

BASIC SUMMARY OF THE TAXATION OF INCOME DERIVED BY A TRUSTEE

1. The following is a summary of the main scheme underlying the taxation of trustee and beneficiary income, trust distributions, and the tax obligation of settlors. It should serve as an introduction for those who are not familiar with the regime. It is not exhaustive, and does not, for example, cover the treatment of tax credits relating to income derived by a trustee, the use of tax losses to reduce a taxable distribution, or elections to become a complying trust.

[All references are to the Income Tax Act 2007]

Distinction Between Trustee Income And Beneficiary Income

2. The distinction between trustee income and beneficiary income is central to the tax treatment afforded income derived by a trustee. Income that is derived by a trustee is beneficiary income to the extent to which:

- It vests absolutely in interest in a beneficiary of the trust in the income year; or
- It is paid to a beneficiary of the trust in the income year, or within the extended time available, as explained in the next section.

[Section HC 6(1)]

3. A beneficiary is treated as having derived the income in the same tax year as the income year in which the trustee derived the income.

[Section HC 6(3)]

4. Beneficiary income is part of the gross income derived by a trustee. A beneficiary is not allowed any deductions from beneficiary income. Instead, a trustee is allowed tax deductions treating the beneficiary income as if it was trustee income.

[Section DV 9]

5. To the extent to which it is not beneficiary income, income derived by a trustee is trustee income. When calculating the tax liability of a trustee, all tax deductions relating to both trustee income and beneficiary income can be taken into account.

[Sections HC 7(1) & DV 9(2)]

6. There are certain types of trustee income that cannot be beneficiary income: income derived by a trustee from the forgiveness of debts, and distributions of trustee income to a minor beneficiary that remain trustee income.

[Sections HC 6(2)(b) & HC 7(2)]

7. Beneficiaries are taxed on beneficiary income at their relevant marginal tax rates. A trustee is taxed on trustee income on the tax rate that applies to a trustee (currently 33%).

[Sections HC 17(1) & HC 24(1) & Schedule 1, Clause 3]

8. A taxable distribution from a non-complying trust derived by a trustee is taxed at a special penalty rate. A taxable distribution from a non-complying trust is *excluded income* of the trustee. If distributed as beneficiary income, it is also *excluded income* of the beneficiary. The trustee or beneficiary is taxed under a separate provision that imposes income tax on a taxable distribution from a non-complying trust at the special tax rate that applies (currently 45%).

[Sections CX 59, HC 19, BF 1(b) & HC 34 & Schedule 1, Clause 4]

9. Expenditure incurred in deriving a taxable distribution from a non-complying trust is tax-deductible to the trustee, but it cannot be deducted from the taxable distribution itself.

[Sections DA 1 & DV 9(2)]

10. A trustee is responsible, as agent, for satisfying the income tax liability of a beneficiary on beneficiary income and taxable distributions. However, if the Commissioner agrees, a beneficiary and a trustee may decide that the beneficiary is to file their own tax returns and satisfy their own income tax liability.

[Sections HC 32, HD 12(1) & HD 4(b)]

Date By Which Beneficiary Income Must Be Allocated

11. From the 2009/2010 income year onwards, the date by which beneficiary income must be allocated, by a trustee to a beneficiary, is the later of the following:

- The date that falls within six months of the end of the income year; or
- The earlier of:
 - The date on which the trustee files the return of income for the year; or
 - The date by which the trustee must file a return of income for the income year.

[Section HC 6(1B)]

Distributions From Trusts

12. Apart from receiving beneficiary income, a beneficiary is treated as having derived a distribution from a trust every time there is a transfer of value from the trust to the beneficiary. A distribution could be classified as any of the following:

- A distribution from a complying trust. A distribution (other than beneficiary income) from a complying trust is *exempt income* of the beneficiary and is exempt from tax.
- A taxable distribution from a foreign trust. A taxable distribution from a foreign trust is taxable income of a beneficiary. A distribution from a

foreign trust will be a taxable distribution from a foreign trust to the extent it is not one of the following:

- A distribution of beneficiary income.
 - A distribution of part of the corpus of the trust.
 - A distribution of a capital gain derived by the trustee.
- *A taxable distribution from a non-complying trust.* A taxable distribution from a non-complying trust is taxed separately as noted in paragraph 8. A distribution from a non-complying trust will be a taxable distribution from a non-complying trust to the extent it is not one of the following:
- A distribution of beneficiary income,
 - A distribution of part of the corpus of the trust.

[Sections HC 15, HC 18, HC 19 & HC 20]

13. Ordering rules apply to determine the source of a distribution from a foreign or a non-complying trust. A distribution is treated as being sourced from the amount available to be distributed from the following, in the following order:

- Income derived by the trustee in the current year.
- Trustee income from prior years not previously distributed.
- Capital gains derived by the trustee in the current year.
- Capital gains derived by the trustee in prior years not previously distributed.
- Corpus.

[Section HC 16]

14. The ordering rules do not apply to distributions made by disposing of property to a beneficiary at less than market value, or by providing services to a beneficiary at less than market value. Such distributions from a foreign or a non-complying trust will always be *taxable distributions*.

[Section HC 15(6)]

15. For the purpose of classifying distributions, trusts are divided into the following three categories:

- A complying trust: a trust for which the tax obligations have been satisfied for every tax year for the life of the trust. The trustee is not allowed to derive non-resident passive income, non-resident foreign-sourced income or foreign-sourced amounts that are exempt from income tax under section CW 54.
- A foreign trust: a distribution is treated as made by a foreign trust, if no settlor is resident in New Zealand from the later of 17 December 1987

and the date of the first settlement on the trust to the date of the distribution.

- A non-complying trust: a trust that is neither a complying trust nor a foreign trust is treated as a non-complying trust.

[Sections HC 9, HC 10, HC 11 & HC 12]

16. It can be seen that in order for a complying trust to remain a complying trust, the trustee must not derive non-resident passive income, non-resident foreign-sourced income, or foreign-sourced amounts that are exempt from income tax under section CW 54.

17. Non-resident passive income and non-resident foreign-sourced income are income categories that are derived when a trustee is a non-resident. A trustee that is taxed as a New Zealand resident cannot derive such income. However, a New Zealand resident trustee could derive a foreign-sourced amount that is exempt income. A foreign-sourced amount would be exempt income of a New Zealand resident trustee in an income year if:

- no settlor of the trust is at any time in the income year a New Zealand resident [*transitional residents* are treated as non-residents]; and
- the trust is not a testamentary trust or an inter vivos trust of which a settlor died resident in New Zealand.

[Sections HC 26 & CW 54]

18. Therefore, if a complying trust makes foreign investments, it will be important to ensure that there is a settlor resident in New Zealand, in order to maintain complying trust status.

19. Remember, a trustee is responsible, as agent, for satisfying the income tax liability of a beneficiary on taxable distributions, unless the Commissioner agrees otherwise. (See paragraph 10).

A Settlor's Tax Liability

20. The trust taxation regime is sometimes (erroneously) referred to as the "settlor tax regime". This is because the settlor is liable, as agent of the trustee, for a trustee's income tax liability for an income year, if:

- the settlor is resident in New Zealand in the income year; and
- there is no trustee resident in NZ for the full income year, or for the part of the year following the settlement if the first settlement is made during the year.

[Section HC 29(1) & (2)]

21. There are two exclusions to this rule:

- A settlor of a “charitable trust” (as defined) is not liable. (See the section below on Charitable Trusts).
- A settlor is not liable for income derived by a trustee that has arisen from the settlor having remitted an amount payable to the settlor under a financial arrangement.

[Section HC 29(4)]

22. A “settlor” of a trust, is very widely defined, as a person who:

(a) Transfers value:

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

(b) provides financial assistance, to the trust or, for the benefit of the trust, with an obligation to pay on demand, and the right to demand is not exercised or is deferred;

(c) has a control interest of 10% or more in a controlled foreign company (CFC) that settles an amount on a trust;

(d) has a control interest of 10% or more in a company that settles an amount on the trust, if, treating the company as a CFC at the date of settlement, the person would be treated as having a control interest of 10% or more in the company;

(e) is a settlor of another trust (the Head-trust) that makes a settlement on the trust;

(f) acquires rights or powers in relation to a trustee or a settlor of a trust and the acquisition has the purpose or effect of enabling the person to require the trustee to treat the person, or a nominee, as a beneficiary of the trust;

(g) acts in a way that has the effect of defeating the intent and application of the trust rules.

[Sections HC 27(2) & HC 28]

23. The following persons are excluded from being a settlor:

- An employer who makes a settlement on a trust (that is not a superannuation scheme or a superannuation fund) established mainly to provide retirement benefits to natural persons.
- An employer who makes a payment to a trustee of an employee share purchase agreement, if the trustee uses the payment to acquire shares

under the agreement, and the payment would be income of an employee under section CE 1(d).

[Section HC 27(3) & (3B)]

Value Of Transferred Property

24. A transfer of the following types of property is treated as a disposal by the transferor and an acquisition by the transferee, at the market value of the item for the transferor, on the date of the transaction:

(a) A transfer of property by way of a distribution by a trustee of a trust to a beneficiary of the trust.

(b) A transfer of property by way of a distribution by an executive or, administrator, or trustee of a deceased person's estate, to a beneficiary who is beneficially entitled to receive the property under the will or the rules governing intestacy.

(c) A transfer of property by way of a settlement by the trustee of a trust on the trustee of another trust, if authorised under–

(i) a trust instrument as a power of advancement or resettlement;

(ii) section 41 of the Trustee Act 1956 as the payment of money or the application of property.

(d) A transfer of property by way of a gift.

[Sections FC 1(1) & FC 2]