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| To | Public Consultation, Inland Revenue - |
| Date | 27 June 2017 |
| Matter number | 0911 |
| Subject | PUB00261: Income Tax – taxation of trusts |

Dear Inland Revenue

We set out below our comments on various aspects of the draft Interpretation Statement PUB00261 (Exposure Draft).

## 1.0 Liability of trustee for income tax (Paragraph 3.3-3.4)

**Submission**

**We consider the Exposure Draft could be clearer as to a trustee's liability for income tax where there is a change of trustee/retirement of trustee. Paragraphs 3.3 and 3.4 should be reviewed and the statutory position confirmed and Inland Revenue's "in practice" position clarified.**

**Comments**

The Exposure Draft refers (at paragraph 3.3) to a trustees' liability for income tax ceasing after a trustee retires or resigns, but that the Commissioner will continue to hold a trustee liable until being advised in writing of a retirement or resignation.

In relation to GST, section 57(3B) of the GST Act 1985 specifically provides that a trustee is liable until Inland Revenue (IR) receive written notice of retirement. However, no such treatment is specified in the Income Tax Act 2007 (the Act) or the Tax Administration Act 1994 (the TAA) for the trustee's liability to income tax. It seems to us that the Act follows the common law approach that a trustee is liable for the trust's income tax whilst a trustee until the date of retirement or resignation.

The Exposure Draft (at paragraph 3.4) then states a trustee is liable for the trust's income tax whilst in that role and refers to *Case 5/2013* as authority that in practice a trustee who retires as trustee will be liable for income tax for the tax period prior to resignation. The Exposure Draft states this is because this period is when the relevant trustee has control over the tax position taken.

A consequence of following the "in practice" approach is that a retiring trustee who retires in September of 2016 will not be held liable as a trustee for the trust's income tax for the period from 1 April 2016 to September 2016.

We agree that the Exposure Draft correctly reflects what the Court in *Case 5/2013* decided, however we question its practicality, and without having undertaken extensive research, note there is caselaw to the contrary:

T +64 9 302 8441 W www.turnerlegal.co.nz E info@turnerlegal.co.nz

Turner Legal Limited
Suite B, 7 Windsor Street, Parnell PO Box 137215, Parnell, Auckland 1151 New Zealand

In **S and S Limited v XYZ Limited** (2016) 4 NZTR the Court stated at 87:

> I note the position of W Trustees Ltd on the question of New Zealand taxes. This is the defective title aspect I did not deal with earlier. The taxes the caveators have put in issue result in personal liability to the taxpayers and may be enforced by proceedings for recovery of unsecured debts. It is not clear how W Trustees Ltd could make a defective title claim in respect of taxes not paid by earlier trustees. **A trustee is liable for taxes incurred during its trusteeship. W cannot be liable for taxes incurred by earlier trustees (our emphasis)**. If an earlier trustee is required to pay taxes after its trusteeship has ended, it may have recourse to trust assets under its indemnity. But the fact that as a later trustee W Trustees Ltd may have to allow an earlier trustee to have recourse to trust assets to pay unpaid taxes does not give it a defective title claim or any grounds to sue the earlier trustee. But as S Ltd did not arguably incur any relevant tax liability which remains unpaid, it is not necessary to go further into this aspect

This recent High Court decision makes it clear the liability for taxes relates to the period of trusteeship.

In our submission, the income tax liability of a trustee subsists to the date of resignation/retirement and is not dependent on the trustee giving notice to IR, and the trustee does not have protection from the most recent income tax return filing date until the date of resignation. The retiring trustee will, and usually does, rely on their statutory indemnity and any written indemnity from the continuing and new trustees in respect of the correct filing of the trust's tax return and income tax liability for the period covering their entire trusteeship.

We suggest further consideration be given to the commentary at paragraphs 3.3 to 3.4.

## 2.0 A Protector as a Settlor (Paragraph 2.87)

### Submission

**Further consideration should be given to the situations where a Protector will be treated as a settlor, and/or a carve out where the Protector has true Protector "negative consent" powers only.**

### Comments

The Exposure Draft (at paragraph 2.87) states that a Protector could be treated as a settlor if he or she is appointed to ensure the trustees' decisions are made in accordance with a settlor's wishes.

In practice, a Protector is often appointed with the role restricted to providing consent to major transactions, but who otherwise is not actively involved in managing or controlling the trust. The Protector's role in these cases is to protect the trust fund (particularly in a foreign jurisdiction) from any potential defalcation by the foreign trustees.

We consider the comments in paragraph 2.87 as to a Protector should not be expressed in such wide terms, as it may lead to some confusion as to whether a Protector in the traditional sense could give rise to a settlor status.

## 3.0 Transitional residents and Distributions (8.31/10.0/10.37)

### Submission

**If non resident trustees of a NZ foreign trust make a distribution (other than of beneficiary income) to a transitional resident beneficiary, the ordering rules apply. In determining what is income, accumulated income and capital gains, paragraphs 10.32 to 10.37 set out some useful principles, however paragraph 10.37 is vague and does not**

**address what is income for the purposes of determining the taxable component of a taxable distribution.**

**We consider a NZ trust established by a transitional resident whilst in NZ after becoming a transitional resident will not be a foreign trust but a complying trust. This could be clarified in Part 10.**

**Comments**

The Exposure Draft covers (at paragraphs 10.32 to 10.37) transitional residents receiving distributions from foreign trusts.

It states that if a transitional resident receives a taxable distribution from a foreign trust, it does not retain its underlying character. Paragraph 10.37 is quite confusing as it appears to provide a circular analysis: could this be clarified?

We interpreted the Act as follows: due to the definition of income (refer section BD 1(1)), if an amount is income for NZ purposes, it will be classified as income under the ordering rules, and if accumulated, it will be subject to NZ income tax as a taxable distribution if distributed to a transitional resident. This is so notwithstanding that the NZ rules would not normally have treated the amount as income when derived by the trustees, being non residents foreign sourced income.

An example is where a foreign trust derives investment income, which would be FIF income applying NZ tax rules: if a taxable distribution to a NZ resident beneficiary includes an amount of FIF income being accumulated income by applying NZ's FIF rules, whilst the income is not assessable income, it is income for the purposes of BD 1, which means it is income under sections HC 15 and 16.

It seems illogical to tax the NZ resident beneficiary because the income has not had a NZ source at the time it was derived, given that it was foreign sourced. Is this correct and could the Exposure Draft provide an example of how to calculate what constitutes income and accumulated income in a taxable distribution from a foreign trust?

It does not appear the IS covers what happens if a transitional resident establishes a trust whilst they are a transitional resident in NZ. We consider such a trust would be a complying trust as a transitional resident is a resident, notwithstanding he or she is not taxable on certain foreign sourced income under CW 22. We think it would be useful if Paragraph 8.31 could be clarified to cover this aspect.

## 4.0 Estates and associated persons (9.25/12.13)

**Submission**

**The Exposure Draft expresses the view that a deceased is not an associated person of his or her estate. We do not think the position is entirely clear, and consider the alternative analyses should be properly addressed.**

**The Exposure Draft suggests a deceased may be associated with his or her testamentary will trust. No analysis is provided for this and it should be addressed.**

**Comments**

The Exposure Draft provides (at paragraph 12.13) that a deceased and his or her estate will not be associated persons. This can have particularly important implications for property transactions and the length of ownership of a property for tax purposes pursuant to section CB 15 of the Act.

The Exposure Draft states that an executor is regarded as a trustee for tax administration purposes only. Another stated reason is that Part FC of the Act deems a transfer of the deceased's assets to the executor to take place at market value, therefore there is no transfer for less than market value and no settlement.

There are some technical aspects in the Exposure Draft that in our view require further consideration, as detailed below.

- The definition of trustee in the Act expressly provides that an executor/administrator of a deceased estate is a trustee. It does not restrict its meaning, or state it is for administration purposes only.
- Amongst an executor's duties is the duty to collect in the deceased's assets and there is no trustee/beneficiary relationship until the administration is complete and the value of the residuary estate known. It is at that point that the executor's role changes to that of trustee. This may be the strongest point in favour of the estate not being a trust for general income tax purposes. However, it is noted by many commentators that although beneficiaries have no interest, the executor/administrator is regarded as a trustee according to the rules of equity. The executor is subject to the trusts of the will or according to the trusts set out in the Administration Act. That is, to preserve the assets, deal with the property and apply them for the benefit of the creditors, legatees and residuary beneficiaries. As was explained by John Bassett in his article in the NZ Tax Planning Reports (1988) No 4 August 1998:
    - The nature of the interest held by a beneficiary in an unadministered estate is that of a chose in action comprising the right to have the trust administered in accordance with the duties owed by the personal representative to preserve the assets and deal with them in the proper manner. Once the estate is fully administered a beneficiary will have an equitable interest in any property devised or bequeathed to him or her under the will.

  One might therefore take the position that an executor/administrator effectively does operate as a trustee and a trust has been created by will or intestacy.
- When one considers whether the three certainties necessary to establish a trust are present, one might consider there is no certainty of intention to create a trust; however, a large number of wills specifically create a "trust for sale" in order that the executor can effectively administer an estate by selling any assets and dealing with the estate. There will likely exist the certainty of objects, but it may be that there is no certainty of trust property since the trust assets are not properly known until the date of final administration of the estate.

  Assuming there is sufficient to argue a trust has been created by the will or on intestacy at common law, but whether this is sufficient to be a trust for income tax purposes is unclear. There is no general definition of trust in the Act, however for certain rules (superannuation being one) reference is made to the definition in the Trustee Act. Presumably it is logical to adopt the Trustee Act definition of a trust and this will be the new definition in the new Trusts Act to be enacted and it appears it would satisfy that definition?
- The devolution of assets from a deceased involves a two step process whereby the assets of the deceased are transferred by transmission to the executor and then once the value of the residuary assets confirmed the estate are either distributed to the beneficiaries or held by trustees for the benefit of the beneficiaries under the terms of the will trust. This is recognised in Part FC of the Act where there are two stages in

terms of the transfer of assets. However, there are exceptions under Part C of the Act whereby assets pass to a spouse or close relative and they pass at tax book value, so technically there is a transfer at below market value in that scenario, and technically a settlement. Therefore, there can be a settlement created under Part FC. There is a statement at paragraph 2.39 (in defining settlor) of the Exposure Draft where it provides that transfers of value could be made by will or on intestacy. Does this indicate a contradiction?

- In terms of section CB 15 it has been argued that as the provision refers to assets being transferred, it cannot apply where assets are transmitted. However, this argument potentially loses some merit when one considers Part FC of the Act which refers to a "transfer" from a deceased to an executor, which represents more of a substance over form approach.

The Exposure Draft provides (at paragraph 3.5) that a deceased is not a settlor of their estate unless their will creates a trust on their death. There is no further analysis on this issue. We consider this needs clarification because some testamentary trusts could be established by virtue of a legacy contingent on attaining a certain age, or are established following the administration of the estate and therefore being one step removed from the deceased. If a deceased is a settlor of their estate, being a trust, and the estate distributes to a will trust, will there be an associated person transfer such that the deceased is then a deemed settlor of the will trust?

## 5.0 Can a trust be both a complying trust and a foreign trust?

### Submission

**Many tax practitioners take the view the legislation permits a trust to be both a complying trust and foreign trust. There is no comment in the Exposure Draft on this situation, and which classification takes precedence, and since it is a not uncommon scenario, an indication of IR's position would be welcome**

Technically it is thought that this is possible under the definitions of complying, non-complying and foreign trust which do not preclude such an outcome.

We encounter this issue where there is a non-resident settlor at all times, resident trustees and NZ sourced income, and no foreign sourced income. For example, an expat Kiwi establishes a NZ trust to acquire an investment property in NZ.

If the trustees accumulate the income and pay tax at the trustees' income tax rate of 33%, distributions of accumulated trustee income could be exempt as being distributions from a complying trust, but if also classified as a foreign trust the distribution would be subject to the ordering rules and it could be a taxable distribution from a foreign trust.

Many practitioners believe the trustees can choose to adopt the complying trust status in this situation.

We consider it likely that the requirements of foreign trust disclosure rules would have to be complied with in the case of a foreign but complying trust, and that this has been the case with the previous and new disclosure rules. However, there may be an anomaly here that a trust is a foreign trust for disclosure purposes but a complying trust in respect of distributions.

We note the Exposure Draft refers to a change in definition of a foreign trust in February 2017 from the time of a distribution to 'at any time'. Could IR clarify whether this is intended to, or does, affect the issue? In any case we consider clarification of the issue should be addressed.

## 6.0 General Comments

We commend IR for undertaking the updating of the previous Explanation on the Taxation of Trusts, no easy task and which should assist both the taxpayer and IR in this technically difficult area.

We appreciate the opportunity to comment on the Exposure Draft, and would be happy to discuss any aspects if it would be of assistance.

Yours faithfully

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**Keith Turner**

*Principal*

*T*: 09 302 8441
*M*: 021 580 240
*E*: keith@turnerlegal.co.nz
*W*: www.turnerlegal.co.nz