# ANTI-AVOIDANCE AND DISTRIBUTIONS OF BENEFICIARY INCOME FROM A DISCRETIONARY TRUST

## QB 15/11 – Income tax – scenarios on tax avoidance

This Question We've Been Asked (QWBA) issued by the IRD recently discusses the application of the general anti- avoidance provision of section BG 1 of the Income Tax Act 2007 where trustees of a discretionary trust take into account the tax position of the beneficiaries when making decisions about distributions of beneficiary income.

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## Allocation of income in a discretionary trust – the scenario

The QWBA discusses a scenario where trustees of a trust pay or vest income in an income year to a single beneficiary and that beneficiary is either:

- An individual adult beneficiary who is taxed on that beneficiary income at the lowest marginal tax rate, or
- A corporate beneficiary (that may or may not be solvent) with total tax losses available equal to, or greater than, the beneficiary income, or
- A corporate beneficiary where the beneficiary income is a dividend from a foreign company and exempt income of the beneficiary under sCW9.

In the scenario other relevant facts are:

- The trust was validly established and making these distributions complies with the trust deed and trustee obligations about distributing income to beneficiaries.
- The trust deed does not **require** the trustees to distribute all or any of the income derived each year.
- The trustees have the discretion to choose which beneficiaries receive trust property.
- All beneficiaries are existing trust beneficiaries and NZ tax residents.
- The trust is an ordinary NZ domestic trust with NZ resident settlors and trustees.

## The Commissioner's view of the tax position here

Absent other distinguishing facts the Commissioner takes the view that the distributions contemplated here would not be a tax avoidance arrangement.

### The objectives and tax effects of such arrangements

The view taken is that the objective of these arrangements is to vest or pay income to a beneficiary taking into account their tax position.

The tax effect of the arrangements is that the income is not taxed at the trustee income rate of 33% and instead:

- The individual is taxed at their lower tax rate
- The loss company pays no tax because it has sufficient losses to offset against the income
- The dividend from the foreign company is not taxed because it retains its identity as foreign dividends that are the exempt income of the beneficiary.

## Beneficiary income – the Commissioner's position

For income to be beneficiary income it must 'vest absolutely in interest' or be 'paid' to a beneficiary within the required timeframes.

Income can 'vest absolutely in interest' in a beneficiary by:

- A provision of the trust deed vesting the income in the beneficiary without the need for a trustee resolution
- A trustee resolution vesting the income in that beneficiary
- A payment to, or credit to the account of, the beneficiary in the income year.

An amount is treated as 'paid' if it is actually paid, distributed, credited or dealt with in the beneficiary's interest or on their behalf. A declaration or trustee resolution allocating the income to a beneficiary is regarded as sufficient for it to be 'paid'.

So the Commissioner accepts that **income does not need to be physically paid to a beneficiary for it to be beneficiary income.**

## How do the rules relating to trusts interact with the allocation of beneficiary income?

Where trustees have discretion to choose who should receive trust property, they are entitled to prefer some beneficiaries over others. *Gartside v IRC* [1968] 1 All ER 121 establishes that beneficiaries are entitled to be considered for nomination as a beneficiary by the trustees but they have no proprietary interest in the trust property or its income.

Neither the Income Tax Act nor general trust law prevents trustees taking into account the tax consequences for a beneficiary if they were to receive income.

In the scenario described there is no suggestion that the beneficiaries are not, in reality, entitled under the trust or will not benefit from the distribution of income to them. These circumstances lead the Commissioner to the view that there is no tax avoidance arrangement even though there is a clear implication that the trustee's choices are significantly influenced by tax considerations.


## Factual variations to the Commissioner's scenario

Before we celebrate our right to allocate income as we please, note that different factual scenarios may result in a different tax outcome for trusts and beneficiaries. It will be important to consider whether it is arguable that, in commercial and economic reality, either:

- The beneficiary was not a beneficiary of the trust, or
- No distribution of income was made to the beneficiary.

If either of these circumstances are present then it may be argued that there was no distribution of income to a beneficiary from a commercial or economic perspective.

Carefully consider:

- The timing and pattern of the addition or removal of beneficiaries.
- How and when income is distributed – payments in cash, to bank accounts or to beneficiary current accounts.
- Anything indicating that, in commercial and economic reality, parties other than the trustees or beneficiaries to whom the income is allocated have the use and benefit of the income.
- Anything indicating that the commercial and economic reality is that there is no realistic prospect of the beneficiaries ever benefiting from the income allocated to them.

## Conclusion

The Commissioner's QWBA helpfully clarifies that in ordinary circumstances operating within a discretionary trust structure, trustees can allocate beneficiary income taking into account their tax circumstances. It also establishes that any circumstances that affect the commercial and economic reality of income allocations may affect their validity from a tax perspective.

Before final decisions are made about who should receive income within your trust structure, please consult with your tax advisers and trust consultants to ensure that your allocation of income will withstand scrutiny.



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