



NEW ZEALAND
LAW SOCIETY

NZLS EST 1869

TAXATION (KIWISAVER, STUDENT LOANS, AND REMEDIAL MATTERS) BILL

4/09/2019

Submission on the Taxation (Kiwisaver, Student Loans, and Remedial Matters) Bill

Introduction

1. The New Zealand Law Society (Law Society) welcomes the opportunity to comment on the Taxation (Kiwisaver, Student Loans, and Remedial Matters) Bill (Bill).
2. This submission is confined to comments on the proposed amendments arising from the administrative review of the taxation of trusts, which are summarised on pages 68 to 78 in the Minister of Revenue's Commentary to the Bill (Commentary). The headings in this submission correspond to the relevant headings of the Commentary.
3. The Law Society does not seek to be heard but is happy to discuss this submission with the Finance and Expenditure select committee or officials if that would be of assistance.
4. All statutory references in this submission are to the Income Tax Act 2007 (Income Tax Act) or the Tax Administration Act 1994 (TAA).

Taxation of Trusts

Clause 88: Corpus of a trust

5. Clause 88 of the Bill is intended to clarify that settlements which cannot be distributed cannot be included in the corpus of the trust.
6. We are concerned that the wording of proposed section HC 4(1) of the Income Tax Act may create uncertainty as to whether certain amounts are included in the corpus of the trust. For example, if a person lends money to a trust and subsequently forgives the loan, then in substance the person has settled funds on the trust which are capable of being distributed (being the amount lent), and the amount of the loan forgiven should be corpus of the trust. However, the settlement arises on the forgiveness of the loan. This raises the question whether the amount forgiven would be corpus of the trust under proposed section HC 4(1) as drafted, as the forgiveness of the loan (as opposed to the amount lent) is not capable of being distributed.
7. The Law Society would appreciate confirmation that debt forgiveness would give rise to corpus under proposed section HC 1(4) in this situation. We note that there are likely to be other examples where uncertainty in applying proposed section HC 1(4) may arise.

Clause 91(2): Taxable distribution not subject to the ordering rule

8. Clause 91(2) of the Bill proposes to amend section HC 15(6) of the Income Tax Act by deleting the words "disposing of property at less than market value". Under the proposed amendment, section HC 16(5) of the Income Tax Act would not apply to the disposal of property at less than market value. As such, those transactions would not be treated as a distribution of trustee income which is outside the scope of the ordering rules.
9. The Commentary states that the purpose of the proposed amendment in clause 91(2) is to remove redundant wording relating to the tax consequences of "distribution, transmission and gifts of property", on the basis that these rules treat distributions of property from a trust as being made at market value, so the omitted words are no longer necessary. Although it is not explicitly stated, it is clear that "these rules" are the rules in subpart FC of the Income Tax Act.

10. The basis for the proposed amendment appears to be that disposing of property at less than market value is not a transfer of value, as the disposal is treated as being made for market value consideration under subpart FC of the Income Tax Act. The Law Society submits that the purpose of subpart FC of the Income Tax Act is to determine a value for property which is disposed of where one of the circumstances set out in section FC 1(1) of the Income Tax Act applies. This ensures that any gain or loss on the disposal of the property is taken into account for income tax purposes by comparing the market value of the property on the date of disposal against the book value of the property for income tax purposes. This was the purpose of subpart FC of the Income Tax Act when it was first enacted (as subpart FI of the Income Tax Act 2004), and this is also the purpose as indicated by the opening wording of section FC 1(1) of the Income Tax Act. The Law Society submits that subpart FC is not intended to deem transactions of the type listed in section FC 1(1) of the Income Tax Act to take place at market value for the purpose of applying all other provisions of the Income Tax Act.
11. The Law Society is concerned that the interpretation advanced in the Commentary may result in unexpected and inappropriate outcomes in applying the trust rules. For example, the transfer of an asset from a trust to a beneficiary would not be treated as a distribution because, under the interpretation advanced, there is no transfer of value on a distribution as the distribution is treated as a sale and purchase at market value under section FC 2 of the Income Tax Act. If this were correct, tax on distributions could be avoided by trustees converting cash to property (such as bitcoin) and then distributing the property to beneficiaries. In addition, a person who gifts property to a trust would not be a settlor of the trust and the settlement of property on a trust by way of gift would not be a settlement for tax purposes. This would mean that gifted property would not be included in the corpus of the trust, and so a distribution by a foreign trust or a non-complying trust of property settled on the trust by way of gift would be a taxable distribution.
12. The Law Society submits that further consideration should be given to the current interpretation of the scope and application of subpart FC of the Income Tax Act, and the wider ramifications of the interpretation underlying the proposed amendment to clause 91(2) on the application of other aspects of the trust rules.

Clause 93: Foreign sourced income, resident trustees

13. Clause 93(2) of the Bill proposes to amend section HC 26(1)(a) of the Income Tax Act. The Commentary states that this amendment is intended to clarify the scope of the exemption for a trust that does not have a New Zealand resident settlor at any time during the income year.
14. The Law Society submits that if this proposed amendment is intended to address the situation where no settlor of the trust (natural person or otherwise) exists in an income year, then the relevant issue is whether any settlor of the trust died or ceased to exist when it was a New Zealand resident. This issue can be addressed by amending section HC 25(2)(c) of the Income Tax Act so it includes non-natural person settlors. The proposed reference to the last surviving settlor is unnecessary and increases the complexity of section HC 26.
15. The Law Society also recommends that section HC 25(2)(c) of the Income Tax Act be reviewed in light of the amendment proposed by clause 87 of the Bill, as a trust which has a New Zealand resident trustee will (as a single notional person) be outside the scope of section HC 25 of the Income Tax Act.

Clause 96: Valuation for transfer of values by deferral or non-exercise of right to demand payment

16. Clause 96 of the Bill proposes to introduce a formula to calculate the value of a settlement or distribution arising from a transfer of value on the provision of financial assistance, including a guarantee.
17. The Law Society submits that further work is required so that the formula works in a guarantee situation and that officials should provide detailed examples to illustrate the application of this provision where financial assistance is provided in the form of a guarantee.

Clause 97: Elections to pay New Zealand tax on worldwide trustee income

Notification requirements

18. Clause 97(2) of the Bill proposes an amendment to provide that a non-active trust must notify the Commissioner of Inland Revenue on an annual basis that the election to pay New Zealand tax on worldwide trustee income is to continue.
19. The Law Society submits that imposing an annual notification obligation on non-active trusts is unnecessary and imposes a compliance burden which diminishes the advantage that non-active status affords such trusts.
20. A trust must be a complying trust to be a non-active trust (section 43B(1)(a)(ii) of the TAA). As such, the Law Society considers that it would make more sense for a non-active trust to be deemed to have made an election to pay New Zealand tax on trustee income.

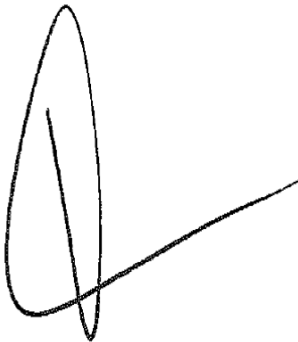
Taxation of distributions from a trust that has elected to become a complying trust

21. Clause 97(8) of the Bill proposes to insert new section HC 33(5), which sets out the treatment of distributions made by trusts which have elected to pay New Zealand tax on their worldwide income.
22. The Commentary states (on page 77) that “The amendment also proposes that, when all income and capital gains from the trust during the period it was a non-complying trust have been fully distributed, only then would distributions be treated as being made from a complying trust”. The Law Society submits that the amendments do not provide for that outcome, and it would not be appropriate if they did.
23. Under the proposed amendments, a trust may be a non-complying trust, a foreign trust and a complying trust at different times over the life of a trust, and may be a complying trust intermittently over the life of the trust. The treatment of a distribution should be determined viewing the trust as a single composite fund. The composition of a distribution by a trust should be determined by applying the ordering rules. Once the character of a distribution is determined under the ordering rules, the time at which amounts distributed arose can be identified, and the distribution will be taxed on the basis of the classification of the trust (as a foreign, non-complying or complying trust) at that time. If it is established that the trust was a complying trust at the time the amounts being distributed were derived, then the amount is treated as a distribution from a complying trust. The Law Society notes that the effect of this approach is that the ordering rules are applied to a complying trust, notwithstanding that the ordering rule in section HC 16 of the Income Tax Act applies only to foreign trusts and non-complying trusts, and it was never contemplated that it would operate in this way.
24. The Law Society submits that careful consideration should be given to whether it is appropriate that the ordering rules are applied in this way, and also whether doing so gives rise to the appropriate

outcome in all circumstances. In particular, the Law Society submits that a detailed analysis of various fact scenarios should be carried out to ensure that the proposed amendments result in an appropriate outcome for a trust which “flips” in and out of being a complying trust under the proposed amendments, and for a trust which has suffered losses in some periods over its lifetime.

Drafting Points

25. The Law Society has identified the following drafting points for consideration.
26. The drafting of clause 89, which proposes to amend section HC of the Income Tax Act, could be improved. The Law Society notes that section HC 7 of the Income Tax Act already excludes an amount of income derived by a trustee of a trust from trustee income if it is beneficiary income, and the drafting of proposed section HC 7(3) could reflect that.
27. The Law Society submits that there are other clauses in the Bill which could be drafted more clearly and simply if the term “trustee income” were used (for example in clause 93(1)), and recommends that the drafting of the amendments to subpart HC of the Income Tax Act be reviewed with this in mind.
28. The Law Society submits that clause 93(4) is unnecessary, as it is clear in section HC 35(2) that such income is only trustee income for certain specified purposes.
29. The Law Society submits that clause 94 should be amended so that proposed section HC 27(4)(b) clearly specifies which persons must be associated.
30. The Law Society further submits that clause 94 should be amended so proposed section HC 27(4)(c) clearly sets out which subsection of section HC 27 the reference “to paragraphs (a) or (b)” relates.

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Andrew Logan
Vice President
4 September 2019