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WEEKLY COMMENT: FRIDAY 5 JUNE 2015

1. This week I look at the Exposure Draft of Public Rulings BR Pub 14/XX *Income tax – Whether a beneficiary will be treated as a settlor where there is no loan* and BR Pub 14/YY *Income tax – Whether a beneficiary will be treated as a settlor where there is a loan* and the Commentary on these draft rulings released by Inland Revenue on 22 December 2014 as Draft Public Ruling PUB0209.
2. A number of useful concepts are discussed:
 - (a) The meaning of “vests absolutely in interest” and “paid” as discussed more fully in Interpretation Statement IS 12/02 *Income tax – Whether income deemed to arise under tax law, but not trust law, can give rise to beneficiary income* (published in *Tax Information Bulletin* Vol. 24, No. 7, August 2012);
 - (b) The distinction between a debtor-creditor relationship and an entitlement under a trust;
 - (c) The distinction between a (proper) “current account” and a “beneficiary account”;
 - (d) The doctrine of set-off; and
 - (e) The relevance of the terms of the trust deed.

When can a beneficiary be a settlor

3. Under s. HC 27(2)(a) and (b), a settlor:
 - (a) “Transfers value” to the trust (or for the benefit of the trust or on the terms of the trust); or
 - (b) “Provides” financial assistance to the trust or for the benefit of the trust with an obligation to pay on demand, and the right to demand is not exercised or is deferred (apparently inserted to ensure that the use of a so-called “Marshall clause” did not result in there being no settlement).
4. The meaning of “transfer of value” in s. YA 1 refers to “provides” money or money’s worth, and includes the release of an obligation to pay money either by agreement or operation of law. The definition states that “transfers value” has a corresponding meaning.
5. A transfer of value can include an interest-free loan, which is supported by a statement by the High Court in *CIR v Dick* (2001) 20 NZTC 17,396 (HC) that a person “clearly is a settlor ... given the interest-free loan”.
6. Reference is made to the definition of the word “provides” in the *Concise Oxford English Dictionary* to support the conclusion that it “implies a need for conscious, positive action on

the part of the person who is providing". In particular, it is noted that "a beneficiary cannot provide what they do not have".

7. The difference between the two draft rulings is that there is no loan from the beneficiary in the first case, whereas there is a loan from the beneficiary on uncommercial terms in the second case.

Meaning of "vests absolutely in interest" and "paid"

8. Under s. HC 6(1) income derived in an income year by a trustee is beneficiary income to the extent to which:

(a) It vests absolutely in interest in a beneficiary in the income year; or

(b) It is paid to the beneficiary in the income year or within the time allowed after the end of the income year, which is the later of 6 months after the end of the year and the date the tax return is filed or is due to be filed.

9. It is noted that the terms "vests absolutely in interest" and "paid" were discussed in IS 12/02. Neither concept requires the amount to be transferred into the possession of the beneficiary.

10. An amount vests absolutely in interest in a beneficiary when the amount derived is indefeasibly vested in the beneficiary so they obtain an immediate right of present or future possession of the income. The beneficiary need not receive possession of the amount vested, or even an immediate right to demand possession of the amount, at the time of vesting; but they must have an indefeasible right to that part of the trust property. The property must exist at the time of vesting (i.e. it must not be future property), although possession of the amount may not be received by the beneficiary until some time in the future.

11. An amount will be "paid" if it is actually paid, distributed, credited or dealt with in the beneficiary's interest. Case law has established that a resolution of the trustees together with a crediting to the beneficiary's account will constitute payment. This follows from the Court of Appeal decision in *CIR v Ward* [1970] NZLR 1. It is stated in paragraph 5.24 onwards of the Appendix to *Tax Information Bulletin*, Vol. 1, No 5, November 1989, that:

"5.24 Income derived by the trustee will be "paid" to a beneficiary in terms of the "beneficiary income" definition if the income is transferred to the beneficiary in money or money's worth. It is not necessary that the income should be transferred directly to the beneficiary: it is sufficient that the income is placed unreservedly at the disposal of the beneficiary. ...

5.27 The Ward case is authority for the following propositions in relation to the meaning of "applied" in the paid or applied limb of the "beneficiary income" definition:

(i) There is an application of income if by virtue of the exercise by the trustee of a power to pay or apply income the income derived by the trustee becomes the absolute property of the beneficiary. But income allotted to a beneficiary by the trustee will not become the absolute property of the beneficiary, and therefore will not be applied for the benefit of the beneficiary, if the trustee has the power to vary or alter any share of the income allotted to the beneficiary.

...

(iii) For there to be an application of income it is not necessary that the income be invested by the trustee on behalf of the beneficiary. The question of whether there is an application of income turns upon the effect of the exercise of the trustee's power and not upon what the trustee does with the income after the power has been exercised.

(iv) Entries in the trust accounts alone do not establish that income has been applied for the benefit of a beneficiary. To establish that income has been applied it is necessary to produce more concrete evidence that the trustee has exercised the power to apply income. For example, a written and recorded resolution of the trustee that the power has been exercised will suffice.

12. Based on the above, a trustee's resolution together with the crediting of the beneficiary's account will be sufficient for there to have been a distribution of beneficiary income for tax purposes.

Debtor-creditor relationship vs entitlement under a trust

13. In *Ward* the notion that a trustee's resolution created a debtor-creditor relationship was rejected as follows:

"... it is misleading to speak of debtor-creditor relationship. The rights of the beneficiaries here do not arise out of debt or contract. They arise out of the trusts created by the deed, and the beneficiaries are entitled to invoke the powers of the Court by reason of a new title "consisting of the exercise of the trustees' discretion in the infant's favour."

14. Therefore, a new trust relationship arises when a trustee allocated an amount to a beneficiary, rather than a debtor-creditor relationship. This is also supported by *CIR v Simpson* [1989] 2 NZLR 704 (CA) where it was noted that an appropriation of income by a trustee in favour of an income beneficiary meant the trustee held the moneys appropriated in trust for the infant. Although these cases concerned infants, the Commissioner's view is that the same conclusions apply in respect of adult beneficiaries. Until possession is given, the amount is subject to a trust relationship.

15. In the Commissioner's view the above suggests until possession is given the beneficiary receives only a beneficial interest and the legal ownership of the amount remains with the trustees. The Commissioner considers that a beneficiary cannot "provide" an amount that is still subject to the ongoing trust relationship and which is still in the possession and control of the trustees.

Current account vs beneficiary account

16. A "current account" is a company law concept, but it is noted that it is frequently used in a trust accounting context.
17. In the company context, it was noted in *Case Q6* (1993) 15 NZTC 5,047 that a shareholder's current account represented "monies advanced to the company or borrowed from it ... pursuant to whatever arrangements are in force between them".
18. In the trust context, where a distribution has not been transferred into the beneficiary's possession, it is suggested that the use of the term "current account" is potentially misleading. The term suggests that a trust owes a debt to the beneficiary, which would not be the case. The term "beneficiary allocation account" or similar is preferable.

Doctrine of set-off

19. Set-off allows two people with payment obligations to each other to discharge (at least partially) those obligations without the need for a physical payment of the amounts that are

set off. In *Trans Otway Limited v Shephard* [2005] NZCA 145, 3 NZLR 678, the Court of Appeal summarised the legal effect of a set-off as follows:

- (a) An agreement that a payment by Trans Otway could be set off against an existing debt Newman owed Trans Otway “was a classic example of the setting of money cross-claims against each other” and “the effect of the agreement was that both payments were made”.
 - (b) Set-off may be regarded as similar to payment. There is a pro tanto redemption, discharge, satisfaction, extinguishment or reduction of the reciprocal debts. Set-off pays them both. In formal terms, set-off is a form of discharge.
 - (c) While no cash was exchanged and while there was no cheque swap, payments were nonetheless made. It is the doctrine of set-off which sees both debts paid.
20. In the second draft ruling, the beneficiary loans a distribution of beneficiary income to the trust. The Commissioner considers that a set-off between the trustees’ obligation to pay the beneficiary and the beneficiary’s obligation to pay the loan principal to the trustees under the loan agreement are satisfied by way of set-off.
21. The set-off could be explicitly provided for in an agreement between the trustees and the beneficiary. Alternatively, the Commissioner considers that the agreement to set-off amounts could be inferred. It is noted that whether a beneficiary has loaned an amount back to the trust will be a factual enquiry. Where there is no written loan agreement the onus of proving that a loan does or does not exist is on the taxpayer.

Terms of the trust deed

22. The terms of the trust deed can lead to the conclusion that a distribution is a loan. In *Pope v FCT* [2014] AATA 532, a clause in the trust deed stated that, for a beneficiary who is not under a legal disability, the payment application or setting aside of income of a financial year may be effectively made by setting the income aside to a separate account in the books of the trust in the name of the beneficiary, whereupon such monies would constitute a loan at call and would not bear interest unless the trustee and the beneficiary otherwise agree.
23. The distributions were included in the taxpayer’s (the beneficiary’s) assessable income. The beneficiary later decided the trust was not going to be able to pay and claimed deductions for bad debts in relation to the distributions. The AAT held that there had been a distribution to the taxpayer in terms of the trust deed, and the debt written off had an entirely different character from the distributions included in the taxpayer’s assessable income.
24. In this case it was the particular provision in the trust deed which led to the conclusion that the distribution was a loan. The case serves to show the relevance of the terms of the trust deed.



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