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## **PUB00261: Interpretation Statement: IS XX/XX Taxation of Trusts – Income Tax**

### **Introduction**

1. The New Zealand Law Society (Law Society) welcomes the opportunity to comment on the updated draft exposure draft *PUB00261: Interpretation Statement IS XX/XX Taxation of Trusts – Income Tax* (updated draft Interpretation Statement). The updated draft Interpretation Statement amends the exposure draft that Inland Revenue originally published for consultation in May 2017 (original draft Interpretation Statement).<sup>1</sup>
2. The Law Society's comments on the updated draft Interpretation Statement are set out below.

### **Part 2: Settlers**

3. Example 10 addresses the anti-avoidance provision in relation to avoiding settlor status. This example has been updated (at paragraph 2.116), but does not acknowledge that both Harriet and James would each be treated as a settlor of the other person's trust as well as settlors of their respective trusts under section HC 28(2). The Law Society recommends that the updated draft Interpretation Statement makes this clear.

### **Part 3: Trustees and beneficiaries**

4. With regard to the notional single person under section HC 2, the explanation in paragraph 3.11 of the updated draft Interpretation Statement does not sufficiently address the point that the notional single person should be treated as resident where one of the trustees is resident.
5. The logic at paragraph 3.11 of the updated draft Interpretation Statement could be reversed to argue that if one co-trustee is non-resident, then the notional single person is non-resident;

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<sup>1</sup> For NZLS comments on the original draft Interpretation Statement, see submission dated 12.7.17 available at [http://www.lawsociety.org.nz/\\_data/assets/pdf\\_file/0017/113417/I-IRD-PUB00261-Taxation-of-Trusts-12-7-17.pdf](http://www.lawsociety.org.nz/_data/assets/pdf_file/0017/113417/I-IRD-PUB00261-Taxation-of-Trusts-12-7-17.pdf).

i.e.: “The definition of “New Zealand resident” in s YA 1 means, generally, a person resident in New Zealand under sections YD 1 to YD 3. This means that if one or more of the trustees is not a resident, the ‘resident’ test is failed. The corollary is that if all of the trustees (or the single trustee if there is only one) are resident then the test is satisfied.”

6. The Law Society submits that in the next available tax bill, a provision should be included to state that the notional single person will be treated as resident where one of the trustees is resident, to clarify this position.

#### **Part 4: Income derived by trustees**

7. The Law Society notes that paragraph 4.4 has been amended, but recommends that the use of the phrases “income derived by a trustee” and “trustee income” in the Income Tax Act (ITA) be referred to IRD’s policy team for review, given the inconsistent use of those phrases in the ITA.

#### **Part 5: Beneficiary income**

8. The Law Society appreciates that paragraph 5.38 has been added to the updated draft Interpretation Statement to better explain the facts of *CIR v Ward* [1970] NZLR 1 and to show that the resolution was consistent with the trustee deed in question. The Law Society submits however that the fact that a resolution to allocate income to a beneficiary can only be effective if it is made in accordance with the terms of the trust deed should be stated explicitly, to avoid confusion.

#### **Part 8: Distributions from complying, foreign and non-complying trusts**

##### *Dual status trusts*

9. Inland Revenue has added commentary on dual status trusts in the updated draft Interpretation Statement (from paragraph 8.47). The Law Society submits that paragraph 8.48 should state that the dual status trust should be treated as having the status of a complying trust, and then the subsequent paragraphs can provide the explanation.
10. The opening of paragraph 8.49 should be amended to begin “A ~~taxable distribution from a foreign trust that has a dual status~~ (of other than beneficiary income) from a dual status trust is not assessable income ...”, to avoid confusion with paragraph 8.50 which states that distributions are excluded from being taxable distributions.
11. An amendment should be made to the discussion of the ordering rules at paragraphs 8.139 and 8.140, to confirm that the ordering rules do not apply to dual status trusts. The ordering rules do not apply to complying trusts. Since a distribution from a dual status trust, not being a distribution of beneficiary income, is not assessable income of the beneficiary, by reason of the trust being a complying trust, there is no policy reason why the ordering rules should apply to dual status trusts.

##### *Extended time period to distribute beneficiary income*

12. Inland Revenue has added paragraph 8.111 to the updated draft Interpretation Statement. The Law Society appreciates that the operation of section HC 6(1B) has been addressed by the updated draft Interpretation Statement. However, the new paragraph does not explain how it is consistent with section HC 14(1) (which provides that a trustee makes a distribution

when the trustee transfers value to a beneficiary) and section HC 14(3) (which provides that a distribution is made when what is transferred “vests absolutely in interest in the person” or “is paid to the person”).

13. Although section HC 6(3) treats a beneficiary deriving beneficiary income as having derived it in the same tax year as the trustee derived the income, section HC 16(2) focuses on when the distribution is made by the trustee. Accordingly the Law Society submits that section HC 16(2)(a) needs to be amended so that it reads: “*First, an amount that is distributed as beneficiary income in the income year*”.

#### *Transactions that are not genuine and other ordering adjustments*

14. Amendments have been made in the updated draft Interpretation Statement regarding section HC 16(5) (see paragraph 8.125 onwards). The Law Society considers that this section should be referred to Inland Revenue’s policy team for review, as the current wording would apply to genuine transactions which are not designed to manipulate distributions for New Zealand tax purposes.

### **Part 10: Entry to the trust regime**

#### *Migrating trusts*

15. The current wording of paragraph 10.4 of the updated draft Interpretation Statement can be read as suggesting that after the trust loses its status as a foreign trust, no distribution from it is treated as being from a foreign trust. However, as paragraph 10.14 explains, distributions of amounts derived before the trust becomes either complying or non-complying, are still treated as distributions from a foreign trust.
16. The Law Society submits that the first sentence of paragraph 10.4 should be rewritten as:  

*“Once a settlor with a pre-migration trust becomes resident, ~~distributions from the trust are treated under s HC 30 as made by a foreign trust~~ the trust remains a foreign trust for up to a year after the settlor becomes resident and is not, or no longer is, a transitional resident.”*
17. Alternatively, the Law Society recommends that the updated draft Interpretation Statement be amended to clarify that the distributions by formerly foreign trusts (whether they elect to become complying trusts or not) from amounts derived while a foreign trust (i.e. before the election or non-election) will continue to be treated as a distribution from a foreign trust even after the year provided for making that election has passed. This continuing status for distributions from former foreign trusts is provided in sections HC 30(3) and (4) – yet the updated draft Interpretation Statement incorrectly states that treatment applies only for the year during which that election may be made.

#### *Miscellaneous amendments and comments*

18. The Law Society submits that paragraph 10.17 might be better expressed as:

*If the trust of a settlor who is a new or returning resident or transitional resident has a dual status as both a complying trust and a foreign trust on the day prior to the settlor becoming resident in New Zealand, the process in s HC 30(2) can be used to formally adopt complying trust status, thereby ending the dual trust status. ~~That status will stop distributions being treated as from a foreign trust, from the date the election is made.~~ If no election is made by the election expiry date such a trust will ~~revert to being~~ become a non-complying trust ~~and lose both its status as a complying trust and also the treatment of distributions as being from~~*

~~a foreign trust~~, even if in fact the trustees continue to only derive New Zealand sourced income and the trustees' tax obligations relating to that income are satisfied for every tax year.

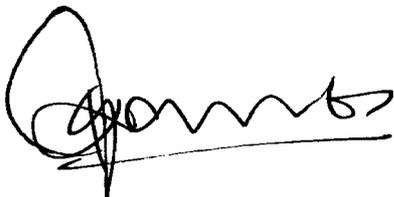
19. Paragraph 10.44 of the updated draft Interpretation Statement provides that one of the section HC 29(5) prerequisites for a natural person settlor to avoid liability as agent of the trustee is for the settlor to make no settlements on a foreign trust after they become resident. As previously noted (in response to the original draft Interpretation Statement), this is incorrect, as the prerequisite is instead that the natural person settlor is not resident in New Zealand at the time of any settlement on the trust.<sup>2</sup> The Law Society considers that paragraph 10.44 should be amended to reflect this.
20. Inland Revenue has added paragraph 10.55 to the updated draft Interpretation Statement. The Law Society submits that the reference to section CW 27 could leave the mistaken impression that the foreign-sourced income is assessable. To avoid confusion, the second sentence could be rewritten as:

*"Therefore, s CW 27 will not itself apply to exempt foreign-sourced amounts that are trustee income from tax in New Zealand, but foreign-sourced amounts will nevertheless not be taxable if no settlor is resident (other than transitional resident)."*

#### Further information

21. This submission was prepared with assistance from the Law Society's Tax Law Committee. If you wish to discuss this further please contact the committee convenor Neil Russ, through the committee secretary Jo Holland (04 463 2967 / [jo.holland@lawsociety.org.nz](mailto:jo.holland@lawsociety.org.nz)).

Yours faithfully,



Tim Jones  
Vice President

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<sup>2</sup> Refer NZLS submission 12.7.17 (note 1 above), at paragraph 65.