Trusts: The Danger of Accumulating Income

Tax planning for a trust will have failed where the trust has become a non-complying trust (**NCT**). That is because distributions from a NCT are taxed at 45% in the hands of a beneficiary unless an exception applies.

What are the exceptions? The main exceptions are where and to the extent that the distribution is made out of the trust corpus and where it is beneficiary income (ie income derived by the trustees that is paid out to beneficiaries in the same year it is derived).

The unfortunate aspect of these rules is that it is so terribly easy for a trust to lose its complying trust status and become a NCT. This will happen for instance where the trustees derive non-resident passive income and the trustees accumulate that income in the trust rather than paying it out as beneficiary income. Non-resident passive income for the trust will arise whenever the trust derives interest, dividends or royalties sourced in New Zealand and the trustees are non-resident.

Loss of complying trust status might also occur where the trust is established by a New Zealand resident settlor and the settlor departs overseas (losing his or her NZ residence). Inevitably, the settlor will have established the trust with himself or herself as a trustee along with at least one other NZ resident trustee. The settlor's departure for overseas shores will result in lost complying trust status for the trust where that other trustee stays in New Zealand and the trust derives foreign sourced income, say interest on a bank deposit in the country where the settlor now resides. These simple circumstances will cause the trust to lose complying trust status wherever the trustees retain the foreign sourced income in the trust rather than paying it out as beneficiary income.

It is a shame that this is the result because it is such a common occurrence, it entails no mischief whatsoever and it carries such a harsh penalty.

Take for example anyone, lets call him Joe, who has grown up in New Zealand and has established a family trust with himself and his accountant, lets call him Craig, as trustees. Joe decides to go and live in London for a while, perhaps because he is a banker and money making opportunities are strong there. His children, now grown up, remain in New Zealand. Joe has, while in New Zealand, conscientiously grown the assets of the trust, mainly by accumulating income from trust assets, and retaining them as part of the trust fund.

Upon arriving in London, Joe continues to provide for his children via his family trust. He chooses to open a bank account in the UK in the name of the trust, say with moneys funded from his UK salary. The bank pays interest on the deposit and, voila, Joe's trust will have become a NCT. That is because the trust now has foreign sourced income, that income is derived by a NZ resident trustee, namely Craig, the accountant who remains as trustee and the income is exempt for Craig by virtue of section CW54.

What is the problem with Joe's trust having become a NCT? The problem is that when the trustees choose to make a distribution to the beneficiaries (Joe's children for example) they will be taxed on the distribution at 45%. This will apply to all accumulated income whether that income was accumulated while Joe was in NZ or while he lived in London. It will also apply regardless of whether the accumulated income has already been taxed, as inevitably, other than for capital gains, it will have been either in NZ or the UK.

How is this fair or appropriate? It isn’t. Moreover, it is nonsensical. What can Joe do about this? Very little. His only viable option is to make an election under section HC33 to restore the trust's complying trust status. This will only be effective, however, where the election is made within the time frame for filing the trust's income tax return for the year in which the offending (foreign sourced) income is derived. Broadly, this is 12 months. If out of time to make the election, there are no solutions.

Might it make a difference if one (or more) of Joe's children leaves NZ and becomes a non-NZ resident (leaving NZ for the bright lights of Wall Street or Shanghai, for example)? Yes and no. The answer is yes where the distribution comprises a capital gain that is not sourced from NZ (newly inserted section HC15(5) establishes this). The answer is no where the distribution is either of a NZ sourced capital gain or is of income.

Relevant also to this analysis is the temporary absence rule in section HC23. By that section, a distribution will be treated as having been made to a person who is a NZ resident, regardless of that person's absence from NZ where that absence is for 5 years or less.

I had hoped that recent taxation of trust remedials may have provided redress for this situation. Unfortunately they did not. Consequently, there is a clear need to be very careful in using trusts whenever the settlor comes or goes from NZ. Perhaps the easiest solution is for trustees not to accumulate income at all.