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WEEKLY COMMENT: FRIDAY 24 MAY 2024

1. The *Taxation (Annual Rates for 2023-24, Multinational Tax, and Remedial Matters) Act 2024* (the “Multinational Tax Amendment Act 2024”), with a date of assent of 28 March 2024, contains a number of major amendments. This week, I continue looking at the changes to the trust taxation rules.

Corporate beneficiary rule

2. New s HC 38 applies for the 2024-25 and later income years. It concerns the beneficiary income of certain close companies. Section HC 38(1) states that the section applies when a close company derives an amount of beneficiary income from a trust in an income year, and a voting or market value interest in the close company is held, directly or indirectly, by one or more of:
 - (a) A settlor of the trust;
 - (b) The trustees of the trust;
 - (c) A person for whom a settlor of the trust has natural love and affection;
 - (d) The trustees of another trust, if a settlor of the trust has natural love and affection for a settlor or beneficiary of the other trust.
3. When s HC 38 applies, the beneficiary income of the close company is excluded income under s CX 58B, and is treated as trustee income and is taxed at the 39% rate specified in Schedule 1, Part A, Clause 3.
4. Inland Revenue notes, in the Special report: 39% trustee tax rate issued in April 2024 (the “39% rate SR”), that such beneficiary income amounts are also treated as trustee income for the purposes of determining who pays the relevant tax, and who provides the return of income.
5. Inland Revenue notes, in the 39% rate SR, that:
 - (a) The corporate beneficiary rule is meant to stop trusts from using companies to shelter income from the 39% trustee tax rate;
 - (b) If the trustees of the trust making the distribution also own shares in the corporate beneficiary (in their capacity as trustees), the income allocation achieves nothing: the income effectively remains within the trust;

- (c) The principal, or in many cases the only, effect of the allocation is to ensure that the income is taxed at 28% rather than the trustee tax rate;
 - (d) While a subsequent distribution of the income by the company to the trust will be taxable as a dividend (with imputation credits attached), such a distribution may never be made;
 - (e) Similar concerns arise if the shareholder of the corporate beneficiary is the settlor of the trust or a related trust.
6. The rule applies to the beneficiary income of a “close company”, which is defined in s YA 1 as:
- (a) Meaning, at any time, a company where there are 5 or fewer natural persons or trustees whose total voting interests (or, if a market value circumstance exists at the time, whose total market value interests) in the company is more than 50%, treating all natural persons associated at the time as 1 person;
 - (b) Excluding a special corporate entity (defined in s YA 1 as public and local authorities, State enterprises and other statutory bodies and life insurance providers).
7. The rule applies if any of the persons referred to in paragraph 2 above have any direct or indirect voting or market value interest in the close company. It is not necessary that such persons themselves have a more than 50% interest in the company.
8. Inland Revenue notes in the 39% rate SR that whether a person has natural love and affection for another person is subjective and can only be considered on a case-by-case basis. The meaning of natural love and affection was discussed in QB 20/02 Income tax – Natural love and affection exception to debt remission income for look-through company *Tax Information Bulletin* Vol. 32, No. 7, August 2020, in which Inland Revenue stated, citing several case law references, that:
- (a) Natural love and affection is not defined in the Act, however, it will often arise in the context of domestic or family relationships;
 - (b) Natural love and affection will most commonly occur between immediate and extended family members, as well as de-facto partners;
 - (c) It can also exist between close friends, such as life-long friends;
 - (d) The Commissioner will generally accept that there is natural love and affection between family members and close friends.
9. Inland Revenue also noted, in the 39% rate SR, that the corporate beneficiary rule also applies in situations where the close company is owned by the trustees of a different trust than the one paying the beneficiary income, because it is not possible to have natural love and affection for trustees (even if those trustees are natural persons).
10. A new s CD 44(7)(dc) includes as a capital gain amount “an amount derived by the company that is subject to section HC 38(3)”. Inland Revenue notes in the 39% rate SR that:
- (a) This means that the available capital distribution amount will be increased on liquidation of the company so that the income subject to the corporate beneficiary rule is not subject to tax again if it is distributed to the shareholders on liquidation;

- (b) For most companies, capital gains cannot be distributed 'tax-free' to shareholders until liquidation, so any distribution (other than on liquidation) of corporate beneficiary income by the company will be subject to the ordinary dividend rules and subject to tax in the shareholders' hands.

11. Consistent with the treatment of minor beneficiary income in corresponding sections CX 58 and LE 4:

- (a) As noted in paragraph 3 above, new s CX 58B provides that beneficiary income subject to the corporate beneficiary rule is excluded income in the hands of the corporate beneficiary; and
- (b) New s LE 4B provides that the trustees can use tax credits to satisfy the tax liability on beneficiary income subject to the corporate beneficiary rule.

12. Section HC 38:

(a) Overrides:

- (i) Section HC 5 (which allocates income derived by a trustee to either beneficiary income or trustee income);
- (ii) Section HC 22 (which permits tax losses to be used to reduce taxable distributions from non-complying trusts);
- (iii) Section HC 23 (which deems beneficiary income to be derived on the first day of NZ tax residence when a beneficiary has been temporarily non-resident for less than 5 years); and
- (iv) Section HC 32 (which makes the trustee an agent of a beneficiary for the purpose of satisfying the tax liability of the beneficiary on their beneficiary income and taxable distributions derived).

(b) Is overridden by s CW 10 (Dividend within NZ wholly-owned group).

13. In relation to the precedence of the inter-corporate dividend exemption in s CW 10, Inland Revenue notes, in the 39% rate SR, that:

- (a) The inter-corporate dividend exemption provides that a dividend is exempt income if it is paid between NZ resident companies within the same wholly-owned group;
- (b) If a trustee derives an amount of income that is of a particular character in the hands of the trustee, the income will retain this character in the hands of the beneficiary when the amount becomes beneficiary income;
- (c) This means that if a trustee earns dividend income and distributes that income as beneficiary income, it will retain its character as dividend income for the beneficiary;
- (d) If imputation credits and/or RWT were attached to the dividend by the paying company, then a credit will arise in the imputation credit account of the recipient company.

14. In other words, a distribution of dividend income as beneficiary income to a close company that is in the same wholly-owned group as the company that paid the dividend will remain exempt income to the company receiving the beneficiary distribution and such income will

not be subject to the 39% tax rate as deemed trustee income under the corporate beneficiary rule.

15. The corporate beneficiary rule does not apply, under s HC 38(2), to a close company that is a:
 - (a) Maori authority;
 - (b) Tax charity;
 - (c) Securitisation trust beneficiary.
16. In relation to the latter exclusion for a close company, a new definition of a “securitisation trust beneficiary” has been inserted into s YA 1 meaning “a beneficiary of a securitisation trust”.
17. A new definition of a “securitisation trust” has been inserted into s YA 1, meaning, for an income year, a trust that, from the establishment of the trust to the end of the relevant income year, only has one beneficiary and that beneficiary is a company, and at all times during the income year:
 - (a) Operates to do 1 or more of the following:
 - (i) Guarantee liabilities of a financial institution that transferred some or all of their assets to the trust;
 - (ii) Guarantee liabilities of a company, incorporated in and resident in New Zealand, that is a member of a wholly-owned group of companies that includes the financial institution that transferred their assets to the trust;
 - (iii) Raise funds by issuing securities backed by its assets;
 - (iv) Raise funds by borrowing money backed by its assets; and
 - (b) Has interests in assets for the sole purpose of carrying out the trust’s operations as described above in paragraph (a); and
 - (c) Receives only funds that:
 - (i) Are used to acquire assets as described in paragraph (b);
 - (ii) Are derived from assets described in paragraph (b);
 - (iii) Are incidental to the trust’s sole purpose described in paragraph (b); and
 - (d) Derives no exempt income; and
 - (e) Is a New Zealand resident; and
 - (f) Meets at least one of the following requirements:
 - (i) The beneficiary of the trust is a lending person; and/or
 - (ii) The trust has its assets included in financial statements that are prepared using IFRSs.

18. A new definition of “lending person” has been inserted in s YA 1, meaning a person:

- (a) Whose main business activity is lending funds or leasing personal property to persons who are not associated with the person; or
- (b) Who is a member of a group whose main business activity is lending funds or leasing personal property to persons who are not associated with any member of the group.

19. Inland Revenue notes in the 39% rate SR that:

- (a) The exclusion from the corporate beneficiary rule for a close company that is a securitisation trust beneficiary ensures that the rule does not impact the use of trusts in the securitisation industry;
- (b) The definition of a securitisation trust is partially based on the existing definition of “debt funding special purpose vehicle” (DF SPV) in s YA 1, with some modifications to recognise that the DF SPV definition does not capture all relevant trusts in the securitisation industry;
- (c) A securitisation trust is required to have only one beneficiary at any point in time, but this does not necessarily need to be the same company throughout the trust’s existence;
- (d) Unlike the DF SPV definition, the securitisation trust definition does not require all of the trust’s assets to be treated as assets of its originators, recognising that a securitisation trust may not necessarily be consolidated with the originator for financial reporting purposes;
- (e) The requirement for a securitisation trust is required to either have a “lending person” as its beneficiary or have its assets included in financial statements that are prepared using IFRSs ensures that the exclusion is targeted towards the securitisation industry and not available to any trust established for the sole purpose of raising funds by borrowing money backed by its assets, for example.



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