



WEEKLY COMMENT: WEDNESDAY 8 AUGUST 2012

1. The taxation of beneficiary income has recently occupied the minds of senior officials in the both the Inland Revenue Department and the Australian Tax Office:
 - In New Zealand, the issue is whether deemed income (or, more generally, taxable amounts that are not income under trust principles) can be distributed to beneficiaries. In my *Weekly Comment* on 23 May I referred to the Draft Interpretation Statement which has since, on 29 June, been released in final form as IS 12/02 *Income Tax: Whether income that is deemed to arise under tax law, but not trust law, can give rise to beneficiary income*.
 - In Australia, the issue is how best to exclude deemed taxable income (referred to as “net notional amounts”) from income under trust principles so that beneficiaries get correctly assessed on their share of the trust’s taxable income. The ATO has issued Draft Tax Ruling TR 2012/D1 *Income tax: meaning of ‘income of the trust estate’ in Division 6 of Part III of the Income Tax Assessment Act 1936 and related provisions*.
2. In court cases concerning trusts, the courts invariably focus – in detail – on the terms of the trust deed. Both IS 12/02 and TR 2012/D1 highlight the importance of trust law in determining what is beneficiary income for tax purposes. The resolution of any dispute with Inland Revenue regarding the beneficiary income/trustee income split will depend crucially on the relevant terms of the trust deed.
3. This week I look at the taxation of beneficiary income in New Zealand. Next week, I look at the position in Australia and compare the tax treatment in the two countries.

Trustee income vs beneficiary income in New Zealand

4. In New Zealand, under s. HC 5(1) of the Income Tax Act 2007, an amount of income derived by a trustee is either:
 - Beneficiary income under s. HC 6; or
 - Trustee income under s. HC 7.
5. Section HC 7(1) states:

“To the extent to which it is not beneficiary income, an amount of income derived by a trustee of a trust is trustee income.”
6. Under s. HC 6, “beneficiary income” is income derived by a trustee that:
 - Vests absolutely in interest in a beneficiary; or
 - Has been paid to the beneficiary, within the time limits imposed by s. HC 6(1B).

Distributable income for tax purposes: gross income vs net income

7. "Income" is defined in s. YA 1 as follows:

"Income, for a person, means income of the person under section BD 1(1)".

8. Section BD 1(1) states:

"An amount is income of a person if it is their income under a provision in Part C."

9. Part C deals only with income. Part D deals with deductions. Section CV 13 deals with amounts derived from trusts:

"An amount derived by a person is income of the person if it is -

(a) beneficiary income to which sections HC 6 (Beneficiary income) and HC 17 (Amounts derived as beneficiary income) apply; or

(b) a settlement on trust of property of the kind described in section HC 7(3) (Trustee income); or

(c) a taxable distribution from a foreign trust to which section HC 18 (Taxable distributions from foreign trusts) applies."

10. The amounts referred to in s. CV 13 are all gross amounts. S. CV 13 does not refer to trustee income, other than trustee income referred to in s. HC 7(3) – the amount that is the market value of a property settlement referred to in s. HC 4(3) to (5).

11. Therefore, the reference to "an amount of income derived in an income year by a trustee" in s. HC 5(1) must be read as referring to the various types of (gross) income referred to in Part C that could be derived by a trustee.

12. Section DV 9 is the deduction provision that deals with trusts. Section DV 9(1) states:

"A person who derives beneficiary income is denied a deduction for expenditure or loss that a trustee incurs in deriving the income."

13. Section DV 9(2) states:

"For the purpose of determining the deductions that a trustee is allowed in an income year, beneficiary income of beneficiaries of the trust in the income year is treated as trustee income."

14. When s. HC 5(1) is read in conjunction with s. DV 9, the effect is to treat a distribution to a beneficiary as a gross taxable amount, with the remainder of the income derived by the trustee being taxed as a net sum: trustee income under s. HC 7(1) reduced by deductions relating to both beneficiary income and trustee income.

15. This should mean that it should be possible, for example, to distribute the gross income derived by a trustee to a tax-exempt beneficiary, while the deductions are attributed to the trustee and are available to be carried forward by the trustee as a tax loss.

16. The Commissioner provided a detailed explanation of the trust taxation regime when it was first introduced into the *Income Tax Act 1976*. That explanation is contained in the *Appendix to Tax Information Bulletin* Vol 1 No 5 November 1989. In the context of the provisions of the *Income Tax Act 1976*, which did not distinguish between gross income and allowable deductions in the way the *Income Tax Act 2007* does, the Commissioner's

explanation clearly implies that “income derived by a trustee” is a net concept and therefore, beneficiary income may only be paid out of the net income derived by a trustee:

“8.41 Where losses are able to be carried forward for offset against future income they are deducted from the income derived by the trustee in the succeeding income year. If after the deduction of such losses in the succeeding income year there is income remaining this income will be beneficiary income or trustee income, depending upon whether the income is vested in or paid or applied to or for the benefit of the beneficiary. Thus, the loss is not carried forward and deducted against beneficiary income or trustee income: rather, *it is carried forward and deducted from income derived by the trustee in the succeeding income year in determining whether there is any income in that year which may be classified as beneficiary income or trustee income.*” (emphasis added)

17. There has been no subsequent statement by the Commissioner suggesting that this view is incorrect in the context of the provisions of the *Income Tax Act 2004* and the *Income Tax Act 2007*.

Distributable income under a trust deed

18. The trust law concept of income is a net concept. Income under trust law is net income. While the importance of the trust law concept of income is emphasised in IS 12/02, *there is no discussion at all about what this concept means or how it is calculated*. The focus of the discussion (on trust law income) in IS 12/02 is on the importance of the distinction between capital and income:

“70. ... The trust deed may define what is to be treated as capital and what is income. In the absence of any such indication in the trust deed the courts must apply the long-established trust law principles distinguishing capital and income.

71. At 22.1.4 and 22.1.5, the authors (N Kelly, C Kelly and G Kelly, *Garrow and Kelly Law of Trusts and Trustees* 6th edition, 2005, Wellington, LexisNexis) comment that capital and income mean different things for income tax, accounting and trust law. At 22.1.6 they state that for trust law purposes trustees cannot simply rely on tax law, generally accepted accounting principles or international financial reporting standards.”

19. In *Latimer & Ors (Trustees for the Crown Forestry Rental Trust) v Commissioner of Inland Revenue* [2004] UKPC 13, (2004) 21 NZTC 18,478 the Privy Council reviewed the terms of the relevant Trust Deed which stated, in Clause 9 headed “Application Of Receipts” that:

(a) Rental Proceeds received by the Trustees shall be capital of the Trust.

(b) Interest earned from investment of the Trust Fund shall be accumulated by the Trustees to be applied at the Trustees' sole discretion:

- To pay the expenses of the Trustees and of the Trust, including the remuneration of the Trustees and all taxes and other levies on income or assets of the Trust; then
- Subject to Clause 10, to assist any Claimant in the preparation, presentation and negotiation of claims before the Waitangi Tribunal which involve, or could involve, Licensed Land.

(c) The Trustees need not distribute in any one year the whole or any part of the income for that year but may at their discretion retain the whole or any part of the income.

20. The case concerned the application of the exemption in s. 61(25) of the *Income Tax Act 1976* for “Income derived by trustees in trust for charitable purposes...”. The references to

the trusts' income are clearly references to the trust's net income after expenses. Lord Millett stated that:

"33. ... their Lordships are satisfied that, had the trust deed required the whole of the *net income* (after expenses) to be used for assisting Maori claims, the Trust would have qualified for exemption under s 61(25). But the Trustees are not obliged to apply the whole of the trust income as it arises. They may carry it forward and apply it in future years;..."

42. ... The *income* of the Trust consists of the *income* derived by the Trustees by investing the forest rentals. Insofar as such income is needed for the purpose of assisting Maoris to prosecute their claims, it is to be devoted to charitable purposes and so exempt from tax; (emphasis added)

21. *Trustees of the Auckland Medical Aid Trust v Commissioner of Inland Revenue* (1979) 4 NZTC 61,404 also concerned the application of s. 61(25) of the *Income Tax Act 1976*. Here again, the trust concept of income referred to is clearly net income. Chilwell J stated:

"... The test is whether its income is ultimately applied to charitable purposes.

In fact in both the years in question the *income* was retained to fund the current and fixed assets of the Trust. In the result by 31 March 1976 the total *net income* of \$140,790 for the two years is found to have been accumulated and invested primarily in the Trust's private hospital and its equipment.

That accumulation (which represents the surplus of assets over liabilities) is held upon the trusts set forth in deed of trust."

Income for tax purposes vs trust income

22. There are a number of circumstances in which the taxable income of a trust could differ from the trust concept of income. IS 12/02 is concerned with deemed income, such as attributed controlled foreign company income, foreign investment fund income, and look-through company income based on an owner's effective look-through interest.

23. However, the trust law distinction between capital and income could also cause mismatches between the tax law and trust law treatments. The mismatch that could result from the financial arrangements tax regime is neatly encapsulated in the following excerpts from the judgment of Richardson J in *Phillips v Foster and Hansen (trustees of the RGJ Trust)* (1991) 13 NZTC 8,088:

"Before the introduction of the accrual regime applying to certain financial arrangements, the taxability of sums receivable over a period on the disposal of capital assets was a difficult area of tax law where the legal answer could depend on fine factual and legal distinctions....

The broad purpose of (the accrual) legislation is to dilute the capital/income distinction and to ensure that all returns on such financial arrangements whatever form they take are brought to tax on a progressive basis over the term of the financial arrangements concerned."

IS 12/02 implies a net concept of beneficiary income

24. The question of whether beneficiary income can be paid out of gross income derived by a trustee is not addressed in IS 12/02. However, the examples included in IS 12/02 imply a net concept of beneficiary income:

- *The trust deed does not define income.* The tax law income and trust law income of a trust are different. Under the trust deed, the trustee can only vest absolutely in interest or pay income of the trust according to trust law concepts of capital and income. Therefore, trustees will not be able to vest absolutely in interest or pay an amount that equates to deemed income.
- *The trust deed defines trust law income as income calculated for income tax purposes.* The tax law income and trust law income of a trust are the same. Under the trust deed, the trustees can vest absolutely in interest or pay income of the trust to beneficiaries according to tax law. To the extent that there are sufficient amounts available in the trust fund, trustees may vest or pay amounts that equate to deemed income.
- *The trust deed defines income using trust law concepts of capital and income, but the trustees have the power to distribute trust capital to income beneficiaries.* The tax law income and trust law income of a trust are different, but the trustees have the power to vest or pay amounts that are more than trust law income to income beneficiaries.

25. The reference to “income calculated for income tax purposes” implies a net approach. The only one of the three circumstances listed above in which gross income for tax purposes may be paid to a beneficiary is where the trustees have the power to distribute trust capital to income beneficiaries.

Ensuring that beneficiary income under tax law can be distributed

26. Based on the foregoing, it should be clear that a trust deed should clearly state that *trustees may pay beneficiary income as determined under tax principles*, if gross income derived by a trustee is to be distributed as beneficiary income.

27. However, that may be undesirable in some situations – for example, where there is a distinction between capital and income beneficiaries. In such situations, trust income could be made to correspond with gross taxable income, and the application of that income could be limited by the terms of the trust.

28. The terms of a trust deed will dictate how beneficiary income is to be paid. It is noted in IS 12/02 at paragraphs 6-8 that:

“6. ... *s HC 6 requires an examination of what has happened within the trust...* The terms of the trust deed and general trust law bind how a trustee may deal with the trust fund.

7. ... *For an amount of trustee income to vest absolutely in interest in, or be paid to, a beneficiary as beneficiary income for tax purposes, it must be effective for trust law. This is true for all types of income derived by a trustee, not just deemed income.*

8. ... *at the time of the vesting or payment, the trust must have sufficient amounts in the trust fund available to be distributed to that beneficiary or beneficiaries in accordance with the trust deed...* (emphasis added)



Arun David, Director, DavidCo Limited