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

All legislative references are to the Income Tax Act 2007 unless otherwise stated. Relevant legislative provisions are reproduced in the Appendix to this Interpretation Statement.

Contents

Summary

1. This Interpretation Statement considers whether income deemed to arise under tax law, but not trust law, can give rise to beneficiary income for tax purposes. If deemed income does give rise to beneficiary income for tax purposes, then the deemed income will be taxed at the beneficiary's marginal tax rate.

2. In this Interpretation Statement, "deemed income" is income deemed to arise under a provision of the Income Tax Act 2007. Where deemed income arises, it generally does not result in an actual cash flow to the trust at all, or at least in that income year. This may cause mismatches between the tax law and trust law treatments. Examples of such deemed income include attributed controlled foreign company income, foreign investment fund income, and look-through company income based on an owner's effective look-through interest.

3. The term "beneficiary income" has a defined meaning in the Act. Under s HC 6, "beneficiary income" is income derived by a trustee that either vests absolutely in interest in a beneficiary, or has been paid to the beneficiary, within the time limits imposed by s HC 6(1B).

4. 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 income must not be future property or an expectancy. This means the beneficiary need not receive the amount vested at the time of vesting, but they must have an indefeasible right to that part of the trust property.

5. An amount will be “paid” if it is actually paid, distributed, credited or dealt with in the beneficiary’s interest. Case law establishes that a declaration or resolution by a trustee allocating income to a beneficiary will be sufficient for an amount to be “paid”.

6. Under the Act, there is no apparent impediment to deemed income giving rise to beneficiary income. However, s HC 6 requires an examination of what has happened within the trust. This is because s HC 6 requires income to actually vest absolutely in interest in, or be paid to, a beneficiary before it can be beneficiary income. The terms of the trust deed and general trust law bind how a trustee may deal with the trust fund. For an amount to vest absolutely in interest in, or be paid to, a beneficiary, the trust deed must provide for such vesting or payment, either by express provision in the trust deed or through appropriate powers of the trustee.

7. As well as having the power to do so, for an amount of income derived by a trustee to be beneficiary income, the amount must actually vest absolutely in interest in, or be paid to, the beneficiary. For an amount of trustee income to vest absolutely in interest in, or be paid to, a beneficiary as beneficiary income for tax purposes, it must be effective for trust law. This is true for all types of income derived by a trustee, not just deemed income.

8. The Commissioner considers that an amount of deemed income cannot itself be vested absolutely in interest in, or paid to, a beneficiary. This is because there is no actual income to vest or pay to a beneficiary. The income is only deemed to arise for tax purposes and does not exist for trust purposes. The trust must have an actual (non-deemed) amount in the trust fund available to be distributed that can be vested absolutely in interest in, or paid to, a beneficiary. Such an amount must actually vest absolutely in interest in, or be paid to, a beneficiary in a way that is effective for trust law. An actual cash payment does not necessarily have to be made to a beneficiary at the time of the vesting or payment. However, at the time of the vesting or payment, the trust must have sufficient amounts in the trust fund available to be distributed to that beneficiary or beneficiaries in accordance with the trust deed. This is because a trustee can only vest or pay amounts of the trust fund to beneficiaries in accordance with the terms of the trust deed.

9. When the trust law income of a trust is the same as or exceeds its tax law income in any income year, this will not pose any problems. Provided an equivalent amount of trust law income is actually vested absolutely in interest in, or paid to, a beneficiary, and that vesting or payment is effective for trust law, the deemed income will be beneficiary income for tax purposes and taxed at the beneficiary’s marginal tax rate.

10. However, when the tax law income of a trust exceeds its trust law income in any income year, it is not possible under trust law for the excess tax law income simply to be vested absolutely in interest in, or paid to, beneficiaries unless the trust deed expressly provides a way for this to happen. The Commissioner considers that deemed income will be beneficiary income only to the extent to which is it reflected by an actual amount vested absolutely in interest in, or paid to, a beneficiary by the trustee or under the terms of the trust deed. Whether this is possible will depend on the terms of the relevant

trust deed. In this situation, it will be necessary for a trustee to resolve that the actual amount from the trust fund is being treated as the vesting or payment of deemed income for tax purposes. If an actual amount from the trust fund is used to vest or pay the deemed income for tax purposes, the Commissioner considers that the amount of deemed income will meet the definition of "beneficiary income", and will be taxed at the beneficiary's marginal tax rate.

11. The examples at the end of this Interpretation Statement apply these principles to three types of trusts in a situation where the tax law income of a trust exceeds its trust law income in a particular income year:

- *The trust deed does not define income.* The tax law income and trust law income of a trust are different. Under the trust deed, the trustee can only vest absolutely in interest or pay income of the trust according to trust law concepts of capital and income. Therefore, trustees will not be able to vest absolutely in interest or pay an amount that equates to deemed income. The deemed income will be treated and taxed as trustee income. This would be the case in any income year.
- *The trust deed defines trust law income as income calculated for income tax purposes.* The tax law income and trust law income of a trust are the same. Under the trust deed, the trustees can vest absolutely in interest or pay income of the trust to beneficiaries according to tax law. To the extent that there are sufficient amounts available in the trust fund, trustees may vest or pay amounts that equate to deemed income. The deemed income will then give rise to beneficiary income.
- *The trust deed defines income using trust law concepts of capital and income, but the trustees have the power to distribute trust capital to income beneficiaries.* The tax law income and trust law income of a trust are different, but the trustees have the power to vest or pay amounts that are more than trust law income to income beneficiaries. To the extent the trustees actually vest absolutely in interest or pay amounts equating to deemed income, the deemed income will give rise to beneficiary income.

12. Therefore, deemed income is never of itself "beneficiary income", but by a combination of the relevant trust deed and the trustees' actions, deemed income can in some situations give rise to beneficiary income. However, any vesting or payment of deemed income must be effective for trust law to be beneficiary income for tax purposes. Where it is not vested absolutely in interest in, or paid to, a beneficiary, deemed income that is in excess of trust law income is taxed as trustee income. Trustees should, if uncertain, seek legal advice on whether, in a particular income year, their particular trust deed allows them to vest absolutely in interest or pay amounts from the trust fund equating to deemed income.

Introduction

13. This Interpretation Statement considers whether income deemed to arise under the Act can be beneficiary income under s HC 6. This issue arises most commonly when the income of a trust under tax law is different from the income of a trust under trust law. A divergence between tax law income and trust law income may occur because of the different rules that apply to each area of law. Trust law requires trustees to treat incomings and outgoings in a particular way, and that treatment is not necessarily aligned with the treatment of such incomings and outgoings under the tax rules.

14. In this Interpretation Statement, "deemed income" is income that arises only because of the provisions of the Act. The income has no necessary counterpart in terms of cash flow to a trust, or income for trust law purposes (although there may be a cash flow to another entity). Deemed income arises in several places under the Act, including under s CP 1 (which attributes income to an investor in a multi-rate portfolio investment entity), s CQ 1 (which provides that attributed controlled foreign company income of a person is income), s CQ 4 (which provides that foreign investment fund income of a person is income) and s CB 32B (which provides that look-through company income is income of an owner based on their effective look-through interest).

15. In addition, there are other types of income that arise under the Act that correspond to a cash flow, but nevertheless create a mismatch between tax law income and trust law income. Sometimes the cash flow may arise in a different income year than the year the trust is treated as deriving it. The financial arrangements rules in subpart EW may give rise to such timing mismatches. Some types of income correspond to cash flows to the trust, but those receipts might be characterised differently under trust law and tax law. For example, the rules in ss CB 6 to CB 15 may treat amounts derived on the disposal of land as income, while a trust may characterise those amounts as being on capital account. While the focus of this Interpretation Statement is on deemed income that does not necessarily correspond to a cash flow, the same reasoning could also apply to these other kinds of income that create a mismatch between tax law income and trust law income.

Analysis

16. The main issue in this Interpretation Statement is whether income that arises under tax law, but not under trust law, can be beneficiary income for tax purposes. The analysis in this Interpretation Statement considers this issue under the following main headings:

- Tax law (including consideration of the definition of "beneficiary income" in s HC 6 and the meaning of the terms "vests absolutely in interest in a beneficiary" and "paid");
- Trust law; and
- Application of the law.

17. Some practical examples are then set out at the end of the Interpretation Statement to illustrate the tax treatment of deemed income when the tax law income of a trust exceeds the trust law income of the trust under general trust law principles.

Tax law

18. To understand beneficiary income under tax law, it is useful to understand broadly how the trust rules in the Act apply. Under the Act, there are three types of trusts: complying trusts, foreign trusts, and non-complying trusts. This Interpretation Statement applies to the vesting or payment of income to beneficiaries by these three types of trusts. Trust income is dealt with in ss HC 5 to HC 7. Section HC 5 provides that an amount of income derived by a trustee of a trust is either trustee income or beneficiary income. Section HC 6 provides a definition of what is beneficiary income. (Section HC 6 is the key provision in determining whether deemed income can be beneficiary income and is discussed in detail below.) Section CV 13(a) provides that an amount derived by a person is income of the person if it is

beneficiary income to which s HC 6 applies. Section HC 7 provides that an amount of income derived by a trustee of a trust is trustee income to the extent to which it is not beneficiary income. Therefore, in a sense the default position is that income derived by trustees of a trust will be taxed to the trustees.

19. Section HC 5(2) provides that if a trustee is treated as having an amount of income in an income year under a provision in the Act and that amount is not derived under ordinary concepts, then the amount is treated as derived in the income year.

20. Complying trusts, foreign trusts and non-complying trusts can all vest or pay amounts to beneficiaries and, provided s HC 6 is satisfied, this will be beneficiary income for tax purposes. If a trust does vest or pay beneficiary income, then that income will be taxed at the beneficiary's marginal tax rate. For a complying trust, an amount vested in, or paid to, a beneficiary that is not beneficiary income will be exempt income to the beneficiary: s HC 20. This reflects the fact that the amount will already have been taxed as trustee income. If a non-complying or foreign trust makes a distribution to a beneficiary that is not beneficiary income under s HC 6, then that distribution may potentially be a taxable distribution (if it is not one of the other types of distributions listed in s HC 15(2) and s HC 15(4)).

21. The trustees are responsible for paying the tax on beneficiary income. Section HC 32(3) provides that, in the trustee's capacity as agent, the trustee must satisfy the income tax liability of the beneficiary for their beneficiary income and any taxable distributions derived by the beneficiary.

What is "beneficiary income"?

22. The focus of this Interpretation Statement is on whether tax law income that does not have a trust law counterpart can be beneficiary income for tax purposes. Certain requirements must be satisfied for an amount to be beneficiary income. Section HC 6(1) defines "beneficiary income":

> **HC 6 Beneficiary income**
>
> *Meaning*
>
> (1) An amount of income derived in an income year by a trustee of a trust is beneficiary income to the extent to which—
>
> (a) it vests absolutely in interest in a beneficiary of the trust in the income year; or
>
> (b) it is paid to a beneficiary of the trust in the income year or by the date after the end of the income year referred to in subsection (1B).

23. Section HC 6(1B) provides the date by which income must be allocated for the purposes of s HC 6(1)(b):

> *Date by which income must be allocated*
>
> (1B) The date referred to in subsection (1)(b) is the later of the following:
>
> (a) a date that falls within 6 months of the end of the income year; or
>
> (b) the earlier of—
>
> (i) the date on which the trustee files the return of income for the income year; or
>
> (ii) the date by which the trustee must file a return for the income year under section 37 of the Tax Administration Act 1994.

24. Section HC 6(1) refers to an amount of "income" derived by a trustee. "Income" is defined in s YA 1 to mean income of the person under s BD 1(1). Section BD 1(1) provides that an amount is income of a person if it is their

income under a provision in Part C of the Act. The significance of this is that the concept of income derived by a trustee in s HC 6 is a reference to the tax law income of the trustee and not the trust law measure of income of a trustee. Importantly, such tax law income of the trustee is beneficiary income only "to the extent to which" it is vested absolutely in interest in, or paid to, a beneficiary under s HC 6. As will be discussed below, the provisions of the trust deed bind a trustee as to what can be vested absolutely in interest in, or paid to, a beneficiary. Therefore, beneficiary income is fundamentally determined according to trust law.

25. The definition of beneficiary income provides for two specific exclusions: (a) an amount of income derived by a trustee of a trust in an income year in which the trust is a superannuation fund; and (b) an amount of income derived by a trustee that is income to which ss CC 3(2) and EW 50 (which relate to income that arises on the forgiveness of a debt) apply. This suggests that all other income derived by a trustee can potentially be beneficiary income for tax purposes. In addition, income that arises on the forgiveness of a debt, which could be considered a type of deemed income, is specifically excluded. The implication from this is that it might otherwise be trustee income or beneficiary income.

26. Therefore, s HC 6 does not, on its face, preclude other types of income from giving rise to beneficiary income, including amounts of deemed income. Section HC 5(2) would seem to also support this. As noted above, s HC 5(2) provides that if a trustee is treated as having an amount of income in an income year under a provision in the Act and that amount is not derived under ordinary concepts, then the amount is treated as derived in the income year. This subsection is essentially a timing provision for the derivation of income arising under the Act, but it also suggests that amounts of income that are not derived under ordinary concepts can potentially be trustee income. This, coupled with the fact that there are only two specific exclusions in the definition of beneficiary income (one being a kind of deemed income), suggests that other types of deemed income can potentially be beneficiary income.

27. However, it is also necessary to determine whether an amount of income derived by a trustee has been vested absolutely in interest in, or paid to, a beneficiary. This is a central requirement of beneficiary income under s HC 6. The Commissioner considers that s HC 6 requires an examination of what has occurred within a trust to determine whether an amount of income derived by a trustee has actually been vested absolutely in interest in, or paid to, a beneficiary. This is because s HC 6 is based on concepts of trust law, including "trustee", "beneficiary" and "vests absolutely in interest". Whether deemed income may be vested absolutely in interest in, or paid to, a beneficiary under general principles of trust law is discussed further below. However, the meaning of "vests absolutely in interest" and "paid" in s HC 6(1) must be determined first.

Section HC 6(1)(a): "vests absolutely in interest"

28. Section HC 6(1)(a) provides that an amount a trustee derives in an income year will be beneficiary income to the extent it vests absolutely in interest in a beneficiary. The gross income must not only "vest absolutely in interest in a beneficiary", but the vesting must occur "in the income year".

29. The phrase "vests absolutely in interest" is not defined in the Act. Vesting is a trust law concept. Therefore, trust law must be considered to determine the meaning of "vests absolutely in interest".

30. The words “vest” and “vested in interest” are defined in *Butterworths New Zealand Law Dictionary* (6th ed, LexisNexis, Wellington, 2005):

> **vest** 1. To deliver to a person the full possession of land, and so to clothe him or her with the legal estate therein. 2. To become a vested interest.
>
> **vested in interest** A phrase used to indicate a present fixed right of future enjoyment, as reversions, vested remainders, and other future interests which do not depend on a period or event uncertain. For an interest to be vested in interest the persons who are to take it must be ascertained and there must be no condition precedent other than the determination of the prior interest.

31. The glossary in N Kelly, C Kelly and G Kelly, *Garrow and Kelly Law of Trusts and Trustees* (6th edition, LexisNexis, Wellington, 2005) also defines “vesting” and “vested in interest”:

Vesting	When a person becomes absolutely entitled to the eventual ownership of certain property or a defined part of a fund, that ownership right is said to be vested. …
Vested in interest	A vested right to receive property at a future time.

32. Some guidance on the meaning of the term “vests absolutely in interest” can also be gained from considering cases on earlier trust provisions in the New Zealand tax legislation. The cases include *Doody v Commissioner of Taxes* [1941] NZLR 452 (SC), *Commissioner of Taxes v Johnson and Maeder* [1946] NZLR 446 (CA), *Blathwayt v CIR* (1973) 1 NZTC 61,112 (SC) and *CIR v Simpson* (1989) 11 NZTC 6,140 (CA).

33. These cases considered legislation where the relevant statutory test for an amount to be income of a beneficiary was that the beneficiary was “entitled in possession” to the income. The case law continues to be relevant because the test of “entitled in possession” was found to require that the income be vested absolutely in interest in the beneficiary and that the beneficiary be entitled to the receipt of the income. Accordingly, the discussion in those cases of what was required for something to be vested absolutely in interest (as a part of being “entitled in possession”) is still relevant to the interpretation of the words “vests absolutely in interest”.

34. It has been held in the context of New Zealand trust taxation legislation (in particular s 102(b) of the Land and Income Tax Act 1923) that “vested” means indefeasibly vested in the sense of finally and absolutely vested and not merely defeasibly vested: *Johnson and Maeder*. The use of the word “absolutely” makes it even clearer that income must vest indefeasibly in a beneficiary to satisfy the vests absolutely in interest requirement. In addition, where income is future property or an expectancy the vesting will not be effective until the income is received or receivable: *Garrow and Kelly Law of Trusts and Trustees,* from 45-47; see also *Hadlee and Sydney Bridge Nominees Ltd v CIR* (1989) 11 NZTC 6,155 (HC)).

35. In *Doody,* two infant beneficiaries were entitled to one third each of their father’s estate under the Administration Act 1908. During the income years in question, the administrators applied some of the infant beneficiaries’ entitlement for their maintenance and education. In relation to the beneficiaries’ entitlements that had not been applied for their benefit, the court accepted that the shares of the infant beneficiaries in the estate were indefeasibly vested. However, being infants, the beneficiaries could not demand receipt of their entitlements. Smith J said, at 457, that for a beneficiary to be “entitled in possession” they must be a person who has not only a right to the income that is absolutely vested but also be entitled to the actual receipt of that income under the terms of the trust during the income year in question.

36. The Court of Appeal in *Simpson* came to the same conclusion. In that case the Commissioner attempted to tax the taxpayer and his wife as discretionary beneficiaries under a trust. The trustees had resolved to appropriate income for a particular income year to the taxpayer's two infant children. The money was paid into the joint account of the taxpayer and his wife. Richardson J found that the money was paid to the taxpayer and his wife in a fiduciary capacity for the children and not in their own right as beneficiaries under the trust. The court accepted that the resolution of the trustees was validly passed and legally effective to confer on the infants an absolute and indefeasibly vested interest in the income for the year. That decided the issue in the case, but Richardson J went on to approve the earlier New Zealand authorities and expressed doubt that infant beneficiaries could be entitled in possession (which was the legislative requirement for income to be beneficiary income). Somers J also endorsed the earlier decisions of *Doody* and *Blathwayt*, while Wylie J expressed no view on this. The implication is that the income should instead have been taxed as trustee income because, although the income was vested absolutely, the infant beneficiaries were not entitled in possession.

37. In *Davidson and Duke v CIR* (1976) 2 NZTC 61,121 the court considered different ways in which a trustee could vest amounts in (or pay or apply amounts to) a beneficiary. In that case, the trustees signed a memorandum recording their decision that "income from the trust be allocated" to certain beneficiaries on the basis of a two-thirds share going to one of the children and a one-third share to the other. The court found that such an "allocation" was sufficient to vest the amounts in the beneficiaries.

38. The relevant legislation at the time referred to both "vest" and "pay or apply". Somers J did not differentiate between "vest" and "pay or apply" but concluded that trustee resolutions would be sufficient to "vest" or "pay or apply" income to beneficiaries if they used wording that:

- "allocated" amounts to beneficiaries;
- provided an amount "shall belong to" beneficiaries; or
- stated income "shall be disposed of … to be held for the credit of" beneficiaries.

39. In 1988, the legislation was changed. The test had been whether the beneficiary was "entitled in possession" to the income. This test was changed to the current test of "vests absolutely in interest". This was understood to be a widening of the test for "beneficiary income".

40. Therefore, "vests absolutely in interest" means a present fixed right of future enjoyment. This means that the beneficiary need not receive the amount vested at the time of vesting absolutely in interest, but they must have an indefeasible right to that part of the trust fund. For an amount of deemed income to be vested absolutely in interest in a beneficiary, the amount must be dealt with by a provision of the trust deed, the actions of the trustee, or both. Vesting absolutely in interest may occur because the trust deed specifies that income will be dealt with in a certain way. Alternatively, the trust deed may facilitate the vesting but not provide for it, so it will be vested only if the trustees take some action to vest it. This illustrates an important point: "deemed income" will not always give rise to beneficiary income. A provision of the trust deed, the actions of the trustees, or both, must grant a fixed right of future enjoyment to an amount of deemed income for the deemed income to give rise to beneficiary income under s HC 6(1)(a). Where the deemed income is not beneficiary income for tax purposes, it is trustee income.

41. Based on the cases discussed above, the mechanisms by which an amount can vest absolutely in interest in a beneficiary include:

- a provision of the trust deed that vests the income in the beneficiaries;
- a resolution of the trustees vesting the income in the beneficiaries;
- a payment to, or crediting to an account of, the beneficiaries in the income year (or, as in *Simpson*, even a payment into the beneficiaries' parents' bank account).

Section HC 6(1)(b): "paid to a beneficiary"

42. This part of the analysis considers the meaning of "paid" in s HC 6(1)(b). Section HC 6(1)(b) provides that an amount a trustee derives in an income year will be beneficiary income to the extent it is "paid" to a beneficiary. The word "paid" is not defined in the Act. However, the word "pay" is defined in s YA 1 and provides (as relevant):

> **pay,—**
>
> (a) for an amount and a person, includes—
>
> (i) to distribute the amount to them:
>
> (ii) to credit them for the amount:
>
> (iii) to deal with the amount in their interest or on their behalf, in some other way:

43. Section 32 of the Interpretation Act 1999 makes it clear that all parts of speech and grammatical forms of a word are to have the same meaning throughout the Income Tax Act, unless the context takes a different meaning (see also *Tax Information Bulletin* Vol 20, No 2 (March 2008), which provides commentary on the rewrite of parts M to Z of the Income Tax Act 2007). Therefore, the definition of "pay" in s YA 1 is relevant in determining the meaning of "paid" in s HC 6(1)(b).

44. Before the Income Tax Act 2007, the definition of "beneficiary income" was different to the current definition in s HC 6. In particular, the definition of "beneficiary income" in s OB 1 of the Income Tax Act 2004 included an amount derived by a trustee to the extent to which the trustee "pays or applies it to or for the benefit of the beneficiary".

45. The new definition of "beneficiary income" removed two parts of the old definition relating to the word "applies":

- the reference to the trustee applying income "to" a beneficiary;
- the reference to the trustee applying income "for the benefit of" the beneficiary.

Section HC 6(1)(b) now applies to an amount to the extent to which "it is paid to a beneficiary of the trust in the income year or by the date after the end of the income year referred to in subsection (1B)".

46. The definition of "pay" in s YA 1 is noted in schedule 51 of the Act ("Identified changes in legislation"), but the annotation is as follows:

> The provision is simplified and structured so it is to apply generally for the Act. This is consistent with the objectives of plain accessible legislation and is thought highly unlikely to result in any material change in law. However, as this change in drafting could conceivably result in a change in outcome in some circumstances, the change should be identified for readers.

Schedule 51 makes no reference to s HC 6. It would seem this change was intended to simplify the definition of "beneficiary income" by relying on the definition of “pay” in s YA 1, rather than being a change to the definition of “beneficiary income”.

47. The definition of “beneficiary income” in s HC 6 no longer refers to a trustee applying income to or for a beneficiary. In addition, the new definition of “pay” does not use the word “apply”. The new definition now includes, in subparas (ii) and (iii), crediting a person for an amount, or dealing with an amount in a person’s interest or on their behalf. The question that arises is whether the definition of “pay” is wide enough to encompass concepts previously covered by the word “apply”. It is therefore helpful to look at case law on “apply” to determine whether that concept is covered by the new definition of “pay” in s YA 1.

48. The leading New Zealand decision on “paid or applied” is *CIR v Ward* [1970] NZLR 1 (CA). This was a majority decision of the Court of Appeal with North P and McCarthy J in the majority, and Turner J dissenting. The facts of the case involved a trust deed under which property was held on trust for four children. The children were entitled to the trust property (including capital and income) when they reached the age of 21. For the year ended 31 March 1963, the trustee made a declaration that she held the trust income in stated amounts for each of the four infant beneficiaries. The declaration was made before the end of the income year, but no entries were made in the trust accounts until after the end of the income year. The Commissioner assessed the trustee with income tax on the whole of the income of the trust, on the basis that the declaration was inadequate to transfer the income to the beneficiaries. The majority of the Court of Appeal found that the income had been applied to the beneficiaries.

49. The majority concluded that once the trustee had made the declaration for the children, who until then merely had a contingent interest, the children became absolutely entitled to the sums allotted to them. The trustee’s declaration was an application of income. The majority also considered that when the trustee made her declaration it was a matter for her to determine what income was presently available. There was nothing before the court to justify the conclusion that the income was not presently available. The declaration by the trustee amounted to an application.

50. The decision in *Ward* establishes that a trustee will be able to apply a presently available amount to a beneficiary simply by way of a declaration. The effect of *Ward* is that it is not necessary for that declaration to be reflected in the books of the trust in the relevant period, nor is an actual payment of the amount to the beneficiary or beneficiaries required at the time of the application.

51. Subparagraph (i) of the definition of “pay” refers to the ordinary meaning of “pay”: namely, to distribute (cash or other consideration) or to otherwise transfer funds to a person. However, subparas (ii) and (iii) of the definition appear to cover other situations that were previously covered by the word “applies”. Subparagraphs (ii) and (iii) apply to crediting the beneficiary for the amount, and dealing with the amount in their interest or on their behalf in some other way. The situation in *Ward,* where a declaration by a trustee amounted to an application, would fall within subparas (ii) or (iii).

52. In addition, a recent case supports the view that the expanded definition of “pay” is broad enough to cover the concepts previously covered by the word “applies”. The case is the High Court decision of Clifford J in *CIR v Albany Food Warehouse* (2009) 24 NZTC 23,532. The case concerned the timing of a dividend payment. Section ME 5(1)(a) of the Income Tax Act 1994 provided there would be a debit to the company’s imputation credit account

for imputation credits attached to a dividend "paid" by the company. Section OB 1 of the Income Tax Act 1994 defined "paid" for the imputation rules to include any amount distributed, credited, or dealt with in the interest of, or on behalf of, a person. On 6 June 2001, the directors of the company declared a fully imputed dividend. The dividend was resolved by the directors to be credited to the relevant shareholders' current accounts, with payment from those accounts conditional on the shareholders agreeing to subordinate their claims to the company's creditors generally and only to be made "as and when finance permits". The shareholders agreed to those terms that day. Later that day, there was a change in shareholding in the company. This change breached shareholder continuity.

53. If the dividend was paid before the breach of continuity, the company would be able to attach those credits to the dividend payment. However, if the dividend was not paid before the breach, the credits would be forfeited and any eventual dividend would potentially have no credits available to be attached. Clifford J concluded (at [27] and [28]):

> [27] I have little difficulty in concluding that the directors' resolution provided for the "crediting" of the dividend to the shareholders' current accounts within the meaning of the word "credited" as it appears in s OB 1 in para (g) of the extended definition of "paid".
>
> [28] In my judgment, and as a matter of general company law, the effect of the directors' resolution, albeit together with the shareholders' resolution agreeing to the subordination terms, was that funds that were previously available to the directors, in their discretion to apply for the purposes of the respondent's business generally, were placed outside the directors' control and became debts due and owing to the shareholders and able to be sued for as such if not paid on their terms, and proved for in liquidation. This substantive change is reflected in the accounting treatment, whereby amounts that had previously stood to the credit of the shareholders' funds of the respondent, were re-categorised by the dividend resolution and became credits in the shareholders' current accounts. As the respondent in my view correctly submitted, the declaration and subsequent crediting of the dividend amount to the shareholders' current accounts therefore constitute a "crediting".

54. The similarities between the resolution in *Albany Food Warehouse* and the declaration in *Ward* suggest that the use of the term "applies" and the extended definition of "paid" (or "pay" in the current legislation) lead to a similar result. As such, the removal of the word "applies" from the definition of "beneficiary income" and its absence from the definition of "pay" do not alter the scope of what is "beneficiary income" under the 2007 Act.

55. Given the decision in *Albany Food Warehouse*, and that schedule 51 suggests there has been no material change in the law, the Commissioner considers that the revisions to s HC 6 and the definition of "beneficiary income", and the reliance on the meaning of "pay" in s YA 1, are not intended to change what is "beneficiary income". Therefore, the previous law and commentary on the meaning of "beneficiary income" (including the case law on the meaning of "applies") are still relevant.

Effect of the deeming provisions

56. Whether there are any limits on the effect of a provision that deems an amount of income to arise must also be considered. In particular, whether the deeming of income is limited so that it can be taxed only as trustee income, or whether the effect is broader so that deemed income could potentially be beneficiary income.

57. In F A R Bennion, *Bennion on Statutory Interpretation* (5th ed, LexisNexis, London, 2008) at 950 the author states that "[t]he intention of a deeming

provision, in laying down a hypothesis, is that the hypothesis shall be carried as far as necessary to achieve the legislative purpose, but no further". At 1,004 the author notes that "[w]henever an Act sets up some fiction the courts are astute to limit the scope of its artificial effect. They are particularly concerned to ensure that it does not create harm in ways outside the intended purview of the Act". Both of these comments make it clear that deeming provisions in an Act need to be given effect to, but should not be construed any more widely than absolutely necessary. In a tax context this will often mean that a deeming provision will only have effect within the tax legislation and will not have wider consequences for other areas of law (such as company law or trust law).

58. This Interpretation Statement is concerned with whether deemed income can be beneficiary income. As deemed income can be income of a trustee as a taxpayer, the Commissioner considers that this deeming must take effect at least for a trustee in all relevant contexts in the Act. A trustee cannot argue that the deeming does not apply for all of the trustee's various responsibilities under the Act. The question then is whether, in a deemed income context, there is any indication in the Act that the portion of a trustee's income that relates to deemed income should not be able to be beneficiary income. There does not appear to be any obvious indications of this. There are no clear policy indications or principles that would lead to such a rule. Indeed, as already noted, arguably s HC 5(2) suggests otherwise.

59. Therefore, under the Act, the position is that deemed income can potentially be beneficiary income provided it is vested absolutely in interest in, or paid to, a beneficiary. However, the income deemed to arise under the Act does not exist in trust law. This is because the deeming provisions only operate within the context of tax law.

Summary of New Zealand tax law

60. The discussion of New Zealand tax law above establishes that for income derived by a trustee to be beneficiary income either it must be vested absolutely in interest in the beneficiary within the income year it was derived, or it must be "paid" (in the broad sense of that term) to the beneficiary in the income year or within the time limits in s HC 6(1B).

61. The notion of vesting absolutely in interest in s HC 6(1)(a) is that the amount derived is indefeasibly vested in the beneficiary. The beneficiary obtains an immediate right of future possession of the income. The income must not be future property or an expectancy. An amount of income is "paid" under s HC 6(1)(b) if it is actually paid, distributed, credited or dealt with in the beneficiary's interest. The *Ward* case establishes that a declaration of trust allocating income to a beneficiary is sufficient. Based on the decision in *Davidson and Duke,* an application of income can occur even if a specific sum is not allocated to a beneficiary, as long as there is some mechanism to apply the income.

62. In practice, there may be some overlap between the concept of "vest absolutely in interest" at common law and the definition of "pay" in s YA 1, particularly since neither concept necessarily requires an immediate payment of an amount in order to be effective.

63. Section HC 6(1) does not make a distinction between different types of income derived by a trustee (except for the two exclusions in s HC 6(2)). Therefore, nothing under the Act appears to prevent deemed income from giving rise to beneficiary income for tax purposes. However, s HC 6 requires

an examination of what has happened in the trust. This is because s HC 6 requires income to vest absolutely in interest in, or be paid to, a beneficiary before it can be beneficiary income. A trustee is bound by the terms of the trust deed and general trust law as to how they may deal with the trust fund. For an amount from the trust fund to vest absolutely in interest in, or be paid to, a beneficiary, the trust deed must provide for such vesting or payment, or the trustee must have a power to do so under the trust deed. This is discussed further below.

64. Finally, income deemed to arise under the Act does not exist in trust law. This is because the deeming provisions operate only within the context of tax law. Whether deemed income can vest absolutely in interest in, or be paid to, a beneficiary, as a matter of trust law, will now be discussed.

Trust law

65. Trust law must be considered to understand when amounts derived by a trustee may be beneficiary income. This is because trustees are bound to adhere to the terms of the trust deed when they make distributions from the trust fund to beneficiaries. This applies to amounts vested absolutely in interest in or paid to beneficiaries under s HC 6, whether deemed income or not.

66. One of the leading New Zealand texts on trust law is *Garrow and Kelly Law of Trusts and Trustees*. This text explains the nature of a trust as follows (at 3):

> 1.1.1 A trust is an equitable obligation under which a person (the "trustee") having control of property is bound to deal with that property either:
>
> (a) For the benefit of definite persons (of whom that trustee may be one) and any one of whom may enforce the obligation; or
>
> (b) For some object or purpose permitted by law.

67. Amounts that are deemed income exist only for tax law purposes and do not result in an actual cash flow or an accretion to the trust in the relevant income year, if at all. This is because the deeming provisions in the Act only operate within tax law. The deeming provisions in the Act do not cause the deemed income to exist for trust law purposes. Therefore, such an amount could not itself be distributed to a beneficiary as a matter of trust law.

68. The trust law distinction between capital and income is particularly relevant in determining whether deemed income can be beneficiary income. Traditionally, the need to classify capital and income under trust law is one of the fundamental fiduciary duties of a trustee and this continues to be the case for many modern trusts. There are legal impediments to the trustees treating the amounts differently to accord with a tax treatment.

69. Chapter 22 of *Law of Trusts and Trustees* is entitled "Capital and Income" and refers to the distinction between these two concepts. This distinction is important where a trust has both capital and income beneficiaries. An example is a conventional life estate with a remainder interest – when assets are held on trust to pay the income to "A while A is alive and after A has died to transfer the assets to B".

70. The authors state that the basic duty of a trustee (which is a fiduciary duty) is to ensure that each beneficiary receives everything he or she is entitled to (at 22.1.3). As a result, trustees need to identify carefully what is to be treated as capital and income and ensure the appropriate beneficiaries receive such amounts. The authors observe that the distinction between capital and income is relevant only to the extent the trust deed requires this.

Ultimately it is the trust deed that indicates what each beneficiary is entitled to receive. The trust deed may define what is to be treated as capital and what is income. In the absence of any such indication in the trust deed the courts must apply the long-established trust law principles distinguishing capital and income.

71. At 22.1.4 and 22.1.5, the authors comment that capital and income mean different things for income tax, accounting and trust law. At 22.1.6 they state that for trust law purposes trustees cannot simply rely on tax law, generally accepted accounting principles or international financial reporting standards.

72. The authors say a trust may provide that a life interest beneficiary is entitled to the income of the trust, and the capital reverts to the remainder interest in the estate or the trust. Therefore, only income as determined by trust law can be distributed to an income beneficiary. Any amount greater than this received by the trust must be treated as a capital sum attributable to the capital beneficiary.

73. At 22.2 the authors discuss two cases that demonstrate the importance of distinguishing correctly between capital and income: *Wong v Burt* [2005] 1 NZLR 91 (CA) and *Wendt v Orr* [2004] 6 ITELR 989; [2004] WASC 28. In *Wong*, over $300,000 was wrongly paid to the income beneficiary in 1989 and the capital beneficiary plaintiffs were able to recover that sum 14 years later.

74. Not all trusts provide separately for capital and income beneficiaries. At 22.1.6 the authors state that life interest provisions in wills are less common than they were in the past. Where funds do need to be held on trust for a beneficiary, trustees often have the power to apply capital and income as required. The authors state:

> Similarly most modern family trusts are more flexible discretionary trusts with income and capital payable at the trustees' discretion. Such provisions avoid the sometimes artificial (and difficult) distinction between income and capital.

75. The important point to understand is that under trust law, trustees must act within the powers given to them by the trust deed. Trustees acting under their fiduciary duties must carefully consider any distinctions required under the trust deed to avoid legal consequences. If, as in *Wong*, the trustees must distinguish between capital and income, trustees must be careful when making distributions. Some other relevant trustee duties include the duties to:

- adhere to the terms of the trust;
- act fairly by all the beneficiaries (also called the duty of impartiality or even-handedness); and
- keep proper accounts of the trust.

76. It is not possible to cover all the different types of trust deeds in this Interpretation Statement. Instead, it is essential that trustees are familiar with their trust deeds. Trustees should also, if uncertain, seek legal advice on whether, in a particular income year, their particular trust deed allows them to vest absolutely in interest or pay amounts from the trust fund equating to deemed income.

Application of the law

77. It is helpful to summarise the above discussion of tax and trust law. As discussed above, the definition of "beneficiary income" in s HC 6 refers to an

amount of income derived in an income year by a trustee. The word "income" is a defined term in the Act. Therefore, the income of the trustee referred to in s HC 6(1) is a tax law measure of income, and not the trust law measure of income. However, while the income of a trustee may be measured on a tax law basis, such income is only beneficiary income to the extent to which it:

- vests absolutely in interest in a beneficiary; or
- is paid to a beneficiary in the income year or within the time limits specified in s HC 6(1B).

78. Section HC 6 works on the premise that the trustee has derived the income, so it must be the trustee who is paying that income to the beneficiary. Accordingly, although the tax measure of income may exceed the trust measure, no statutory mechanism exists in s HC 6 to make the tax law measure the relevant measure when it comes to beneficiary income. That is, when the tax law income of a trust is greater than its income according to trust law, the excess tax law income does not automatically become beneficiary income.

79. Under s HC 6(1)(a), an amount will vest absolutely in interest in a beneficiary where the beneficiary obtains an immediate right of present or future possession of the income. This means the beneficiary need not receive the amount vested absolutely in interest at the time of vesting, but they must have an indefeasible right to that part of the trust property. In a trust relationship, this can happen only where a provision of the trust deed, the actions of the trustee, or a combination of both, provides for such income to be vested absolutely in interest in a beneficiary. This requires a focus on what is possible under the trust deed. If the trustees attempt to act outside the trust deed they risk breaching their fiduciary duties to the beneficiaries.

80. Beneficiary income includes not only amounts that are vested absolutely in interest but also amounts that are paid (s HC 6(1)(b)). As seen, the word "paid" includes distributing an amount to a beneficiary, to credit a beneficiary for an amount, and to deal with the amount in a beneficiary's interest or on their behalf in some other way. Implicit in the definition is that it is the action of the trustee that gives rise to something being paid, because the trustee is the person who has the authority to undertake such actions. As with vesting absolutely in interest, this requires a focus on what is possible under the trust deed. If the trustees attempt to act outside the trust deed they risk breaching their fiduciary duties to the beneficiaries.

81. For an amount of income derived by a trustee to be beneficiary income, the amount must actually vest absolutely in interest in, or be paid to, the beneficiary. A trustee is bound by the terms of the trust deed in relation to the vesting or payment of amounts from the trust fund. Therefore, any vesting absolutely in interest or payment of an amount of trustee income must be effective for trust law for it to be beneficiary income. This is true for all types of income derived by a trustee, not just deemed income.

82. However, as noted above in the discussion of trust law, amounts that are deemed income amounts exist only for tax law purposes and do not result in an actual cash flow or an accretion to the trust because the deeming provisions in the Act only operate within tax law. The deeming provisions in the Act do not make the deemed income exist for trust law purposes. Therefore, deemed income could not itself be vested absolutely in interest in, or paid to, a beneficiary as a matter of trust law.

83. In addition, the two limbs of s HC 6 require something to have happened within the trust. That is, the trustee must actually vest absolutely in interest in, or pay something to, a beneficiary. The Commissioner considers a trustee cannot vest absolutely in interest, or pay, notional amounts. However, the Commissioner will recognise deemed income as beneficiary income for tax purposes if an equivalent actual amount of the trust fund is vested absolutely in interest in, or paid to, a beneficiary.

When trust law income is the same or exceeds tax law income

84. When the trust law income of a trust is the same as, or exceeds, the tax law income of a trust in an income year, the Commissioner considers that amounts of deemed income will be able to vest absolutely in interest in, or be paid to, beneficiaries as a matter of trust law. In this situation, sufficient trust income will exist to support the vesting or payment of the tax law income, including the deemed income. Provided sufficient amounts of trust income are actually vested absolutely in interest in, or paid to, beneficiaries in a way that is effective for trust law, the deemed income will satisfy s HC 6 and will be taxed as beneficiary income.

85. The Commissioner considers that the trustees will generally not need to resolve that the actual amount of trust income is a vesting or payment of deemed income for tax purposes (compare the situation discussed below where tax law income exceeds trust law income). However, depending on the terms of the trust deed, to make the vesting or payment effective for trust law, trustees might still need to make a resolution exercising their discretion to actually vest absolutely in interest or pay the trust income.

When tax law income exceeds trust law income

86. When the tax law income of a trust is greater than its trust law income under trust law the excess tax law income cannot simply be vested absolutely in interest in, or paid to, beneficiaries unless the trust deed expressly provides a way for this to happen. This is because the trustee is limited to the amounts in the trust fund available to be vested absolutely in interest in, or paid to, beneficiaries. For deemed income to be beneficiary income under s HC 6, the vesting absolutely in interest in, or payment to, the beneficiary must be effective for trust law.

87. If the trust deed makes a clear distinction between capital and income beneficiaries, or defines the meaning of income by applying traditional trust law concepts, legal impediments will exist to prevent the trustee making payments to a beneficiary to match the amount of deemed income arising under tax law. First, the trustee will be bound by the terms of the trust deed as to what it can vest absolutely in interest in, or pay, to beneficiaries. Trustees may have no discretion as to what each beneficiary is entitled to. Secondly, if the tax law income of the trust exceeds the trust law income, the trustees will be unable to vest or pay an amount from the trust fund equating to the excess tax law income amount. A beneficiary entitled to a fixed amount will not be able to receive any more than their entitlement. Similarly, beneficiaries entitled to a proportion of trust income will only be entitled to receive a share of the trust income as determined under trust law. In such situations, the excess tax law income must be taxed as trustee income.

More flexible trust deeds

88. Some of these legal impediments may be overcome by different formulations of the trust deed. If, under the trust deed, trustees are able to distribute amounts that are more than the trust law definition of income, the trustees

may be able to vest absolutely in interest or to pay amounts available in the trust fund equating to deemed income. For instance, some discretionary trusts allow the trustees to distribute capital and income to beneficiaries as they see fit. Also, some trust deeds give trustees the discretion to distribute capital to income beneficiaries. In these situations, the distinction between capital and income becomes less important and amounts of capital could be used to vest absolutely in interest or to pay deemed income to income beneficiaries. It is, therefore, the terms of the trust deed, or the actions of the trustees (or both), that allows the deemed income to become beneficiary income for tax purposes.

89. If "income" is defined in the trust deed to mean income calculated for income tax purposes, the trustees may vest absolutely in interest or pay amounts that equate to the deemed income to the beneficiaries. In this situation, the tax law income and trust law income of the trust are the same. Similarly, if trustees have discretion as to how they characterise receipts (that is, whether as capital or income), they will be able to vest absolutely in interest in, or pay a greater sum to, income beneficiaries than the conventional trust law definition of income. Where the trust is a flexible trust with all beneficiaries able to receive capital and income, there will similarly be a greater flexibility to vest absolutely in interest or to pay sums greater than the conventional trust law definition of income. To do this, however, the trust must have an actual (non-deemed) amount that can be vested absolutely in interest in, or paid to, a beneficiary. This is because the deemed income does not exist outside tax law. The deemed income does not represent anything that can be vested absolutely in interest in, or paid to, a beneficiary.

90. Accordingly, the Commissioner considers deemed income will be beneficiary income only to the extent to which it is reflected by an actual amount vested absolutely in interest in, or paid to, a beneficiary by the trustee or under the terms of the trust. This means that, at the time the deemed income is purported to be vested or paid, the trust must have sufficient amounts in the trust fund available to be distributed to the beneficiary. This is because the trustees only have the power to deal with the trust fund. This reiterates the point made earlier that the trustee simply deriving deemed income is not sufficient for it to be treated as beneficiary income for tax purposes. If trust law is to be complied with, there must be a provision of the trust deed, or the actions of the trustees, or both, to allow the deemed income to be vested absolutely in, or paid to, the beneficiary. If the trust deed does not allow for deemed income to be vested absolutely in interest in, or paid to, the beneficiaries, or the trustees do not act in such a way as to vest or pay it, then the deemed income will remain as trustee income and be taxed accordingly. There is no automatic process outside of the trust deed, or the trustees' actions, for deemed income to become beneficiary income.

91. Tax law deems an amount of income to exist, and the Act should be read in a way that is consistent with the deemed existence of the income. Therefore, when an actual amount is vested absolutely in interest in, or paid to, a beneficiary by the trustee equal to the amount of "deemed income" (in accordance with an explicit power in the trust deed or the actions of the trustees, or both) the requirements of s HC 6 are met and the amount will be beneficiary income. The "deemed income" is not, of itself, "beneficiary income"; rather, the terms of the trust deed may enable an actual amount that reflects the "deemed income" to be vested in, or paid to, a beneficiary. In this way, the deemed income amount can then be treated as beneficiary income.

Explicit link between actual amount and deemed income required

92. The Commissioner considers that where the trustees exercise their power under the trust deed to vest or pay an actual amount to a beneficiary reflecting the amount of deemed income, then the deemed income will be taxable as beneficiary income. For an amount to "reflect" the amount of deemed income, there must be an explicit link between the amount of deemed income for tax purposes and the amount vested absolutely in interest in, or paid to, the beneficiary. Importantly, the trustees' resolution (or the trust deed) must clearly specify that the actual amount being vested absolutely in interest in, or paid to, a beneficiary is a payment of an income amount for tax purposes. For example, the trustees may resolve that the trustees are paying the sums to the beneficiaries because the amount of tax income exceeds the amount of trust income.

93. If there is no such link, then the payment may be a payment of capital or corpus (ie, the character of the actual amount) instead of a payment of the deemed income for tax purposes. Such a payment may not always be beneficiary income because the Act does anticipate payments of capital and corpus to beneficiaries. For example, if the amount that is vested absolutely in interest in, or paid to, a beneficiary is trust capital, then this will not have the effect of giving rise to beneficiary income. The vesting absolutely in interest or payment will not automatically be treated as the vesting absolutely in interest or payment of income.

94. The Commissioner considers the definition of "beneficiary income" is broad enough to include this use of an actual amount to vest or pay the deemed income amount. This is for two reasons:

- There is "an amount of income derived in an income year by a trustee of a trust" for tax purposes, as "income" is a defined term measured using tax law concepts (and it includes the "deemed income").
- Such an amount will be beneficiary income "to the extent to which" it is vested absolutely in interest in, or paid to, the beneficiary of the trust in the required timeframe. This requirement is met because the amount of tax law income is, factually, vested absolutely in interest in, or paid to, a beneficiary of the trust within the required timeframe by the trustees.

Source of the actual amount vested in, or paid to, a beneficiary

95. Therefore, in some situations, trustees may vest absolutely in interest in, or pay to, beneficiaries an amount that represents deemed income. The absence of an actual cash flow for the deemed income could mean that the trustees would have to take funds out of previously taxed income reserves or even trust capital to make the payment. It might be thought that payments from previously taxed income reserves or trust capital should not be taxable as beneficiary income, but should be treated as a payment of corpus or some other type of distribution (depending on the type of trust). However, the Commissioner considers this is not a concern for two reasons.

96. Firstly, the concept of "paid" is not solely about distributions of cash, but includes crediting in account, applying or otherwise dealing with, and can be as simple as a trustees' resolution that the amounts be held in the name of the beneficiaries. The concept of "vesting absolutely in interest" is similarly unconstrained. In saying that of course, as already discussed, a trustee can "vest absolutely" or "pay" only existing property. Also, there must still be a reality to any payment or vesting. Trustees can deal only with the trust

fund, and any vesting or payment from the trust fund must be effective for trust law.

97. Secondly, any concern about the actual source of funds being previously taxed income confuses the source of the funds used to make any payment with the actual classification of the deemed income for tax purposes for that particular income year. That is, the key focus ought to be on the amount of income derived in the income year (ie, the deemed income). The trust property that is used to vest or pay the equivalent amount (should vesting or payment occur) is not critical.

98. Further, as a practical matter, some trustees may not necessarily keep track of the actual identity of funds used to allocate amounts to beneficiaries. Sometimes this is because trustees are not actually making a payment of cash (they are just crediting or applying it). Sometimes this is because of the way the trustees treat funds, taking into account the fungibility of money. That is, once the amounts are in a trust bank account they do not require any particular classification under the trust rules. (However, this latter point does not mean that the trust does not keep records of the amounts it earns and how they are distributed, it is just that the actual cash that the trust holds might not be tracked in this way.)

Summary

99. In summary, for an amount of income derived by a trustee to be beneficiary income under s HC 6, the vesting or payment of that amount must be effective for trust law. This also applies to amounts of deemed income. Deemed income does not exist outside tax law and does not, in itself, represent anything that a trustee could vest absolutely in interest in, or pay to, a beneficiary.

100. However, the Commissioner considers the definition of “beneficiary income” in s HC 6 of the Act is broad enough to encompass the situation where an actual amount is used to vest absolutely in interest or pay the deemed income. This will not pose any problems where the trust income under trust law concepts of capital and income is greater than or equal to the tax law income of the trust, provided that actual amounts equating to the deemed income are vested absolutely in interest in, or paid to, beneficiaries in that income year.

101. However, where the tax law income of the trust is greater than the trust income under trust law concepts of income and capital, there may be limits on the trustee’s ability to vest or pay actual amounts equating to the deemed income. If it is not possible under the trust deed for an actual amount equating to the deemed income to be vested absolutely in interest in, or paid to, a beneficiary, or the trustees do not vest or pay it (in accordance with their powers under the trust deed), then the deemed income will remain as trustee income and be taxed accordingly. There is no automatic process outside of the trust deed or the trustee’s actions for deemed income to become beneficiary income. Even though “paid” and “vests absolutely in interest” are wide concepts, there must still be a reality to any vesting or payment. Trustees can deal only with the trust fund and any vesting or payment of amounts of the trust fund must be effective for trust law.

Alternative views

102. The Commissioner acknowledges there are alternative views on some aspects of this Interpretation Statement. One view is that deemed income can be beneficiary income by simply making an adjustment in the tax return

of the trust. The basis for this view is that deemed income only exists for tax law purposes. Accordingly, the deemed income can be vested absolutely in interest in, or paid to, beneficiaries as beneficiary income purely for tax law purposes. The Commissioner considers this is incorrect because s HC 6 requires that something must have actually happened in the trust. This is evident from the requirement in s HC 6 that an amount of income derived by a trustee must be vested absolutely in interest in, or paid to, a beneficiary within certain time limits in order to be beneficiary income for tax purposes.

103. Another view is that deemed income can, of itself, be vested absolutely in or paid to a beneficiary. There is no need under trust law for an actual amount to be vested absolutely in interest in, or paid to, a beneficiary in order to vest or pay deemed income. In addition, it has been suggested that this is even more true for automatic vesting provisions in trust deeds. The Commissioner disagrees with this view. This is because a trustee is bound by trust law (including the terms of the trust deed) and can only vest or pay amounts from the trust fund to beneficiaries in accordance with the trust deed. The provisions in the Act that deem income to arise only operate for the purposes of tax law. The deemed income does not exist for trust law purposes and notional amounts cannot be vested or paid. An actual amount must be vested or paid that reflects the deemed income amount. This is also the case for automatic vesting situations. If this is done effectively under the trust deed, the Commissioner will recognise this as effective for tax purposes and tax the deemed income amount as beneficiary income.

Examples

104. The following examples are included to assist in explaining the application of the law. The examples deal with situations where, in an income year, the tax law income of a trust exceeds its income according to trust law concepts of capital and income. The examples address the tax implications of deemed income derived by trustees of the following three types of trust, where:

- the trust deed determines the income of the trust according to trust law concepts of capital and income;
- the trust deed defines trust law income as meaning income calculated for income tax;
- the trust deed determines income using trust law concepts of capital and income, but the trustees have the power to distribute trust capital to income beneficiaries.

105. In each example, the trust provides for a mix of entitlements – Fred is entitled to the first $50 of income, Mary is entitled to the next $60 of income and George and Alice are entitled to 50% each of the balance of the income of the trust. In each example, the trust earns $100 of traditional trust law income and $150 of tax law income. For these examples, it is assumed that the amounts are paid within the time limits imposed by s HC 6(1B).

106. The examples show that where the trust deed does not allow the trustees to vest or pay an amount equating to deemed income, or the trustees decide not to vest or pay an amount equating to the deemed income, the deemed income is taxed as trustee income. The beneficiaries may not receive any more than their entitlements under trust law and as represented by amounts available in the trust fund.

Example 1 – Trust deed does not define income

107. Fred is entitled to the first $50 of income, Mary is entitled to the next $60 of income and George and Alice are entitled to 50% each of the balance of the

income of the trust. In this situation, the trust deed does not define "income". Therefore it is necessary to determine the income of the trust according to trust law concepts of capital and income.

108. In the 2011/2012 income year, the trust derived $100 of trust law income. However, the trustees derived $150 of income as calculated under the Act ($50 of which is deemed income), and must return this amount in the income tax return of the trust. In this situation the trust law income of the trust is $100 and the tax law income of the trust is $150.

109. The excess tax law income ($50) does not represent trust income according to ordinary concepts. For trust law purposes, it cannot be included in the income of the trust that may be distributed to the beneficiaries. Therefore, in this situation, Fred would receive $50, Mary would receive $50, and George and Alice would not receive any income. This is because the income of the trust for trust law purposes is only $100.

110. In the case of s HC 6(1)(a) ("vested absolutely in interest in a beneficiary") the same treatment would apply for tax purposes as applies for trust purposes. There is nothing in the Act to provide that the beneficiaries are entitled to anything more than what they are entitled to under trust law. They do not have an immediate fixed right to the income deemed to arise under the Act. As beneficiaries, their rights arise in trust law and not in tax law. For a beneficiary, any immediate fixed right sufficient to amount to vesting absolutely in interest can be established only under the trust deed and/or the relevant trustees' resolutions.

111. Similarly, in terms of s HC 6(1)(b) ("paid to a beneficiary") there is nothing to increase the amounts that the beneficiaries receive by payment from the trustee. Again, the tax law follows from trust law. If a beneficiary is entitled to income only on a trust law basis, there is nothing in s HC 6 to increase that amount.

112. The trustees are bound by the trust deed as to what they can vest absolutely in interest in, or pay to, the beneficiaries. The extra $50 of tax law income cannot be vested or paid to the beneficiaries under the trust deed because the trustee is limited to the trust law concepts of capital and income.

113. In this situation, $100 of the tax law income is taxed as beneficiary income, reflecting the $50 each paid to Fred and Mary. The extra $50 of tax law income must be taxed as trustee income.

Example 2 – Trust deed defines trust law income as income calculated for income tax purposes

114. In this situation, the trust deed defines income as income calculated under the Income Tax Act 2007. Therefore, the amount of income under the trust deed will be the same as that calculated under the Act.

115. In the 2011/2012 income year, the tax law income of the trust is $150. Therefore, in accordance with the trust deed, the trust law income of the trust is also $150. However, the trustee only received $100 in cash because $50 of the tax law income was deemed income. As a result, there is a difference between the actual amounts received by the trustee and the income derived under the Act.

116. As stated above, Fred is entitled to the first $50 of income, Mary is entitled to the next $60 of income and George and Alice are entitled to 50% each of the balance of the income of the trust. However, the trustee cannot vest or pay a notional amount. The trust has only received an actual amount of $100. If the trustees took no further steps, Fred and Mary would each

derive beneficiary income of $50. George and Alice would not derive any beneficiary income. This is because the trust has only $100 of income available to be vested absolutely in interest in, or paid to, the beneficiaries.

117. However, the trust deed adopts the tax law measure of income which increases the amount that may be distributed to beneficiaries as income. This means the trustees could resolve that, for tax purposes, other amounts from the trust fund (that are available to be distributed to Mary, George and Alice) are to be vested absolutely in interest in, or paid to the appropriate beneficiaries to reflect the $50 of deemed income. In this way, the deemed income could be treated as vested absolutely in interest in, or paid to, the beneficiaries. Mary would then receive a further $10, and George and Alice would receive $20 each in accordance with their entitlements under the trust deed. However, this depends on the trust having an actual (non-deemed) amount corresponding to the amount of deemed income that is available to be vested or paid to the beneficiaries. This is because amounts of income derived by a trustee (including amounts of deemed income) must be able to be actually vested absolutely in interest in, or paid to, a beneficiary to be beneficiary income.

118. In exercising their powers under the trust deed, the trustees determine that there is nothing in the trust fund available to be vested or paid to Mary, George and Alice in that year. Only $100 of trust income has actually been vested absolutely in interest in, or paid to, the beneficiaries. Therefore, the extra $50 of trust income must be taxed as trustee income.

119. If the trustees had determined that there were sufficient amounts in the trust fund available to be vested absolutely in interest in, or paid to, Mary, George and Alice, the trustees could vest or pay some additional amounts to be treated as the deemed income for tax purposes, after making appropriate resolutions. To the extent they do this, the extra $50 of tax law income will be taxed as beneficiary income.

Example 3 – Trust deed defines income using trust law concepts of capital and income, but the trustees have the power to distribute capital to income beneficiaries

120. In this situation the trust deed provides that the income of the trust is defined using trust law concepts of capital and income. However, the trust deed also gives the trustees the discretion to distribute capital amounts to income beneficiaries. As before, Fred is entitled to the first $50 of income, Mary is entitled to the next $60 of income and George and Alice are entitled to 50% each of the balance of the income of the trust.

121. In the 2011/2012 income year, the trust derived $100 of trust income. However, the trustees derived $150 of tax law income, as calculated under the Act, and must return this in the income tax return of the trust. In this situation the trust law income of the trust is $100 and the tax law income of the trust is $150.

122. For tax law purposes, the treatment of the vesting absolutely in interest of income in a beneficiary under s HC 6(1)(a), or a payment to a beneficiary under s HC 6(1)(b), would be the same as in the first example. That is, Fred would receive $50, Mary would receive $50 and George and Alice would not receive anything. The extra $50 of tax law income would be treated as trustee income if the trustees took no further action.

123. However, the trustees exercise their discretion and pay $50 from available trust capital to Mary (who receives an extra $10), and George and Alice (who receive $20 each) to match the excess tax law income. In exercising their

discretion, the trustees resolve that the payment of the capital amounts to Mary, George and Alice are to be treated as the payment of the deemed income for tax purposes.

124. In this situation, the $150 of tax law income will be taxed as beneficiary income.

References

Subject references
Beneficiary income
Deemed income
Deeming provisions, effect of
Income tax
Pay
Trust
Trustee income
Vests absolutely in interest

Legislative references
Income Tax Act 2007, ss CV 13, HC 5, HC 6, HC 7, YA 1
Interpretation Act 1999, s 32

Case references
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CIR v Albany Food Warehouse (2009) 24 NZTC 23,532 (HC)
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Appendix – Legislation

Income Tax Act 2007

1. Section CV 13 of the Income Tax Act 2007 provides:

CV 13 Amounts derived from trusts

An amount derived by a person is income of the person if it is—

(a) beneficiary income to which sections HC 6 (Beneficiary income) and HC 17 (Amounts derived as beneficiary income) apply; or

(b) a settlement on trust of property of the kind described in section HC 7(3) (Trustee income); or

(c) a taxable distribution from a foreign trust to which section HC 18 (Taxable distributions from foreign trusts) applies

2. Section HC 5 provides:

HC 5 Amounts derived by trustees

Either beneficiary or trustee income

(1) An amount of income derived in an income year by a trustee of a trust is either—

  (a) beneficiary income under section HC 6; or

  (b) trustee income under section HC 7.

Statutory amounts treated as derived

(2) For the purposes of subsection (1) and sections HC 6 and HC 7, if the trustee is treated as having an amount of income in the income year under a provision in this Act and the amount is not derived under ordinary concepts, then the amount is treated as derived in the income year.

3. Section HC 6 provides:

HC 6 Beneficiary income

Meaning

(1) An amount of income derived in an income year by a trustee of a trust is beneficiary income to the extent to which—

  (a) it vests absolutely in interest in a beneficiary of the trust in the income year; or

  (b) it is paid to a beneficiary of the trust in the income year or by the date after the end of the income year referred to in subsection (1B).

Date by which income must be allocated

(1B) The date referred to in subsection (1)(b) is the later of the following:

  (a) a date that falls within 6 months of the end of the income year; or

  (b) the earlier of—

    (i) the date on which the trustee files the return of income for the income year; or

    (ii) the date by which the trustee must file a return for the income year under section 37 of the Tax Administration Act 1994.

Exclusions

(2) Beneficiary income does not include—

  (a) an amount of income derived by a trustee of a trust in an income year in which the trust is a superannuation fund; or

  (b) an amount of income derived by a trustee that is income to which sections CC 3(2) (Financial arrangements) and EW 50 (Income when debt forgiven to trustee) apply.

Deriving beneficiary income in same year

(3) When an amount derived by a trustee in an income year is also beneficiary income, the beneficiary is treated as having derived the income in the same tax year as that corresponding to the trustee's income year.

4. Section HC 7 provides:

Trustee income

Meaning

(1) To the extent to which it is not beneficiary income, an amount of income derived by a trustee of a trust is trustee income.

Minors' beneficiary income

(2) An amount of beneficiary income to which section HC 35 applies that is derived in an income year by a person who is a minor is treated as if it were trustee income for the purposes of—

(a) determining the tax rate that applies; and

(b) paying the tax; and

(c) providing returns of income.

Exclusions from corpus

(3) The amount that is the market value of a property settlement referred to in section HC 4(3) to (5) is treated as trustee income of the trustee of the recipient trust derived in the income year of settlement.

5. Section HC 14 provides:

HC 14 Distributions from trusts

Transfers of value

(1) A trustee makes a distribution when the trustee transfers value to a person because the person is a beneficiary of the trust.

Transfers to other trusts included

(2) Despite subsection (1), a settlement for the benefit of a beneficiary is treated as a transfer of value only—

(a) if the amount or the property being settled would have been beneficiary income of, or a taxable distribution to, a beneficiary, had it been distributed at the time to a beneficiary resident in New Zealand; or

(b) when sections EW 50 or EZ 39 (which relate to forgiveness of debt) applies, if the property being settled is an amount forgiven and treated as paid as described in section EW 44(1) or (2) (Consideration when debt forgiven for natural love and affection) or EZ 39(1).

When distribution made

(3) A distribution is made when what is transferred—

(a) vests absolutely in interest in the person; or

(b) is paid to the person.

Manner of distribution

(4) A distribution may be made directly or indirectly, or by 1 transaction or a number of transactions, whether related, connected, or otherwise.

Nil value of beneficiary relationship

(5) The fact that a person is, or will become, a beneficiary of a trust does not constitute the giving or receiving of value.

6. Section HC 15 provides:

HC 15 Taxable distributions from non-complying and foreign trusts

When subsection (2) applies

(1) Subsection (2) applies for a trust that is a non-complying trust at the time a distribution to a beneficiary is made.

Taxable distributions: non-complying trusts

(2) The distribution is a taxable distribution to the extent to which it is not a distribution of—

(a) beneficiary income; or

(b) a part of the corpus of the trust; or

(c) a payment or a transaction that represents a distribution of the corpus of the trust.

When subsection (4) applies

(3) Subsection (4) applies for a trust that is a foreign trust at the time a distribution to a beneficiary is made.

Taxable distributions: foreign trusts

(4) The distribution is a taxable distribution to the extent to which it is not a distribution of—

(a) beneficiary income; or

(b) a part of the corpus of the trust; or

(c) a profit from the realisation of a capital asset or another capital gain; or

(d) a payment or a transaction that represents a distribution of either the corpus of the trust referred to in paragraph (b) or a capital gain referred to in paragraph (c).

Determining amount of gain

(5) For the purposes of subsection (4)(c),—

(a) the profit does not include—

(i) a gain that must be taken into account for the purposes of determining an income tax liability; or

(ii) a capital gain derived by the trustee through a transaction or series of transactions between the trustee and a person associated with them:

(b) the amount of the profit is determined after subtracting any capital loss that the trustee incurs in the income year in which the amount was derived.

Amounts not subject to ordering rule

(6) To the extent to which a distribution is made from a trust that is not a complying trust by disposing of property at less than market value or providing services to a beneficiary at less than market value, the distribution is a taxable distribution and is not subject to the ordering rule in section HC 16.

Inadequate records

(7) If the records of a trust that is not a complying trust do not allow an accurate determination of the elements of a distribution under section HC 16, the distribution is a taxable distribution.

7. Section HC 16 provides:

HC 16 Ordering rule for distributions from non-complying and foreign trusts

When this section applies

(1) This section applies for the purposes of the trust rules when a trustee of a non-complying trust or a foreign trust makes a distribution in an income year to a beneficiary. Subsections (6) and (7) override this subsection.

Order of elements of distribution

(2) The distribution is treated as consisting of the following elements in the following order:

(a) first, an amount of income that the trustee derives in the income year:

(b) second, an amount of income, other than beneficiary income, that the trustee has derived in an earlier income year:

(c) third, an amount that the trustee derives in the income year from the realisation of a capital asset of the trust or another capital gain:

(d) fourth, an amount that the trustee has derived in an earlier income year from the realisation of a capital asset of the trust or another capital gain:

(e) last, the corpus of the trust.

Order and elements

(3) In subsection (2),—

(a) an amount must not be treated as included in the distribution if the amount has been treated under this section as being included in an earlier or contemporaneous distribution from the trust:

(b) the paragraphs are applied in order, and the next paragraph applies only to the extent to which the amount of the distribution is more than the cumulative amounts described in that paragraph and the preceding paragraphs.

Deductions and capital losses subtracted

(4) For the purposes of subsection (2),—

(a) in paragraphs (a) and (b), the amount of income is determined after subtracting the amount of a deduction that is taken into account in the income year in the calculation of net or taxable income for the corresponding tax year:

(b) in paragraphs (c) and (d), the amount is determined after subtracting the amount of a capital loss that the trustee incurs in the income year.

Transactions that are not genuine

(5) In the determination of the elements of a distribution to a beneficiary (beneficiary A), no amount of income or capital gain derived by the trustee of the trust is treated as distributed to another beneficiary of the trust (beneficiary B) if the effect is that some or all of the distribution to beneficiary A would be treated as not being a taxable distribution, unless the distribution to beneficiary B meets all the following requirements:

(a) it is a genuine transaction entered into and carried out in good faith; and

(b) it places the amount beyond the possession and control of the trustee in their capacity as trustee; and

(c) it does not itself constitute a settlement.

Exclusions: terms of trust

(6) This section does not apply to the following distributions which are instead treated as consisting of the amount that reflects the terms of the trust or the terms of the exercise of the trustee's discretion:

(a) a distribution by the trustee of a complying trust which is treated as exempt income under section CW 53 (Distributions from complying trusts), unless an election to pay income tax on trustee income has been made for the purposes of section HZ 2 (Trusts that may become complying trusts); or

(b) a distribution from a non-discretionary trust—

(i) created by will or codicil, or by an order of court varying or modifying the provisions of a will or codicil; or

(ii) created on an intestacy or partial intestacy; or

(iii) on which no settlement has been made after 17 December 1987; or

(c) a distribution from a trust other than a non-complying trust that is settled by a natural person who makes an election under section HC 30(2).

Exclusions: taxable distributions

(7) This section does not apply to a distribution described in section HC 15(6).

Meaning of non-discretionary trust

(8) In this section, a non-discretionary trust is a trust in relation to which the trustee has no discretion as to the source, nature, and amount of distributions to beneficiaries, including but not limited to the classification of trust property as capital or income.

8. Section HC 20 provides:

HC 20 Distributions from complying trusts

An amount that a person derives in an income year is exempt income of the person under section CW 53 (Distributions from complying trusts) if—

(a) the amount is a distribution from a complying trust other than a community trust; and

(b) the amount is not beneficiary income.

9. Section HC 32 provides:

HC 32 Liability of trustee as agent

When this section applies

(1) This section applies in an income year when a beneficiary of a trust derives an amount of beneficiary income or a taxable distribution.

Exclusion

(2) Subsection (1) does not apply to a person who derives an amount from a community trust.

Agency

(3) In their capacity as agent, the trustee must satisfy the income tax liability of the beneficiary for their beneficiary income and taxable distributions derived.

Relationship to other provisions

(4) Section HD 4(b) (Treatment of principals) overrides this section.

10. In s YA 1, the word "pay" is defined as follows:

pay,—

(a) for an amount and a person, includes—

(i) to distribute the amount to them:

(ii) to credit them for the amount:

(iii) to deal with the amount in their interest or on their behalf, in some other way:

(b) for a dividend that is a bonus issue, means to issue shares or to give credit for the shares comprising the bonus issue:

(bb) is defined in section LD 4(7) (Tax credits for payroll donations) for the purposes of that section and section LD 8(1) (Meaning and ranking of payroll donation) and for section 24Q of the Tax Administration Act 1994

(c) is defined in section RD 51(6) (Calculation of all-inclusive pay) for the purposes of that section

Interpretation Act 1999

11. Section 32 of the Interpretation Act 1999 provides:

32 Parts of speech and grammatical forms

Parts of speech and grammatical forms of a word that is defined in an enactment have corresponding meanings in the same enactment.