Trusts and Tax – Be careful

The way trusts are taxed in New Zealand can be confusing for people. The reason it can be confusing is that it depends on what type of trust you have, and also what sort of distribution you intend to make.

A trust is a creation of the law of equity. A trust is not a legal entity distinct from its trustee. Instead, a trust is a fiduciary relationship where a trustee holds property for the benefit of the beneficiaries of the trust or, where the trust is a charitable trust, for the specified charitable purpose. Although a trustee has legal ownership over the trust property, it holds the property subject to the beneficial interests of the beneficiaries and must act in the best interests of the beneficiaries of the trust.

A trustee may be an individual (or natural person) or an entity such as a company. There may also be multiple trustees, who can be removed and replaced from time to time.

The "trust rules" definition in the Income Tax Act 2007 sets out most of the rules for taxing income derived by trustees of a trust and the amounts distributed to beneficiaries of a trust. The trust rules also contain various rules relating to the compliance obligations of trustees, settlors and beneficiaries of trusts.

Since the re-write of the income tax legislation, the rules that relate to trusts are contained in different parts of the Income Tax Act, but most of the rules are in subpart HC. Since the introduction of the trust rules, the income tax legislation has been reordered, reformatted, and progressively reviewed and rewritten over several years on a part-by-part basis. The trust rules have also been affected by the introduction of the Core Provisions to the Income Tax Act.

The structural change made by the Core Provisions for the taxation of trustees was that they became taxed under the Core Provisions under the same source and residence rules that apply to any "person" rather than under a charging regime contained within the trust rules.

Income derived by a trustee of a trust is taxed either as "beneficiary income" or "trustee income". Beneficiary income is income derived by the trustee of a trust that is vested absolutely in interest in a beneficiary in the income year when it was derived; or paid to a beneficiary during the income year or within the extended period allowed for in the Income Tax Act. Trustee income is all the annual gross income derived by the trustee of a trust in an income year that is assessable, other than income that is beneficiary income.

What makes these rules more complex, among other things, is the fact that the tax treatment of distributions to beneficiaries of amounts that are not beneficiary income depends on the classification of the trust. For tax purposes, trusts are classified as:

(a) complying trusts — trusts where none of the income derived by the trustee is non-resident passive income, non-residents' foreign-sourced income, or income that is exempt under section CW 54 and where the trustees have always satisfied their tax obligations;

(b) foreign trusts — trusts that have not had a New Zealand resident settlor at any time since 17 December 1987; and

(c) non-complying trusts — trusts that are neither complying nor foreign trusts.

Foreign trusts are under the microscope at present following the Fossack Monseca incident and the Government review.

Given the complex nature of these rules, it would be prudent for any professional person involved in financial planning, conveyancing or dealing with investments involving trusts to get advice from an experienced tax lawyer because there may be serious tax consequences for their clients.

Ismail Rasheed, the owner of IR Legal, has 17 + years of tax law experience and is available to offer solutions and advice on immigration and tax law matters. IR Legal is a specialist law practice.

Offices are located on Level 2, Westpac House, 318 Lambton Quay, Wellington and Level 31, Vero Centre, Shortland Street, Auckland.

#lawyer #taxlawyer #immigrationlawyer