The Offshore Tax Planning Review

THE NEW ZEALAND TRUST AS A VEHICLE FOR FOREIGN INVESTMENT

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1 Introduction

1.1 Sections HH 1 to HH 8 of the New Zealand Income Tax Act 1976 contain a special regime for the taxation of trusts. Broadly speaking, income that is distributed by the trustee is taxed in the hands of the beneficiary, and income that is accumulated is taxed to the trustee. The regime contains a number of provisions that are designed to prevent people using trusts to avoid tax on New Zealand source income or to relieve New Zealand resident beneficiaries from tax that they might otherwise have to pay.

1.2 On the other hand, the regime is carefully crafted so that the mere fact of trustees' being resident in New Zealand does not attract tax. This policy takes into account that trustees as trustees are mere custodians of income, not beneficial recipients of income. As explained in more detail later in this article, the policy enables non-residents to appoint New Zealand trustees to hold income-producing assets without incurring New Zealand tax liability. At the same time, the trust tax policy proceeds from the point of view that trustees are in a sense agents or surrogates for the settlor of their trust: if the settlor had not settled the trust the settlor would retain the trust property and be taxed on its income (or not, as the case may be) according to the residence of the settlor and the source of the income.

1.3 The policy in effect takes a substantive, economics-based approach to trusts, rather than an approach that gives effect to trusts' legal form. The policy recognises that trustees of the modern trust ordinarily act according to the advice of the settlor, or according to policies that the settlor may have set down in founding the trust. That is, in a sense, trustees look after funds that the settlor would otherwise have taken care of. Although trustees' legal duty is strictly to their beneficiaries rather than to their settlor, trustees are in an economic sense a surrogate for the settlor, and perform functions that the settlor might otherwise

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have performed, even if they do not strictly speaking perform those functions on the settlor's behalf.

1.4 A consequence of this policy is that New Zealand residents who settle trusts may remain liable for tax on the income that is derived by the trustees. In recognition of the formal legal structure of the trusts, trustees are primarily liable for tax on trustee income. Moreover, having control of the funds of their trust, they are in the best position to pay tax that may be attracted to trust income. But if trustees are non-resident this liability cannot be enforced. Consequently, a New Zealand resident settlor can be liable to pay tax as agent of non-resident trustees of a trust that the settlor has established. These points are expanded later in this article.

1.5 Strictly speaking, the Income Tax Act does not recognise the trust as a taxable entity. Rather, trustees, beneficiaries, and settlors (that is, people or companies, not trusts) are taxed or not, according to the relevant rules. Conceptually, the Act treats trust income as one income (as contrasted with company income, where profits derived by a company are, conceptually, a different income stream from dividends derived by shareholders). Thus, for example, income that vests in a beneficiary is treated as being derived by both the trustee and the beneficiary, and may be taxed in the hands of either party. However, the income is taxed once only, and (in respect of income that vests in a beneficiary) at the rate and according to the computations appropriate to the beneficiary.

2 Three Categories of Income

2.1 The Act divides income of and distributions from trusts into three categories. Trustee income is income that trustees accumulate as they derive it. Beneficiaries' income is income that vests in a beneficiary in the year in which it is derived by the trust, or that the trustees apply for the benefit of a beneficiary during that year or within six months of the end of the year. Distributions are (broadly speaking) distributions of income that trustees accumulated in earlier years. Such distributions are sometimes assessable to New Zealand tax if the accumulations from which they are made were not taxed in the hands of the trustee.

2.2 Trustees have primary liability for tax on trustee income. Trustees are also liable to tax on beneficiary income as agents of their beneficiaries. Trustees are similarly liable to tax on distributions, where the distributions are assessable in the hands of beneficiaries.

2.3 There are special rules about distributions from the corpus of trusts and distributions of capital profits derived by trustees. These rules are not discussed in this article.

3 Source

3.1 Income with a New Zealand source that is derived by trustees or beneficiaries presents no conceptual problems. It is assessable to tax by virtue of its source, as it is derived, either as trustee income or as beneficiary income. It makes no difference whether the trustee or beneficiary in question is a New Zealand resident. The principal complexities of the trust taxation regime are in respect of foreign source income.

4 A Domestic Trust

4.1 Where a trust's beneficiaries and settlor are New Zealand residents and always have been, foreign-source income is assessable as either trustee income or beneficiary income, as appropriate. Foreign-source income derived by a non-resident beneficiary is not assessable, even if the trust in question was settled by a New Zealand resident settlor. Where trustees are resident abroad, the settlor is liable for tax on trustee income as well as the trustees.

4.2 Formally, the Income Tax Act treats the settlor as agent of the trustees; so, for example, at least by New Zealand law, the settlor can recover from the trustees tax that he may have to pay on behalf of the trust. In substance, and following the policy of the trust regime, the settlor could be considered in a sense to be the principal taxpayer, by virtue of his having established the trust. That is, the rule gives effect in a backwards manner to the underlying assumption of the regime that has been mentioned: that trustees look after income-producing assets that might otherwise have belonged to the settlor.

4.3 Distributions to beneficiaries of income that has been accumulated by trustees, and taxed as trustee income, are free of tax in the hands of a beneficiary. The reason is that the income has been taxed once already, in the hands of the trustee. This treatment is consistent with the principle of treating income derived by trustees and/or beneficiaries as one income, not two. A trust that qualifies in this manner to distribute accumulated income to beneficiaries free of further tax is termed a 'qualifying trust'. Most standard, domestic trusts are 'qualifying trusts'.

5 Income Accumulated by Trustees

5.1 The assessability of income derived by New Zealand-resident trustees, and not paid out to beneficiaries, depends first on the source of the income. As mentioned, where income has a New Zealand source, it is assessable in New Zealand by virtue of that source, not by virtue of the residence of the trustee. If the income is sourced abroad, its assessability depends on the residence of the settlor, not on the residence of the trustee.

5.2 If any settlor of the trust is resident in New Zealand at any time during the income year, then the income is assessable to the trustee. The same applies if the settlor is dead, but died resident in New Zealand. 'Settlor' is widely defined, and catches most, and probably all, people who in substance make settlements on trusts, whether directly or indirectly.

5.3 If the settlor is not resident in New Zealand (or did not die resident in New Zealand) and the income does not have a New Zealand source, it is not assessable in New Zealand. Section HH 4(3) of the Income Tax Act specifically provides that 'a trustee is not otherwise [that is, otherwise than just explained] assessable to income tax on trustee income derived from outside New Zealand'.

5.4 An important consequence of the rule that has just been described is that non-residents can settle property on New Zealand trustees without triggering a New Zealand tax liability, so long as the income that is produced by the property has its source outside New Zealand. (If the settlor later becomes resident in New Zealand, then the income that is subsequently derived by the trustees becomes assessable.) Some non-residents use this rule to employ New Zealand trustees to look after their family's property and to accumulate income from the property. From the point of view of, say, a United Kingdom resident, one benefit is a shelter from capital gains tax.

6 Settlor's Liability

6.1 Settlors are liable to tax on income derived by trustees in certain circumstances. The rules reflect a compromise between, on the one hand, the principle that, for tax purposes, trustees are to be treated as quasi agents for the settlor, and on the other hand, a recognition of the formal existence and structure of trusts.

6.2 First, settlors are not subject to tax on beneficiaries' income. This rule reflects the fact that, if income has been derived by a beneficiary, the trustee cannot be said to act in any quasi-agency capacity for the settlor in respect of that income: the income has gone from the trust to the beneficiary.

6.3 In respect of trustee income, the liability of settlors depends on several factors. First, a settlor is liable to tax on trustee income only if (but not always when) the trustee is liable. That depends in turn on the residence of the settlor. Trustees are liable to tax on income derived in years when the settlor has been resident in New Zealand.

6.4 If a trustee himself or herself is also resident in New Zealand in such a year the New Zealand government has no need to make the settlor liable, and the Act does not do so: tax can be collected from the trustee directly. If the trustee is not resident in New Zealand, the settlor is in principle liable for tax on trustee income as agent of the trustee. This rule applies to settlors who have always been resident in New Zealand, and to immigrants who settle trusts **after** taking up residence.

7 Settling Trusts before Emigrating to New Zealand

7.1 The more difficult case is the immigrant who, **before** becoming resident in New Zealand, settled a trust that derives foreign-source income. There are special rules about pre-1987 trusts, which this article does not discuss. Putting those rules to one side, people who settle trusts before coming to New Zealand are divided into two categories, according to whether between 17th December 1987 (when the new rules came into effect) and the date of settlement they had, or had not, at any time been resident in New Zealand for tax purposes.

7.2 If they had been so resident (that is, their current residence is at least their second period of tax residence in New Zealand), then they are compulsorily subject to the rules and, as settlors, are liable to tax on trustee income where the trustees are non-resident. If they had not been so resident, then the rules do not compulsorily apply.

7.3 The two-category rule is reflected in the liability of trustees for tax on trustee income. Where the settlor falls into the second category, and the trustees are not resident in New Zealand, the trustees are not liable to tax on trustee income.

7.4 The rationale of the rule in respect of people who had, before their current period of residence, been resident in New Zealand at some earlier time since 1987, even if they later moved away again, is that such people have had a chance to discover that, by New Zealand law, non-residents who settle funds on trust if they later move to New Zealand can become liable as settlors to tax on trustee income. On the other hand, people who have never been resident in New Zealand (at least, not since the rules were announced in December 1987) have not had the same opportunity to find out about New Zealand law.

8 Opting to Pay Tax

8.1 People in this second category have the option of electing to pay tax on trustee income, or a trustee or a beneficiary may elect to take responsibility for the tax. The reason for opting to pay tax is to render the trust a 'qualifying trust', in respect of which New Zealand tax has been paid on income that has been accumulated by the trust since the settlor brought the trust into the New Zealand tax net by taking up New Zealand residence. Distributions of accumulated income from qualifying trusts to beneficiaries are tax free, whereas distributions from non-qualifying trusts are taxed at a penal rate in the hands of a beneficiary, as is explained later in this article.

8.2 A newly-immigrated settlor has twelve months from the start of his fiscal residence to make the election. A settlor may elect to pay tax on trustee income even in years when the trustee has no liability for the tax because neither any trustee nor the settlor has been resident in New Zealand.

9 Income of Beneficiaries

9.1 Where trust income vests absolutely in a beneficiary in the year in which it is derived, or where the trustee applies the income for the benefit of the beneficiary in that year or within six months of the end of the year, the income is assessable to the beneficiary: if the income has a New Zealand source it is taxed to the beneficiary in any event; if it has a foreign source it is taxed to the beneficiary only if the beneficiary is resident in New Zealand. The trustee is jointly liable for tax on the beneficiary's income, as agent for the beneficiary. In practice, most tax on beneficiaries' income is paid by trustees on behalf of beneficiaries.

9.2 Because foreign-source income of trusts that vests in beneficiaries is taxed to the beneficiaries only if they are resident in New Zealand it would be possible for a trust to accumulate income due to a New Zealand resident beneficiary for several years and then to pay that income to the beneficiary in a year when the beneficiary was not resident in New Zealand. Later, the beneficiary could return to New Zealand and enjoy the receipt free of New Zealand tax. That plan is frustrated by a special provision in the Act. Where a beneficiary is resident in New Zealand, becomes a non-resident, and takes up New Zealand residence again within five years, any distributions of current or accumulated income derived by the beneficiary while non-resident are assessable when residence is resumed.

10 Distributions to Beneficiaries of Accumulated Income

10.1 In principle, as mentioned, New Zealand income tax law treats trust income as one income. It follows that income accumulated by a trustee, and taxed to the trustee as it was derived, does not bear tax a second time when it is distributed to a beneficiary. The trustee is treated as having paid tax on behalf of the beneficiary. The distribution to the beneficiary is comparable to a taxpayer drawing tax-paid savings out of a bank account, an action that, of course, does not trigger any liability for tax.

10.2 The approach that is described in the previous paragraph works well enough in respect of income that has been taxed in New Zealand. However, where trust income did not bear New Zealand tax when it was derived, New Zealand legislative policy requires that the income should be taxed to a beneficiary when it is distributed to that beneficiary. The rate of tax varies according to the degree of connection between the trust and New Zealand in the years when the income was accumulated. In particular, was the settlor resident in New Zealand during that time?

11 Distributions from Wholly or Partly Foreign Trusts

11.1 Where no settlor of a trust has been resident in New Zealand since the date of the settlement, distributions to beneficiaries of accumulated income are taxed as income, at the marginal rate for the beneficiary in question. Such trusts are termed 'foreign trusts', to distinguish them from 'qualifying trusts'. A third category, 'non-qualifying trusts', comprises trusts that are neither qualifying trusts nor foreign trusts. Broadly speaking, non-qualifying trusts are trusts that have been brought into the New Zealand tax net by a settlor's becoming resident in New Zealand for a time, but in respect of which tax has not been paid.

11.2 Distributions from non-qualifying trusts are taxed at a penal rate of 45%, as compared with the standard rate of 33% on income that a trustee accumulates. The reason for this higher rate is to claw back some of the benefit that is assumed otherwise to be enjoyed by beneficiaries of such trusts. That benefit is the compounding of income within the trust free of New Zealand income tax. Forty-five per cent is a rough estimate of the rate that would claw back the compounding benefit in typical cases, rather than an endeavour precisely to recover the benefit for the New Zealand tax system.

11.3 New Zealand does not seek to tax the compounding benefit in respect of 'foreign trusts' because there is no factor that connects these trusts with the New Zealand fiscal system until there is a distribution of accumulated income to a beneficiary. The categorisation of trusts according to the terms 'qualifying trust', 'non-qualifying trust' and 'foreign trust' is significant only in the context of the taxation of distributions to beneficiaries.

12 Non-Qualifying Trusts becoming Qualifying Trusts

12.1 Suppose a trustee of a non-qualifying trust derives and accumulates income in year 1, and distributes that accumulated income to a New Zealand resident beneficiary in year 2. There will be no New Zealand tax in year 1, but the distribution to the beneficiary will bear tax at 45% If the trust were a qualifying trust, the accumulated income would bear tax at 33% in year 1, and the distribution would be free of tax. For this reason, it can be worth while for a trustee or a settlor or a beneficiary to opt to pay tax on income as it is derived, and thus to convert a non-qualifying trust into a qualifying trust. As mentioned earlier, an immigrant has twelve months from taking up New Zealand residence to opt to pay tax on income derived by what would otherwise be a non-qualifying trust.

13 Ordering and Distributions from Mixed Trusts

13.1 As will be apparent, in the absence of special rules it would be possible for trustees of discretionary trusts with beneficiaries in several jurisdictions to minimise the impact of tax on distribution to a New Zealand resident beneficiary by opting to distribute, say, accumulated income to a beneficiary resident somewhere else, and, say, non-assessable corpus to the New Zealand resident. That possibility is forestalled by an ordering rule that, broadly speaking, treats distributions from trusts as being made on a 'last in, first out' basis, and that apportions receipts by New Zealand resident beneficiaries over the whole of the trust fund.

13.2 For purposes of calculating tax on distributions from a trust, the trust may fall into two categories: for example, foreign and qualifying, or foreign and non-qualifying. Appropriate rates of tax are apportioned over distributions from such trusts, and the ordering rules that have just been described determine the deemed component parts of any particular distribution.

14 Credit for Foreign Tax

14.1 Where a receipt is taxed as trustee income the trustee may claim credit for foreign tax paid on the income according to New Zealand's general unilateral rules, or under an applicable double tax agreement. If the trustee is non-resident, but the income is assessable by virtue of a settlor being resident in New Zealand, in principle the trustee cannot claim a tax credit because credits for foreign tax are available only to New Zealand residents. In these circumstances, if it is intended to pay tax in order to make the trust a qualifying trust, it would be sensible for the settlor to opt to be the taxpayer. As a resident, the settlor could qualify for a credit.

14.2 Where income vests in a beneficiary, or where accumulated income is distributed to a beneficiary, the New Zealand Act limits foreign tax credits to credits for withholding taxes; there is no credit for tax on business profits. The reason for this restriction is the difficulty of attributing tax on business profits to funds that have passed through a trust (and possibly that have spent some years under the trustee's control) when the funds are later distributed to a beneficiary. Whether any of New Zealand's double tax agreements require credit for foreign tax to be passed on to beneficiaries has not been explored.

14.3 New Zealand residents who apply for a credit for foreign tax face a time limit of four years. However, time runs from the year in which New Zealand tax is due, and does not necessarily relate to the time of payment of the foreign tax. Accordingly, withholding tax borne by income derived and accumulated by a trustee, say, six years earlier may be claimed as a credit against tax due from a New Zealand resident beneficiary who derives a distribution from the trust.

14.4 Distributions may comprise a mixture of income from several sources, only some of which have borne foreign withholding tax. In these circumstances, the Act provides for the foreign tax to be apportioned.

15 Immigrants and Trusts

15.1 How might the rules described above apply to immigrants to New Zealand? Take, for example, a family of three generations that is resident in Arcadia, for convenience referred to as grandfather, father and son. Suppose that father proposes to emigrate to New Zealand with son. Suppose that grandfather proposes to give certain income-producing property to father and/or son.

15.2 A tax-effective structure would be for grandfather to settle the property on a discretionary trust, with a New Zealand trustee, for father and his family. Father could in fact be the trustee, if so desired. So long as income was not distributed to the beneficiaries it would remain free of New Zealand income tax.

15.3 An alternative would be for father, while still resident in Arcadia, to give property to grandfather, and for grandfather to settle the property on the trust as just described. If father's gift to grandfather were truly beneficial, and independent of any obligation or understanding about settlement on the trust, the structure would be effective. Another possibility is that the gift and the settlement should be considered together as a series of transactions that renders the father the settlor of the trust for purposes of the New Zealand Income Tax Act. If that were the correct conclusion, then, when the father took up residence in New Zealand, the income of the trust would then become assessable in New Zealand by virtue of there being a New Zealand resident settlor.

15.4 Questions of proof arise at this stage. No doubt some transactions such as that described are undertaken by intending immigrants; no doubt the resulting trustee income is treated as non-assessable by its recipients. On the other hand, on the face of the transaction, there is no reason for the Commissioner to question the settlement by the grandfather.

15.5 An immigrant who is already rich in his own right might settle investments on trust (using a trustee not resident in New Zealand) before moving to New Zealand. When he takes up New Zealand residence the income of the trust will become vulnerable to New Zealand tax. However, that liability will not be enforced against the immigrant or the trust unless and until the trust makes a distribution to a New Zealand resident beneficiary. If and when funds are distributed to a New Zealand resident beneficiary, tax is borne by that distribution only. The rest of the accumulations of income in the fund remain untaxed by New Zealand in practice, although by virtue of the residence of the settlor they are potentially liable to New Zealand tax.

15.6 If there is a distribution to a New Zealand resident beneficiary in these circumstances the distribution is assessable at 45%, unless the distribution comes entirely from current year income. In that event, it bears tax at beneficiary's marginal rate, either 24% or 33%, the latter cutting in at an income of $NZ30,875 per annum. These rates include social security contributions, which are consolidated with income tax in New Zealand. (At the time of writing the New Zealand dollar is worth a little more than one third of a pound sterling.) The government plans to relax the rates in 1996. Distributions to beneficiaries who are not resident in New Zealand are not assessable to New Zealand tax.