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Public Consultation
Inland Revenue
Wellington

By email: public.consultation@ird.govt.nz

PUB00345: Income tax – Distributions from foreign trusts

Introduction

1. The New Zealand Law Society (Law Society) welcomes the opportunity to comment on the draft Interpretation Statement: *Income tax – Distributions from foreign trusts* ('exposure draft'). Subject to the issues noted below, the Law Society considers the exposure draft reads well and the examples provided are appropriate and useful to the reader.

Comments

Identifying the existence of a trust

2. Paragraphs 96 to 103 of the exposure draft set out when an arrangement amounts to a trust for income tax purposes. Paragraphs 99 to 103 could be replaced by a reference to section 13 of the Trusts Act 2019, which sets out the characteristics of an express trust. Section 13 of the Trusts Act 2019 provides that an express trust is a fiduciary relationship in which a trustee holds or deals with trust property for the benefit of beneficiaries or for a permitted purpose, and the trustee is accountable for the way in which the trustee carries out the duties imposed on the trustee by law.
3. Paragraph 121 of the exposure draft notes that not all arrangements treated as valid trusts in a foreign jurisdiction will be treated as trusts for New Zealand income tax purposes. By way of example, the exposure draft states that an arrangement may not be a trust for New Zealand tax purposes because of the degree of control retained by the settlor. The Law Society is concerned that the exposure draft may be overstating when New Zealand courts will decline to recognise the existence of a trust on the grounds that the settlor retains control over the trust assets.
4. For example, the exposure draft refers to *Mezhdunarodniy Promyshlenniy Bank v Pugachev* [2017] EWHC 2,426 (Ch), which does not consider whether a trust established overseas is a valid trust for New Zealand purposes, but whether a trust established in New Zealand was a valid trust for United Kingdom purposes. The decision in the *Pugachev* case has been criticised by a number of New Zealand trust law commentators and, while an appeal was lodged, the dispute was settled before the appeal was heard.
5. The exposure draft also refers to *Clayton v Clayton* [2016] NZSC 29. It is not clear why reference is made to this case, given that the decision proceeded on the basis that the trust was a valid trust, despite the level of control able to be exercised by Mr Clayton over the trust property.

Definition of “foreign trust”

6. Paragraph 127 of the exposure draft attempts to describe what is a foreign trust for New Zealand income tax purposes. Paragraph 127 states that a trust will meet the definition of a foreign trust “[i]f no property in the trust has ever been transferred to the trustee by a New Zealand resident”. That statement is not correct, as a trust will not be a foreign trust if it is settled by a non-resident who subsequently becomes New Zealand tax resident. It would be clearer if paragraph 127 referred to the actual wording of section HC 11 of the Income Tax Act 2007, which defines when a trust will be a foreign trust, rather than paraphrasing that definition.

Deceased person as settlor of a testamentary trust

7. Paragraph 157 of the exposure draft states that a testamentary trust arising from a non-resident deceased’s estate will be a foreign trust. This appears to be on the basis that the deceased will be treated as the settlor of the testamentary trust. Example 4 of the exposure draft is also based on this assumption (see below).
8. While the Law Society agrees with this analysis, it is contrary to the position the Commissioner has taken in paragraph 12.13 of Interpretation Statement IS 18/01, “Taxation of trusts – Income tax”. Paragraph 12.13 of IS 18/01 states that a transfer of a deceased person’s assets to their executor is treated as a transfer for market value under sections FC 1 and FC 2 of the Income Tax Act 2007, which means that a deceased person is not a “settlor” of their estate as there has not been a transfer for less than market value. The analysis in paragraph 12.13 of IS 18/01 is flawed and gives rise to a number of unintended consequences.
9. The Law Society recommends that the exposure draft records that the Commissioner has reconsidered the statement made in the last two sentences of paragraph 12.13 of IS 18/01 and no longer considers that analysis is correct.

Confirmation of tax treatment of dual status trusts

10. Paragraph 85 of the exposure draft sets out when a trust will be a foreign trust. It would be helpful if paragraph 85 also noted that a foreign trust can also be a complying trust, that such a trust is termed a “dual status trust” (with a reference to paragraph 8.47 of IS 18/01), and that distributions from a dual status trust are treated as distributions from a complying trust (with a reference to paragraphs 8.48 to 8.50 of IS 18/01).
11. Paragraph 109 of the exposure draft states there is no fourth category of “trust” that is not a complying, non-complying or foreign trust. While that is correct, it would be helpful if paragraph 109 acknowledged that a trust can be both a complying trust and a foreign trust, and that such a trust is termed a “dual status trust” (with a reference to paragraphs 8.14 and 8.47 of IS 18/01).

Application of the ordering rules

12. Paragraph 133 of the exposure draft notes there are exceptions to the ordering rules. It would be helpful if paragraph 133 also noted that the ordering rules do not apply to foreign trusts that are also complying trusts (i.e. dual status trusts) and included a cross reference to paragraph 8.145 of IS 18/01.
13. Paragraph 134 of the exposure draft notes that a beneficiary will need access to the trust’s detailed financial records to apply the ordering rules. It would be helpful if paragraph 134 also confirmed that the trust’s financial statements would need to be recast in accordance with New Zealand income tax principles to identify the amount of accumulated income, capital gains and corpus for each year.

14. Paragraphs 88 and 135 of the exposure draft note that if the records of a foreign trust do not allow for an accurate determination of the elements of a distribution, then the entire distribution will be treated as a taxable distribution. Reference should be made to paragraph 8.157 of IS 18/01, where the Commissioner notes that if there are accurate records relating to corpus, but not to income or capital gains, then it will still be possible to distribute trust corpus tax-free when the trust is wound up (i.e. the distribution will not be treated as a taxable distribution to the extent that the amount does not exceed trust corpus).

Examples

15. Example 1 (paragraphs 45 to 48 of the exposure draft) concerns a US revocable trust. The Law Society agrees that the “living trust” referred to in Example 1 is not a trust for New Zealand income tax purposes, as there does not appear to be a separation of the legal and beneficial interest in the property (so there is no trust) and the “trustee” does not appear to owe any fiduciary obligations to the “beneficiary” (reference could be made to the requirements for there to be an express trust in sections 13 and 14 of the Trusts Act 2019). However, the Law Society is concerned that Example 1 may lead to an inference that a US revocable trust is not treated as a trust for New Zealand purposes because it can be revoked. If such a trust arrangement meets the requirements of sections 13 and 14 of the Trusts Act 2019, then it should be treated as a trust until such time as it is revoked.
16. Example 2 (paragraphs 49 to 53 of the exposure draft) concerns a contract made under Swiss law. Paragraph 51 states that “... at first sight there would be a trust under New Zealand general law, despite the arrangement being likely to be considered a contract under Swiss law”. The Law Society notes that the existence of fiduciary obligations is essential to the existence of an express trust (section 13 of the Trusts Act 2019), and it is not clear on the face of Example 2 that Roger owes fiduciary obligations to Ursula. If the contractual arrangement does not give rise to a fiduciary relationship, then there will be no trust for New Zealand purposes.
17. Example 4 (paragraphs 58 to 61 of the exposure draft) concerns a distribution from a non-resident’s testamentary trust. Paragraph 61 states “The trust will be a foreign trust because Joe has never lived in New Zealand and he is the only person who has ever settled anything on the trust”. Example 4 is predicated on the basis that the deceased person (Joe) is the settlor of the testamentary trust. While the Law Society agrees with this analysis, it is contrary to the position the Commissioner has taken in paragraph 12.13 of IS 18/01 (see paragraph 8 above). The Law Society does not consider that the analysis in paragraph 12.13 of IS 18/01 is correct and the exposure draft should acknowledge this.
18. Example 5 (paragraphs 62 to 65 of the exposure draft) concerns distributions from a non-complying trust settled by a New Zealand tax resident beneficiary of a foreign estate. It would be helpful if Example 5 noted that the New Zealand tax resident settlor (Joseph) has also breached his obligation to disclose, within three months of the date of the settlement, the particulars of the trust to the Commissioner (section 59(1) of the Tax Administration Act 1994). Example 5 should also note that if Joseph satisfied the trustee’s obligation to file income tax returns and pay New Zealand income tax on the trust’s worldwide income since its inception, then the trust would become a complying trust with retrospective effect (with a reference to paragraph 8.33 of IS 18/01). If Joseph does this, then the taxable distribution made while the trust was a non-complying trust will be unwound (see the Commissioner’s statement on “Qualifying Trust Status” in Tax Information Bulletin Volume 16, No 1, February 2004, at page 85).

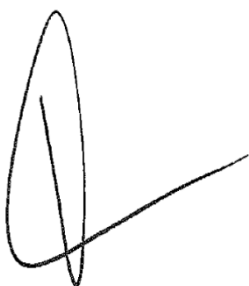
Minor error

19. Paragraph 7 of the exposure draft refers to section HC 15(6) of the Income Tax Act 2007. That statutory reference should be to section HC 15(4).

Further assistance

20. We trust Inland Revenue will find these comments helpful in finalising the exposure draft. If you would like to discuss the comments, please contact the Tax Law Committee convenor Neil Russ, through the Law Society's Law Reform Adviser, Emily Sutton (Emily.Sutton@lawsociety.org.nz).

Yours faithfully

A handwritten signature in black ink, consisting of a large, stylized loop followed by a horizontal stroke extending to the right.

Andrew Logan
Vice President