

Tax Talk

OCTOBER | 2008

Complying trusts versus non-complying trusts: Case Y25

In addition to the points made in our separate article, Case Y25 is significant for another reason. It confirms that trusts established prior to 1988 by a New Zealand settlor with a non resident trustee continue to be bedevilled by a 45% tax rate on ultimate distribution. Furthermore, these trusts (unless they made an election to become a qualifying trust by no later than 31 March 1989) have no means to manage themselves into a better tax position.

Prior to the 1988 reforms, trusts established by New Zealand settlors with non-resident trustees enjoyed exclusion from New Zealand tax on their foreign sourced income. They were able to make tax free distributions to New Zealand beneficiaries from that income, provided the distribution was made no more than 6 months after the end of the income year in which the income was derived by the trustee.

The 1988 reforms changed all this by exposing the distributions to the New Zealand beneficiaries to a 45% tax rate unless the trust elected to become a qualifying trust by 31 March 1989. Trusts for which no such election was made were sent to purgatory with no means of returning.

This position was confirmed in Case Y25 by the Taxation Review Authority (TRA). In this Case, the trustees in question had failed to make the requisite May 1989 election. They sought to elect into the qualifying (now complying) trust regime some years later by making a back payment for arrears of taxes which would have been payable had the trust been a qualifying trust from the outset.

The IRD denied the trust qualifying trust status and this was upheld by the TRA. Whilst technically correct, in our view, this result is nothing short of perverse. We hold this view

because the trust in question was categorised as non-complying, yet at no stage had it failed to comply with its New Zealand tax obligations. Expanding on that, the trust was denied qualifying trust status because it had not at all times paid New Zealand tax on its income. The perversity is that the only reason the trust did not pay New Zealand tax on its income (being the foreign sourced income) is because prior to the 1988 law changes it was not required to.

It seems rather harsh that a trust might be treated as non-complying (with no possible means of remedying that) in circumstances where it has been compliant at all times and its characterisation as non-complying is merely the result of law changes which are retrospective in their effect. These law changes would have been far more palatable if they had carved out the pre-1988 period and treated trusts such as these, as having complied during that period. Instead they were given until 31 May 1989 to elect into the qualifying trust regime. As Case Y25 illustrates, trusts that failed to make that election remain forever imperilled by a 45% tax rate on distributions to New Zealand beneficiaries.

In some cases, this higher than usual tax rate is justified by the deferral of any New Zealand tax liability that non-complying trusts enjoy as a consequence of their non-New Zealand

income only becoming liable to New Zealand tax on distribution. Whether this justifies taxing distributions of capital gains by these trusts in addition to distributions of income is another matter. In any event, the trust in question in Case Y25 did not even enjoy this advantage. Its settlors were treated as having made on-going settlements by virtue of their interest free loans to the trust. This factor rendered the trust a New Zealand resident as a result of the 1988

law changes and liable to New Zealand tax on its worldwide income in any event.

In light of this Case it may be timely to review your trust and the steps you can take to improve your position. If you would like us to assist with this we would be more than happy to do so.

Want to know more?

If you would like more information on this Case, or assistance in reviewing your trust and the steps you may be able to take to improve your position, contact one of our experts.

Peter Speakman

Partner

(09) 918 6515

peter.speakman@kensingtonswan.com

Tony Lines

Partner

(04) 498 0805

tony.lines@kensingtonswan.com