

TAXATION & RESIDENCY OF NEW ZEALAND TRUSTS

First, there are a few terms that are important to understand:

Settlor

The person who provides property for the trust is called the Settlor. A person who stands to receive the property is a beneficiary. A trust may have more than one settlor for tax purposes. Anyone who transfers property to the trust is a settlor and a person who enhances the trust estate (for example, by lending money for a term without interest) will be deemed to be a settlor.

Equity looks to the substance not to the form, however, and a New Zealand settlor named on a trust deed, for a nominal settlement amount will not constitute the settlor for the purposes of classifying the trust.

A settlor is defined very broadly in the Income Tax Act 2007. It includes anyone who provides goods, services or money to a trust for less than full market value, or acquires goods, services or money from a trust for greater than market value. There are extensive provisions designed to catch indirect settlements through nominees, and by other means.

Distributions

Payment of income or capital to a beneficiary, whether or not it the form of cash is called a distribution. The tax treatment of distributions from a trust depends on the trust's classification for tax purposes. There are three classifications:

- Complying trusts
- Foreign trusts, and
- Non-complying trusts

These classifications are for tax purposes only. They have no effect on the general law of trusts.

Classification

The significance of the classifications lies in the tax treatment of distributions made from them, in particular distributions of income that are not beneficiary income. Beneficiary income is income passed straight to a beneficiary during, or within 12 months after the year in which it is received. That income will be taxed in the beneficiary's hands at the beneficiary's marginal income tax rate.

Complying Trusts

A complying trust is an ordinary New Zealand resident trust with New Zealand resident trustees and a New Zealand resident settlor.

Discretionary family trusts settled by New Zealand residents in New Zealand are generally Complying trusts (formerly known as “qualifying trusts”). As a general rule, income from Complying trusts may be distributed to beneficiaries at the marginal tax rate for each beneficiary. However income distributed to minor beneficiaries of more than \$1,000 will be taxed as if it was retained by the Trustees (i.e. at 33%). There are some limited circumstances where this rule will not apply. A minor beneficiary is any beneficiary under the age of 16. The liability for the tax falls upon the trustee.

The trustees themselves pay tax at the flat rate of 33% on any income that is not distributed. That accumulated tax-paid income (tax paid savings - so to speak), is then treated as if it were added to and became part of the corpus of settled trust property as capital. All distributions from this trust property (other than beneficiary income received by beneficiaries') can be tax free, as the trust will have paid income tax on its own income first.

Foreign Trusts

A Foreign Trust is a Trust which has a connection to New Zealand but has had no New Zealand resident settlor from the date the Trust was first settled until the date of the distribution in question. A Foreign Trust can be connected to New Zealand in a number of ways: through a trustee or trustees being New Zealand resident, by the Trust having New Zealand sourced income, or the Trust having a New Zealand resident beneficiary or beneficiaries.

To avoid this classification, the settlement must be made by a New Zealand resident. The classification is not affected by whether there are New Zealand resident trustees or not. The relevant time for classifying the trust is when it makes a distribution of income.

As with Complying Trusts, income from foreign trusts may be distributed to beneficiaries with tax paid at the marginal tax rate for each beneficiary. Again, the minor beneficiaries rule will apply to these distributions.

Unlike Complying Trusts, distributions from foreign trusts (with exceptions including distributions from non-discretionary trusts and wills) are taxed on distribution to beneficiaries at their marginal rates of tax. Double taxation occurs when the trustees retain income as this is taxed at the trust tax rate, (presently 33%). The residue will then be taxed again when distributed to a beneficiary if there is no New Zealand settlor at the time the distribution is made or an election has been made (see below).

A trust settled prior to a settlor acquiring New Zealand tax residence is a foreign trust regardless of the residence of the trustees and beneficiaries. This is because for New Zealand tax purposes the residence of the trust is determined by the residence of the settlor not the trustee.

New Zealand law is unique in fixing on the residency of the settlor when determining the tax position of a foreign trust. This asymmetry with other tax regimes can be very advantageous. Because the trustees are the legal owners of the trust property, they are the people overseas tax authorities look at when determining whether any overseas tax is payable. If the trustees are resident in New Zealand this could mean that no overseas tax is

payable. The end result may be that a New Zealand foreign trust may have no tax liability in any jurisdiction.

If a beneficiary ceases to be a New Zealand resident then becomes a New Zealand resident again within 5 years, they must pay New Zealand income tax on any beneficiary income or taxable distribution received from a Foreign or Non-Complying Trust while they were a non-resident.

The Foreign trust will become a complying trust from the date of election. If no election is made, the trust will be deemed a non-complying trust after the election period expires. This could result in higher tax being payable on certain distributions, as noted above.

The trustees of a foreign trust may want to distribute retained earnings of the trust to the beneficiaries or trustees whilst they are still transitional residents as any distributions from foreign trusts to transitional residents are not taxable in New Zealand.

Tax Residency

There is another concept also to be considered – Tax residency. As we have said, the type of trust, and therefore the tax effect of distributions is determined by the residency of the settlor. Tax residency is affected by both the residence of the trustees and by where the investments are held.

The normal determining factor for tax residency is the residence of the trustees. The exception is where foreign income is derived. If foreign income is derived, then the residence of the settlor determines whether that foreign income derived by resident trustees is taxable in New Zealand.

If a non-New Zealand resident settled a trust on New Zealand trustees for a New Zealand resident, and the investments were in the UK, for example, then the taxation would be at UK rates, and there would be no tax to pay in New Zealand.

Tax Consequences of Migration from New Zealand

Particular care must be taken when settlors or trustees or the executors of estates migrate from New Zealand. The treatment of trusts in different jurisdictions can depend on factors that are different to those applied in New Zealand.

For Australian tax purposes, the residence of a trust is [understood to be] determined by the residence of the *trustees* and the place where the central control and management of the trust is exercised. Consequently when individuals move from New Zealand to Australia and remain trustees of their family trust, the trust will often accompany them into the new jurisdiction.

This will risk the trust becoming subject to the Australian tax regime including:

- Exposure to Australian capital gains tax on disposals
- Exposure to Australian income tax on worldwide income and medicare levy charged on trustee income.
- Exposure to capital gains tax on deemed disposal on any subsequent migration of the trustee from Australia =

To maintain the locus of a New Zealand trust one must ensure (1) that the settlor or parties with a power of appointment are New Zealand tax residents and (2) that the trust is not

controlled from Australia. This will keep the trust outside the Australian tax regime, even if the settlor becomes an Australian tax resident. There are some risks for settlors however, as they can have capital gains attributed to them in certain circumstances.

A change in the residence of the settlor may also affect the status of a trust. If the trust becomes “non-complying”, certain distributions could be subject to tax at the penal rate of 45%.

There is no test of residence for trusts (other than unit trusts, which are treated like companies). This is because a trust is not a legal entity that can exist independently of the trustee and beneficiaries. Unlike a company, a trust is not a legal person at law. Care is accordingly necessary when a settlor or trustee moves from one jurisdiction to another as the trust may inadvertently acquire a new tax residence.

Non-complying Trusts

As noted above, the distinction between the types of trusts **turns on whether [the] settlor** is resident at the time a distribution is made. A foreign trust becomes non-Complying if the settlor becomes a New Zealand resident and does not elect to make the trust into a Complying trust before the trust makes a distribution.

If no election is made and no further settlements are made after the settlor becomes a New Zealand tax resident, the Trust is treated as a Foreign Trust for 12 months. After 12 months, the Trust will become a Non-Complying Trust.

For non-complying trusts, all distributions other than beneficiary income and the original corpus of the trust are taxed in the hands of beneficiaries at a penal rate of 45%. Income previously taxed does not become part of the original corpus of the trust estate as it does for Complying trusts. This type of trust is to be avoided.

Alternatively, the trustees may elect that the trust become Complying upon gaining a New Zealand settlor. The new status applies to future distributions only. This requires the settlor to come to New Zealand for over 183 days in any 12 month period. Making this election is important. If you live in New Zealand, you must elect to have the trust qualified within 12 months of becoming New Zealand resident.

A trust will constitute a non-complying trust where, at the time a distribution is made, it is neither a complying trust nor a foreign trust. This will include:

- An otherwise Complying Trust has not satisfied all of its obligations under the Income Tax Act 2007.
- If non-New Zealand resident trustees derive trustee income from interest or dividends in New Zealand
- If the New Zealand resident settlor moves overseas and makes further settlements to the Trust.

A trust where the settlor has subsequently become New Zealand resident, and after a specified period has not elected to be a complying trust.

To avoid the undesirable tax consequences of being classified as a Non-Complying Trust, the trustees should elect to make the Foreign Trust a Complying Trust when the settlor

moves to New Zealand. All income of the Trust will then become taxable in New Zealand from the date the trustees make the election.

The election must be made to Inland Revenue within 12 months of the settlor becoming a New Zealand tax resident, unless the settlor elects to become a transitional resident (see below).

Transitional residency

A transitional resident is a person who has become resident in New Zealand for the first time, or a returning expatriate who has been non-resident for a continuous period of ten years or more.

The key downside of a non-complying trust is that capital gains when distributed will be taxed. By contrast, capital gains distributed from a foreign trust to a New Zealand-resident beneficiary may be tax free, and advice should be sought before a foreign trust loses that status.

Past year income derived by the trustee prior to the commencement of the individual's residency is a taxable distribution if distributed to the beneficiary while resident in New Zealand. This is the case for both foreign trusts and non-complying trusts

In light of this, it is desirable to seek advice regarding revenue reserves prior to becoming a New Zealand tax resident, or ceasing to be a transitional resident.

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