resident derived business profits from within and outside New Zealand only the profits derived from New Zealand would be liable to income tax. However, if the settlor became resident in New Zealand and an election was made to pay tax on trustee income both the New Zealand and foreign business profits would be liable to income tax. In these circumstances, s.228A would apply in relation to the assets and financial arrangements used to produce the foreign source business profits.

**Premises, plant, machinery, equipment and trading stock**

11.5 Section 228A(1)(a) establishes the method for determining the "cost" of premises, plant, machinery, equipment and trading stock on the date on which the trustee income becomes liable to New Zealand income tax. In the case of premises, plant, machinery, and equipment the "cost" thus determined forms the basis for depreciation allowances which are allowable under the Income Tax Act in calculating trustee income. With respect to trading stock, the "cost" determined under s.228A establishes an opening value of the trading stock for the purpose of applying the trading stock provisions.

11.6 Two methods are prescribed for calculating the cost of the premises, plant, machinery, equipment or trading stock. The person who is liable to income tax on trustee income has an option to apply either method. The person who is liable to pay tax on the trustee income should indicate the option which is taken in the return of income furnished in relation to the trustee income.

11.7 Under the first method the person may use the historical cost of the asset, less accumulated depreciation, or other value at that date used for the purpose of income tax calculations in any country or territory in which the trustee income has been liable to income tax. That is, the person may elect to use the depreciated basis or other value of the asset which is used for the purpose of income tax calculations in another country. The relevant date will probably fall within the income year used for the purposes of calculating income tax in the other country. If so, it will be necessary to calculate the depreciated value by apportioning the depreciation allowed in the foreign country in the relevant income year to the periods before and after the relevant date. It will also be necessary to value the trading stock on the relevant date according to the methods used for income tax purposes in the foreign country, even though an actual valuation is not required for the purpose of the foreign country's tax laws on that date.

11.8 For the first method to be available the trustee income must have been liable to income tax in another country or territory and the asset must have a value (whether historical cost less depreciation or any other value) for the purposes of income tax calculations in that country or territory.

11.9 Under the second method, the person may use the value which would be used for the pur-

poses of the Income Tax Act at the relevant date if the trustee income had at all times been liable to income tax under the Income Tax Act other than only as non-resident withholding income. Thus, in the case of premises, plant, machinery and equipment the "cost" is calculated:

(i) first, by establishing the value of the asset which would have been used for New Zealand depreciation purposes when the asset was first employed in income producing activities if the income from those activities had been liable to New Zealand tax; and

(ii) second, by deducting from the original depreciation basis calculated under (i) the aggregate amount of depreciation which would have been allowed as a deduction up to the date on which the trustee income became liable to New Zealand income tax if during the period the asset was used to produce trustee income which was not liable to New Zealand income tax the asset had been used in producing trustee income which was liable to New Zealand income tax.

11.10 With respect to trading stock, the person may use any of the three valuation methods prescribed in s.85 to obtain a value on the date on which the trustee income became liable to New Zealand income tax.

11.11 For the purposes of the second method of establishing cost specified in s.228A(1) it is assumed that the trustee income of the trust had at all times been liable to New Zealand income tax. This does not mean that it is assumed that the asset was at all times located in New Zealand and that therefore special rates of depreciation available in respect of activities carried on in New Zealand are applicable. Thus, if the asset was used in carrying on a business in Hong Kong the depreciation is calculated by assuming that the trustee income derived from the Hong Kong business was always liable to New Zealand income tax and that depreciation was allowed in the amount which would have applied on the basis of the asset being located in Hong Kong.

**Financial arrangements**

11.12 Section 228A(1)(b) provides a method for calculating the acquisition price of a financial arrangement at the date on which the trustee income becomes liable to New Zealand income tax. The acquisition price thus determined is then used in calculating the base price adjustment under s.64F in relation to the financial arrangement when it matures, or when it is remitted, sold or otherwise transferred. The objective of adjusting the acquisition price is to ensure that income or expenses which would have been accrued in relation to the financial arrangement in the period before the date on which the trustee income became liable to New Zealand income tax if the trustee income had been liable to income tax are not accrued in the period succeeding the date on which the trustee income became liable to income tax.

11.13 There are two options which those who are liable to income tax in respect of the trustee income may adopt in establishing the acquisition price. The first is the market value of the financial arrangement on the date on which the trustee income became liable to New Zealand income tax. The second is the "adjusted base price". The adjusted base price of a financial arrangement on the date on which the trustee income became liable to New Zealand income tax is defined in relation to an issuer of a financial arrangement as the acquisition price of the financial arrangement plus all accrued expenditure incurred by the issuer less consideration paid by the issuer in relation to the financial arrangement before that date. The adjusted base price is defined in relation to a holder of a financial arrangement as the acquisition price of the financial arrangement plus all accrued income derived by the holder less consideration received by the holder in respect of the financial arrangement prior to the relevant date.

11.14 The acquisition price referred to in the definition of "adjusted base price" is the original acquisition price of the financial arrangement in relation to the person. The terms "accrued expenditure incurred" and the "accrued income derived" are not defined in the legislation. However, they constitute the expenditure which would have been incurred and the income which would have been derived if the trustee income had been liable to New Zealand income tax and if the accruals legislation contained in s.64B to s.64M had applied with respect to the financial arrangement from the date of its acquisition or issue.

11.15 The acquisition price calculated under s.228A(1)(b) is taken into account as item b of the formula in s.64F(2) when calculating the base price adjustment in relation to the financial arrangement.

**Exceptions to s.228A(1): s.228A(2)**

11.16 Section 228A(2) provides that s.228A(1) does not apply in two situations where the trustee income was not liable to New Zealand income tax in the period before the date on which the trustee income became liable to New Zealand income tax. The first is where there was no liability to income tax solely because the trustee derived no income in

the period preceding the date on which the trustee income became liable to New Zealand income tax. The second is where there was no liability solely because the deductions allowable under the Income Tax Act exceeded income derived by the trustee in the period before the trustee income became liable to income tax or losses carried forward pursuant to s.188 exceeded the income derived by the trustee in the period before the trustee income became liable to income tax.

11.17 In these circumstances if there had been trustee income derived by the trustees it would have been liable to New Zealand income tax. Consequently, the assets of the trust would already have values attached to them for the purpose of calculating New Zealand income tax and it would not be appropriate to apply the rules in s.228A(1).

## PART 12: RENTS, ROYALTIES AND INTEREST DERIVED BY MAORI TRUSTEE

12.1 Section 229 provides that to the extent that rent, royalty, or interest income derived by the Maori Trustee in the Maori Trustee's capacity as collecting and distribution agent for such income is not also beneficiary income, the Maori Trustee is assessable and liable for income tax on that income as if the Maori Trustee were beneficially entitled thereto.

12.2 This provision is carried over largely unchanged from the previous trust taxation regime and ties in with the taxation of Maori Authorities (which include the Maori Trustee) under s.234 to s.240. The taxation treatment of Maori Authorities is outside the scope of this bulletin and is not considered any further.

## PART 13: DISTRIBUTIONS FROM TRUSTS

**Overview of s.230**

13.1 By s.227(1) beneficiaries of trusts are required to include taxable distributions in their assessable income. The expression "taxable distribution" is defined in s.226(1). In relation to a foreign trust a distribution is a taxable distribution to the extent that it does not constitute beneficiary income or a distribution of capital profits or gains or corpus. In relation to a non-qualifying trust a distribution is a taxable distribution to the extent that it does not constitute beneficiary income or a distribution of corpus.

13.2 As distributions of corpus and capital profits or gains from foreign trusts and distributions of corpus from non-qualifying trusts are not taxable distributions opportunities could arise for avoiding or deferring tax on amounts accumulated in such trusts by distributing taxable amounts to non-resident beneficiaries or by distributing non-taxable amounts before taxable amounts. The rules contained in s.230 are intended to limit opportunities for manipulating distributions from non-qualifying and foreign trusts in this manner. This is achieved by overriding the provisions of the trust deed or the exercise of the trustee's discretion as to the characterisation of distributions from non-qualifying and foreign trusts and by providing a series of ordering rules that determine the order in which amounts are deemed to have been distributed from such trusts.

13.3 Section 230(1) contains the ordering rules which apply to distributions to beneficiaries. It provides that distributions are deemed to consist of the following amounts in the following order:

(i) income derived by the trustee in the income year in which the distribution is made;

(ii) income derived by the trustee in earlier income years;

(iii) capital profits or gains derived in the income year in which the distribution is made;

(iv) capital profits or gains derived in earlier income years;

(v) corpus.

13.4 Section 230(2) specifies the circumstances in which the ordering rules contained in s.230(1) do not apply. These are: where the trust is a qualifying trust; where the trust is a specified type of non-discretionary trust; where the distribution is a distribution by virtue of paragraphs (a) and (b) of the definition of "distribution"; and where s.226A(2) applies to the trust. Section 230(3) provides that to the extent to which the records maintained in relation to any trust do not permit the s.230 ordering rules to be applied with respect to a distribution the distribution is treated as a taxable distribution. Section 230(4) contains an anti-avoidance rule whereby income or capital profits distributed to one beneficiary are not treated as having been distributed to that beneficiary if the effect is that any part of a distribution to another beneficiary is not treated as a taxable distribution. This rule does not apply where the distribution to the beneficiary was made in a bona fide transaction which placed the amount distributed beyond the possession and control of the trustee provided that the transaction does not constitute a settlement.

**Ordering rules: s.230(1)**

Distribution to consist of current year's income

(a) Description of the rule

13.5 Section 230(1)(a) provides that a distribution made to a beneficiary during an income year is deemed to consist of the income derived by the trustee in that income year. This rule applies whether or not the income was also beneficiary income when derived by the trustee. The rule does not apply where the income was deemed pursuant to s.230 to be part of an earlier or contemporaneous distribution.

(b) Section 230(1)(a) and calculation of beneficiary income

13.6 Section 230(1)(a) deems the distribution to be made from income derived in the income year in which the distribution is made whether the income is beneficiary income when derived or otherwise. The application of s.230(1)(a) may determine whether a distribution constitutes beneficiary income. If the distribution involves the vesting or payment or application of an amount derived by the trustee, it will be beneficiary income if s.230(1)(a) deems the amount thus vested or paid or applied to be income derived by the trustee in the income year during which the distribution was made. Thus, amounts which would be beneficiary income if s.230(1)(a) were not applied may be deemed not to be beneficiary income by application of that provision.

13.7 For example, if during an income year the trustee of a non-qualifying trust derived $100 income and $100 capital profit, and the $100 capital gain was paid to the non-resident beneficiary on 1 February and the $100 income was paid to the resident beneficiary on 1 March, the $100 payment to the resident beneficiary would ordinarily be treated as beneficiary income. However, the effect of s.230(1)(a) is that the $100 payment to the non-resident beneficiary is deemed to consist of the $100 income derived by the trustee and the $100 payment to the resident beneficiary is deemed to consist of the $100 capital gain derived by the trustee (assuming that there is no income from prior years accumulated by the trustee which would be deemed to be distributed before the current year's capital gain). Therefore, the distribution to the resident beneficiary would be a taxable distribution rather than beneficiary income.

13.8 The language in parentheses in s.230(1)(a) provides that the amount taken into account in applying that provision includes amounts which are beneficiary income when derived. The reference to beneficiary income in this context means amounts which are beneficiary income in terms of the trust or in terms of the exercise of the trustee's discretion. The question of whether a distribution finally constitutes beneficiary income is determined after s.230(1) has been applied.

(c) Earlier and contemporaneous distributions

13.9 When s.230(1)(a) is applied to determine the constituent elements of a distribution, income deemed pursuant to s.230 to have constituted part of any earlier or contemporaneous distribution from the trust in that income year is deducted from the income derived by the trustee in that income year. Thus, once income is deemed to have been included in an earlier or contemporaneous distribution in that income year it is not thereafter available to characterise any other distributions. In the case of contemporaneous distributions it may be necessary for the trustee to determine how the current year income is spread among the distributions. This will not be important if the contemporaneous distributions do not exceed the total income derived by the trustee in the income year in which the distribution was made. However, where the contemporaneous distributions do exceed the current year income it will be necessary to establish how the current year income is spread among the distributions. As no method is prescribed by the statute the method of spreading the income will be a matter for the trustee to establish.

(d) Method of calculating income

13.10 Section 230(1)(a) deems the distribution to consist of "income" derived by the trustee in the income year during which the distribution is made. "Income" in this context means income calculated according to the rules contained in the Income Tax Act. It does not mean income calculated according to the rules which apply in any other country where the income derived by the trustee is liable to income tax.

Distribution to consist of prior years' income

13.11 Section 230(1)(b) provides that to the extent to which the distribution exceeds the amount specified in s.230(1)(a) it is deemed to consist of income, apart from beneficiary income, derived by the trustee in preceding income years during which the trust was in existence. Amounts which are deemed to have constituted part of any earlier or contemporaneous distribution are excluded from the pool of income available for characterising the distribution under s.230(1)(b).

13.12 Therefore, the amount available for charactensing a distribution under s.230(1)(b) is the aggregate of the income derived by the trustee in income years preceding the income year in which

the distribution is made less amounts which constituted beneficiary income with respect to those earlier income years and less any other amounts previously or contemporaneously distributed.

13.13 To the extent that the distribution does consist of income derived by the trustee in preceding income years it will be a taxable distribution as defined in s.226(1). However, to the extent that the distribution is deemed to consist of income derived by the trustee in income years commencing before 1 April 1988 the distribution will not be treated as a taxable distribution by virtue of the proviso to s.9 of the Income Tax Amendment Act (No 5) 1988 (s.9 is discussed in Part 3 of this bulletin).

Distribution to consist of current year's capital profits

13.14 Section 230(1)(c) provides that to the extent that the distribution exceeds the amounts specified in s.230(1)(a) and (b) it is deemed to consist of profits derived during the income year in which the distribution is made from the realisation of a capital asset or from any other capital profit or capital gain realised during that income year by the trustee less any capital loss suffered by the trust in that income year. Capital profits, gains and losses which are required to be taken into account under the Income Tax Act for the purpose of assessing income tax are not included in the amount to which s.230(1)(c) applies. These amounts are taken into account in calculating the amount of income available to characterise the distribution under s.230(1)(a). For example, capital profits on the sale of land to which s.67 would apply are taken into account in calculating the income to which s.230(1)(a) applies.

13.15 The profits taken into account under s.230(1)(c) are those which are derived from the "realisation" of a capital asset or from any other capital gain or profit "realised" during the income year. A capital gain or profit will be realised when it has been converted into money or money's worth. A capital gain or profit which has accrued but which has not been converted into money or money's worth will not be realised. Realised capital profits and gains are reduced by capital losses suffered during the income year in which the distribution was made. The expression "suffered" is taken to mean endured or sustained and a loss will be suffered during an income year to the extent that it is realised during that income year.

13.16 If the trustee distributes an appreciated asset to a beneficiary in specie the distribution will constitute a realisation of the capital profit or gain accrued on the asset prior to distribution. This is because the distribution discharges any claim of the beneficiary against the property of the trust. As an in specie distribution of an appreciated asset realises the profit or gain accrued in respect of the asset the realised profit or gain will be available to characterise the distribution and any other distributions from the trust.

Distribution to consist of prior years' capital profits

13.17 Section 230(1)(d) provides that to the extent to which the distribution exceeds the amounts specified in s.230(1)(a), (b), and (c) it shall be deemed to consist of profits derived in preceding income years from the realisation of a capital asset or from any other capital profit or capital gain realised during preceding income years less any capital losses suffered during such preceding income years.

13.18 Where the distribution is made by a foreign trust it will not be a taxable distribution to the extent that it is deemed to consist of capital gains derived during the income year in which the distribution is made or in preceding income years: s.226(1) "taxable distribution" definition (note in this context that capital profits or gains realised in transactions with associated persons are treated as income for the purpose of the taxable distribution definition: s.226(11)). However, if the trust is a non-qualifying trust the distribution will be a taxable distribution to the extent that it is deemed to consist of prior years' income and current and prior years' capital gains. This is subject to the proviso to s.9 of the Income Tax Amendment Act (No 5) 1988. That provision (discussed in Part 3 of this bulletin) states that distributions of income or capital profits or gains derived in income years commencing before 1 April 1988 are not assessable for income tax.

Distribution to consist of corpus

13.19 Section 230(1)(e) provides that to the extent that the distribution exceeds the amounts specified in s.230(1)(a), (b), (c), and (d) it is deemed to consist of corpus of the trust. The definition of "corpus" in s.226(1) is relevant in this context. In terms of that definition certain amounts settled on trust are excluded from corpus.

Time of application of s.230(1)

13.20 Section 230(1) is applied on an end of year basis. That is, a distribution is not characterised under s.230(1) at the time at which it is made. Rather, it is characterised at the end of the income year in which it is made by reference to the total income and capital gains derived in that income year and in previous income years. Section 230(1) is applied individually to each distribution in the order in which it was made. As s.230(1) is applied

to each distribution the amounts available under that provision to classify other distributions are reduced to reflect the fact that such amounts have already been used to characterise distributions.

**Exceptions to s.230(1): s.230(2)**

Distributions from qualifying trusts

13.21 Section 230(2)(a) provides that s.230(1) does not apply to any distribution from a trust which is a qualifying trust. Where the trust is a qualifying trust in relation to the distribution the concluding language of s.230(2) provides that the distribution is deemed to consist of such amounts as reflect the terms of the trust or the terms of the exercise of the discretion of the trustee.

13.22 Section 230(1) does not apply to distributions from qualifying trusts because a trust will only be a qualifying trust if all trustee income has been liable to income tax and the trustee's obligations in relation to that liability have been satisfied. As the income will be taxed either to the beneficiary as beneficiary income or to the trustee as trustee income it is not necessary to apply the ordering rules to limit opportunities for manipulation of distributions.

Distributions from non-discretionary trusts

13.23 Section 230(2)(b) provides that s.230(1) does not apply to distributions from three categories of trust where the trustee has no discretion as to the source, nature and amount of distributions to beneficiaries. These are: first, trusts created by will or codicil or by order of Court varying or modifying the provisions of any will or codicil; second, trusts created on any intestacy or partial intestacy; and third, trusts on which no settlement has been made since 17 December 1987. The concluding language of s.230(2) provides that distributions from these trusts are deemed to consist of such amounts as reflect the terms of the trust.

13.24 In these circumstances there is less scope for distributions to be manipulated deliberately to avoid New Zealand income tax. First, the trusts in question are non-discretionary so that the trustee has no discretion to direct distributions to beneficiaries in a manner which results in the avoidance of New Zealand tax. Second, the trusts are of a type where it is unlikely that the provisions governing distributions would have been structured with a view towards avoiding New Zealand tax. Non-discretionary trusts on which a settlement has been made after 17 December 1987 (apart from those created by will or codicil or on any intestacy or partial intestacy) are outside the scope of the exception. If this were not the case it would be possible to create non-discretionary trusts, or to use non-discretionary trusts established before 17 December 1987, to avoid the s.230(1) ordering rules.

13.25 As s.230(2)(a) provides that s.230(1) does not apply to distributions from qualifying trusts, s.230(2)(b) effectively operates to provide an exception in relation to distributions from foreign trusts and non-qualifying trusts only.

Distributions where property disposed of to beneficiary, or where services provided by trustee, at less than market value

13.26 Section 230(2)(c) provides that s.230(1) does not apply to any distribution which would not be deemed to be a distribution but for the application of paragraphs (a) and (b) of the definition of "distribution" in s.226(1). Paragraph (a) of that definition provides that where property of the trust is disposed of or made available to a beneficiary for less than market value there is a distribution to the extent that the property was disposed of or made available to the beneficiary at below market value. Paragraph (b) of the definition of "distribution" provides that where the trustee has provided services to a beneficiary for less than market value there is a distribution to the extent that the services were provided to the beneficiary for less than market value.

13.27 In the case of distributions to which s.230(2)(c) applies there may be no amounts derived by the trustee which correspond to the distribution made to the beneficiary. For example, although it is appropriate to provide that there is a distribution where property is made available to a beneficiary at below market value there may be no income or capital gains derived by the trustee which corresponds to the making available of that property by the trustee. Accordingly, it would not be appropriate to apply the ordering rules because the distribution is not actually out of income, gains or corpus.

13.28 The concluding language of s.230(2) provides that where a distribution is specified in s.230(2)(c) the ordering rules in s.230(1) do not apply in relation to the distribution. In these circumstances it is provided that the distribution is a taxable distribution. This rule only applies if the distribution is not of a type specified in any of the other paragraphs of s.230(2). For example, if a distribution of the type described in paragraph (a) or (b) of the "distribution" definition is made from a qualifying trust the s.230(1) ordering rules do not apply with respect to the distribution by virtue of s.230(2)(a). Thus, the operation of the ordering rules is excluded by s.230(2)(a) rather than by s.230(2)(c). Accordingly, the concluding language to s.230(2) does not make the distribution a taxable

distribution. This is because a distribution is a taxable distribution by virtue of the concluding language only if the s.230(1) ordering rules do not apply to the distribution pursuant to s.230(2)(c). The concluding language does not operate to make a distribution a taxable distribution where the ordering rules do not apply to a distribution by virtue of one of the other paragraphs of s.230(2).

Distribution from trust to which s.226A applies

13.29 Section 230(2)(d) provides that s.230(1) does not apply to a distribution from a trust to which s.226A(2) applies except where the trust is deemed to be a non-qualifying trust pursuant to s.226A(2)(b). Section 226A(2) applies where a settlor of a foreign trust becomes resident in New Zealand and an election is made in accordance with s.228(7) to pay tax on trustee income. In these circumstances s.226A(2) provides that for the purpose of the definition of the term "taxable distribution" the trust is deemed to be a foreign trust to the extent that any distribution from the trust consists of income, capital profits or capital gains derived before the date on which the election was made, and a qualifying trust to the extent that any distribution consists of income, capital profits or capital gains derived by the trustee after the date on which the election was made. Where in respect of the income year in which the election was made, or in any subsequent income year, the trustee's obligations are not satisfied the trust is deemed to be a non-qualifying trust in relation to any distributions made in that income year.

13.30 Thus, where the settlor of a foreign trust becomes resident in New Zealand and an election is made to pay tax on trustee income the ordering rules contained in s.230(1) do not apply in determining whether any distribution from the trust consists of income, capital profits or capital gains derived before or after the date on which the election was made. In these circumstances the concluding language of s.230(2) provides that the distribution is deemed to consist of such amounts as reflect the terms of the trust or the terms of the exercise of the discretion of the trustee.

**Inadequate records: s.230(3)**

13.31 Section 230(3) provides that a distribution from a trust is a taxable distribution to the extent that the records maintained in respect of the trust do not permit s.230(1) to be applied accurately to determine the constituent elements of the distribution.

13.32 Section 230(3) applies subject to s.230(2). Thus, it does not apply where the s.230(1) ordering rules do not apply pursuant to s.230(2). Section 230(3) applies to the extent to which the records maintained in relation to any trust do not permit s.230(1) to be applied accurately to determine the constituent elements of a distribution. If, for example, the trust records were sufficient to indicate accurately that a portion of the distribution was income derived by the trustee during the income year in which the distribution was made s.230(1) will be applied to classify that portion of the distribution as beneficiary income. However, if the records did not permit s.230(1) to be applied in relation to the remainder of the distribution that remaining portion of the distribution would be a taxable distribution.

**Distributions to other beneficiaries: s.230(4)**

Overview

13.33 Section 230(4) provides that in determining the constituent elements of a distribution made to a beneficiary no amount of income, capital profits or gains derived by the trustee is treated as having been distributed to any other beneficiary of the trust if the effect is that any part or all of the distribution would be treated as not being a taxable distribution. This rule does not apply where the amount distributed to the other beneficiary was distributed in a bona fide transaction which placed the whole of the amount beyond the possession and control of the trustee in the trustee's capacity as trustee of that trust, so long as that transaction did not itself constitute a settlement.

13.34 The object of this provision is to limit opportunities for distributing non-taxable amounts to beneficiaries who are assessable for tax on taxable distributions by distributing taxable amounts to beneficiaries who are not taxable in relation to such amounts. This could occur, for example, where in the case of a foreign trust income was distributed to non-resident beneficiaries and capital gains were distributed to resident beneficiaries. The s.230(1) ordering rules would not prevent the streaming of income and capital gains in this manner if the distribution to the non-resident was made before the distribution to the resident. In this situation s.230(4) will treat the income as not having been distributed to the non-resident beneficiary and such income will therefore be available for the purpose of determining the constituent elements of the distribution made to the resident beneficiary. Section 230(4) will not apply if, as will usually be the case, the distribution was made in a bona fide transaction which placed the whole of the amount beyond the possession and control of the trustee in the trustee's capacity as trustee of that trust. However, this exception does not apply if the transaction constituted a settlement.

Application and effect

13.35 Section 230(4) applies in relation to a distribution to a beneficiary where a distribution to any other beneficiary has the effect that all or part of the distribution to the beneficiary is not a taxable distribution. The important consideration is the effect of the distribution to the other beneficiary. The purpose of the trustee in making the distribution to the other beneficiary is not relevant. In some circumstances a distribution to a beneficiary may not be a taxable distribution because taxable amounts have been distributed to another beneficiary but at the same time it may not be appropriate to apply s.230(4) because the distribution to the other beneficiary was a taxable distribution in relation to which the other beneficiary was liable to income tax. Section 230(4) does not be apply in these circumstances.

13.36 Section 230(4) applies where the effect of a distribution being made to one beneficiary is that "any part or all" of a distribution to another beneficiary is not treated as a taxable distribution. Where s.230(4) applies the effect is that "no amount of income or capital profits or gains derived by the trustee of the trust shall be treated as having been distributed to any other beneficiary of that trust".

13.37 This does not mean that the entire amount distributed to the other beneficiary is treated as not having been distributed. Rather, it means that the amount is treated as not being distributed if the effect of the distribution of that amount is that all or part of the distribution in question is not a taxable distribution. For example, if the distribution of $100 by a trustee of a non-qualifying trust of to a non-resident beneficiary leaves only corpus in the trust, and a distribution of $80 is subsequently made to a resident beneficiary, $80 of the distribution made to the non-resident beneficiary (not $100) is treated as not having been made to the non-resident beneficiary for the purpose of applying s.230(1) with respect to the distribution to the resident beneficiary. If a further distribution of $50 is later made to the resident beneficiary, the additional $20 which was earlier distributed to the non-resident beneficiary (i.e., the $100 distributed less the $80 added back to the trust accounts in relation to the first distribution to the resident beneficiary) is then treated as not having been distributed for the purpose of applying s.230(1) in relation to the $50 distribution.

13.38 Section 230(4) does not apply if the distribution to the other beneficiary was made in a bona fide transaction which placed the whole of the amount distributed beyond the possession and control of the trustee in the trustee's capacity as trustee of that trust unless the transaction was itself a settlement. A transaction is bona fide if it is real and genuine to all intents and purposes: *CIR* v *Simpson* (1989) 11 NZTC 6,140. Thus, if amounts are distributed to a beneficiary in a transaction which is not real or genuine the amount thus distributed may be treated as not having been distributed for the purpose of s.230(4).

13.39 The transaction must place the income beyond the possession and control of the trustee in the trustee's capacity as trustee of that trust. Thus, transactions of the type considered in *CIR* v *Ward* [1970] NZLR 1, where income was merely appropriated to the beneficiary in the accounts of the trust, would not satisfy the exception to s.230(4) because the income would not be placed beyond the possession and control of the trustee. Similarly, where amounts are vested in a beneficiary but not paid out the exception to s.230(4) will not be satisfied.

13.40 Even if the transaction is bona fide and places the amount beyond the possession and control of the trustee in the trustee's capacity as trustee of the trust, the amount will still be subject to s.230(4) if the transaction in question constitutes a settlement. For example, if the trustee of a foreign trust settled all of the income derived by the trustee on a sub-trust for the benefit of a non-resident beneficiary, and then made a distribution to a resident beneficiary on the basis that only capital gains and corpus remained to be distributed, the amount settled on the sub-trust would be treated as still being available for the purpose of applying s.230(1) to the distribution made to the resident beneficiary.

Example

Example 13

Facts: The trustee of a non-qualifying trust vests $1,500 absolutely in interest in a non-resident beneficiary, A, on 1 October 1990. The trustee retains possession of the amount thus vested. On 1 November 1990 the trustee makes a distribution of $1,500 to a resident beneficiary, B. With respect to the income year ending 31 March 1991 the income, capital profits and corpus available for distribution are as follows:

| Year Ending | Income | CapitalProfit | Corpus |
|---|---|---|---|
| 31 March 1989 | 500 | | 5,000 |
| 31 March 1990 | 500 | 1,000 | |
| 31 March 1991 | 100 | | |
| Totals | 1,100 | 1,000 | 5,000 |

Result:

(i) The vesting of $1,500 in A constitutes a distribution as defined in s.226(1).

Ignoring s.230(4), the distribution of $1,500 to A would be deemed by s.230(1) to consist of the $1,100 income derived by the trustee in the income years ending 31 March 1989, 1990, and 1991 and $400 of the capital profits derived in the income year ending 31 March 1990. The amount thus distributed would no longer be available for the purpose of applying s.230(1) to the distribution to B. Therefore, the distribution to B would be deemed to consist of the remaining $600 of the capital profit derived in the income year ending 31 March 1990 and $900 of the corpus settled in the income year ending 31 March 1989.

(ii) The effect of the distribution to A is therefore that a part of the distribution to B - i.e., the $900 which would be treated as a distribution of corpus if not for the application of s.230(4) - would not be treated as being a taxable distribution. Further, the $1,500 was not distributed to A in a transaction which placed that amount beyond the possession and control of the trustee of the trust because the amount was only vested in A but was not paid out to A. Therefore, s.230(4) applies for the purpose of determining the constituent elements of the distribution to B.

(iii) Section 230(4) is applied by treating $900 of the $1,100 income distributed to A as not having been distributed for the purpose of applying s.230(1) in relation to the distribution to B. Consequently, the distribution to B will be deemed to consist of $900 income derived by the trustee and $600 capital profits derived by the trustee. The entire distribution will thus be a taxable distribution.

(iv) The income which pursuant to s.230(4) is deemed not to have been distributed will not include the $100 income derived by the trustee during the income year ending 31 March 1991 because the effect of that amount being distributed to A is not that a portion of the distribution to B is not a taxable distribution but rather that a portion does not constitute beneficiary income. Section 230(4) does not apply in this situation. However, if a further distribution is made to B in a later income year the $100 will then be treated as not having been distributed to A if the effect of that distribution to A is that all or part of that later distribution does not constitute a taxable distribution.

# PART 14: DISCLOSURE

### Overview of s.231

14.1 Section 231 requires a person who makes a settlement on a trust to disclose the settlement to the Commissioner in three circumstances:

(i) First, where a settlement was made on a non-qualifying trust on or before 31 May 1989 and the trust is still in existence on 31 May 1989: s.231(1);

(ii) Second, where a settlement was made on or after 17 December 1987 and at the time of settlement or at any time thereafter there is no resident trustee of the trust: s.231(2);

(iii) Third, where the settlement was made by a nominee, or by a nominal settlor, who is deemed not to be a settlor of the trust under s.226(3): s.231(3).

14.2 By s.231(4), the Commissioner is permitted to make default assessments in cases where a person has failed to disclose information required under s.231 or under s.17 of the Inland Revenue Department Act 1974, or if the person is unable to obtain sufficient information to calculate trustee income. Section 231(5) requires trustees to furnish returns of trust income. Sections 231(6) and (7) provide that the s.231 disclosure obligations do not apply in relation to superannuation funds and superannuation schemes approved under regulations 29 or 30 of the Superannuation Schemes Regulations 1983.

### Non-qualifying trusts in existence at 31 May 1989: s.231(1)

14.3 Section 231(1) required any person who had made a settlement on the terms of a trust on or before 31 May 1989 to make a disclosure to the Commissioner on or before 31 May 1989 if the trust was still in existence on that date and if the trust would have been a non-qualifying trust in relation to any distribution which was made on 31 May 1989.

14.4 Section 230(1) applied where the trust was a non-qualifying trust as defined in s.226(1) or where the trust would have been a non-qualifying trust if not for the application of s.227A. For s.231 to apply the trust must have been in existence on 31st May 1989. Therefore, the settlor of a non-qualifying trust which had been wound up before this date would not have been required to fulfil the disclosure requirements although the provisions of the trust regime in all other respects would still apply in relation to the trust.

14.5 The disclosure obligation arose where the person made a settlement on the terms of a trust on or before 31 May 1989. By s.226(6), "settlement" means any action or failure to act on the part of a person which has the effect of making the person a settlor. The definition of "settlor" is discussed in Part 6 of this bulletin.

14.6 By way of example, where a person resident in New Zealand settled property producing income from outside New Zealand on a trust with Hong Kong trustees on 1 June 1986, the trust would have been a non-qualifying trust if a distribution had been made on 31 May 1989 because all trustee income derived from the date on which the trust was first settled until 31 May 1989 would not have been liable to New Zealand income tax. If the trust was in existence on 31 May 1989 the settlor would have been required to make a disclosure in accordance with s.231(1).

14.7 Where s.231(1) applied the settlor was required to disclose to the Commissioner in the prescribed form the existence of the trust, the name and address of the trustee and the beneficiary of the trust, and such further details as may be required by the Commissioner.

**Settlement by resident after 17 December 1987: s.231(2)**

14.8 Section 231(2) provides that a disclosure is required by any person who makes a settlement on a trust on or after 17 December 1987 if either at the time of settlement no trustee of the trust was resident in New Zealand or if at any time after the settlement there ceased to be a trustee resident in New Zealand. If there is no resident trustee at the time of settlement the person making the settlement is required to make a disclosure by the later of 31 May 1989 or three months from the date of settlement. If there is a resident trustee at the time of settlement, but at any time after the settlement there ceases to be a resident trustee, the person who made the settlement is required to make a disclosure by the later of 31 May 1989 or three months from the date on which there ceased to be a resident trustee.

14.9 If s.231(2) applies the person who made the settlement is required to disclose to the Commissioner in the prescribed form the fact of the settlement, the name and address of the trustee and beneficiary of the trust and any further details required by the Commissioner.

**Settlements by nominee or nominal settlors: s.231(3)**

14.10 Section 231(3) applies where a person makes a settlement on a trust as a nominee for another person or where a person settles a nominal amount on trust at the request of another person. In these circumstances s.226(3) provides that the person for whom the nominee or nominal settlor acted is deemed to be the settlor rather than the nominee or nominal settlor. However, although the nominee or nominal settlor is not treated as a settlor of the trust such nominee or nominal settlor is still required to make a disclosure under s.231(3) if at the time of settlement no trustee of the trust was resident in New Zealand.

14.11 If s.231(3) applies disclosure is required by the later of 31 May 1989 or three months from the date on which the nominee or nominal settlor made the settlement. If at the time of settlement by the nominee or nominal settlor a trustee of the trust was resident in New Zealand s.231(3) does not apply and the nominee or nominal settlor is not required to make a settlement. However, if at any time after the settlement there ceases to be a resident trustee the person who is deemed to be the settlor of the trust under s.226(3) will have an obligation to disclose the settlement pursuant to s.231(2).

14.12 The nominee or nominal settlor is required to disclose the fact of the settlement, the name and address of the person who is deemed to be the settlor of the trust pursuant to s.226(3) and any further details required by the Commissioner.

**Default assessments: s.231(4)**

14.13 Section 231(4) empowers the Commissioner to make default assessments in three situations:

(i) where a person has failed to disclose in accordance with s.231 the existence of a trust or any of the further details required by the Commissioner;

(ii) where a person has failed to disclose any information requested by the Commissioner pursuant to s.17 of the Inland Revenue Department Act 1974;

(iii) where a person is unable to obtain sufficient information to calculate the trustee income of the trust.

14.14 In any of these circumstances the Commissioner is empowered to determine the amount of trustee income for the income year in relation to which the failure to disclose occurs or in relation to which the information cannot be obtained. The Commissioner is required to determine the amount of trustee income in such manner as the Commissioner considers fair and reasonable.

**Returns: s.231(5)**

14.15 As under the previous trust regime, the trustee of a trust is required to furnish separate annual returns of income for each trust in respect of which the trustee has derived income as trustee. Thus, a trustee is required to keep returns of trust income separate from returns of income derived by the trustee in respect of any other trust or income derived by the trustee in any capacity other than as trustee.

14.16 Section 231(5) requires a disclosure of the "whole income" derived by the trustee. The expression "whole income" means that the trustee is required to furnish a return of all income the trustee derives, whether that income is beneficiary income or trustee income.

**Superannuation regime: ss.231(6) and (7)**

14.17 Section 231(6) provides that ss.231(1) to (4) do not apply in relation to a trust which is a superannuation fund, or to any person in respect of a superannuation fund. This ensures that persons making contributions to superannuation funds are not required to disclose contributions pursuant to s.231.

14.18 Section 231(7) provides that ss.231(1) to (4) do not apply to any superannuation scheme constituted outside New Zealand and classified by the Government Actuary under regulation 29 or 30 of the Superannuation Schemes Regulations.

14.19 Sections 231(6) and (7) do not preclude the application of s.231(5). Thus, the obligation to furnish returns of income imposed by s.231(5) applies with respect to superannuation funds and with respect to superannuation schemes described in s.231(7).

**Offences and penalties**

14.20 Several offences in relation to the disclosure obligations imposed under s.231 are created by s.416(1)(ba), s.416(1)(bb) and s.416A:

(i) Section 416(1)(ba) provides that a person commits an offence if that person knowingly fails, or knowingly permits the failure, to disclose any information which that person is required to disclose under s.231. Prior to the enactment of the Income Tax Amendment Act 1989, s.416(1)(ba) applied only to any corporate body which was required to make a disclosure under s.231. Section 416(1)(ba) was amended by s.76 of the Income Tax Amendment Act 1989 with effect from 22 March 1989. The paragraph now applies to any person who is obliged to make a disclosure under s.231.

(ii) Section 416(1)(bb)(ii) provides that any person who knowingly makes false disclosure or knowingly gives any false information to the Commissioner in respect of the disclosure obligation imposed under s.231 commits an offence.

(iii) Section 416A(3)(a) and (b) apply where an officer or employee of a corporate body is required, by virtue of that office or employment, to make a disclosure under s.231. In these circumstances the officer or employee commits an offence if he or she knowingly fails or permits the failure to disclose information which the corporate body is required to disclose under s.231, or knowingly makes a false disclosure or gives any false information to the Commissioner in relation to the disclosure obligation imposed on the corporate body under s.231.

(iv) Section 416B(2)(b) provides that for the purpose of s.416(1)(ba), s.416(1)(bb) and s.416A(3) the term "person" includes any person who aids, abets, or incites any other person to commit the offences specified in those provisions. This effectively means that s.416(1)(ba), s.416(1)(bb) and s.416A(3) create offences of aiding, abetting or inciting the offences specified in those provisions.

14.22 The penalties for the offences created by s.416(1)(ba), s.416(1)(bb) and s.416A(3) are prescribed by s.416B(2A). The penalty for which a person committing an offence against any of those provisions is liable is the same in each case: imprisonment for a term not exceeding 2 years or a fine not exceeding $50,000, or both. A person aiding or abetting such an offence is liable to the same penalty by virtue of s.416B(2B).

## PART 15: TRUSTEES OF ESTATES

**Income received by trustee after death of deceased person: s.232**

15.1 Section 232 provides that any amount received in any income year by the trustee of the estate of a deceased person is deemed to be assessable income derived by the trustee during that income year if it does not represent assessable income derived by the deceased during that person's lifetime but if it would have been included in that person's assessable income if the person had been alive when it was received.

15.2 This provision is carried over from the previous trust taxation regime and deals with the

rule under general law that income earned by a deceased person before his or her death is capital in the hands of the beneficiary of that person's estate. In the absence of s.232, the effect of this rule under general law is that there is no tax liability on income earned by a deceased person prior to his or her death if the income had not been derived for income tax purposes. The deceased person would not have been liable to tax because the income was not derived by that person before his or her death, and the income would be treated as capital in the hands of the trustee and the beneficiary of the deceased's estate. This situation would arise where the deceased person returned income on a receipts basis and services were performed by the person before his or her death for which payment was not received until after the person's death. Employees, barristers and doctors fall into this category. It would also arise where the deceased person was an accruals method taxpayer under general tax accounting principles if the income had been earned but at the time of death the income earning process was not at the stage where the deceased was required to account for the income.

15.3 Section 232 applies only where the amount received by the trustee does not represent assessable income derived by the deceased person during that person's lifetime. If the amount received had been assessable income derived by the deceased, the deceased, or his or her representatives, would have been liable to income tax in respect of the income and it is not appropriate to deem the trustee of the deceased's estate to derive the income. Section 232 also applies only if the amount received by the trustee would have been included in the deceased's assessable income if he or she had been alive when it was received. That is, the amount must be one which would have had the character of assessable income in the hands of the deceased if it had been received by the deceased during his or her lifetime.

15.4 The effect of s.232 is that the amount received by the trustee is deemed to be assessable income derived by the trustee. As the amount is deemed to be assessable income, rather than trustee income, it will be treated as income which can be vested absolutely in interest in the beneficiary or which can be paid or applied to or for the benefit of the beneficiary thus constituting beneficiary income. If there is no vesting or payment or application the income will be trustee income.

**Deduction of irrecoverable book debts: s.233**

15.5 Section 233 applies where a debt owing to a person at the date of his or her death has been included in the assessable income of the person or of the trustee of the person's estate for any income year, and the debt or any part of it is proved to the satisfaction of the Commissioner to be irrecoverable and to have actually been written off by the trustee as a bad debt. In these circumstances the amount thus written off is deemed to be a loss incurred by the trustee in the income year in which the amount was written off and is allowed as a deduction:

(i) first, against any income derived by the trustee as trustee income during that income year;

(ii) 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;

(iii) 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.

15.6 Section 232 applies only to amounts written off as bad debts where the amount written off was earlier included in the deceased person's assessable income or in the assessable income of the trustee of the deceased's estate. It does not apply to losses arising from the fact that deductible expenses and allowances exceed income derived by the deceased or by the trustee of the deceased's estate.

15.7 The amount written off is deductible first against trustee income with any excess being deductible against beneficiary income derived by a beneficiary who has a vested interest in the capital of the estate. To apply s.233 it is necessary first to calculate the trustee income and the beneficiary income derived by the trustee and beneficiaries of the deceased's estate in the income year in question, ignoring the loss incurred by the bad debt write off. The loss incurred on writing off the bad debt is then deducted against any trustee income with any excess being deducted against beneficiary income derived by beneficiaries with a vested interest in the capital of the trust. The amount written off is not deductible against beneficiary income derived by beneficiaries who have an interest in the income of the trust only.