

**INCOME TAXATION THE NEW ZEALAND MINOR  
BENEFICIARY REGIME**

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**Working Paper: Do Not Cite**

Income Taxation: The New Zealand Minor Beneficiary Regime

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### Income Taxation: The New Zealand Minor Beneficiary Regime

#### **1. Introduction**

##### **1.1 The minor beneficiary regime**

This working paper comprises a chapter of a book on the taxation of trusts that is scheduled to be published by Brooker's, Wellington, New Zealand, in 2002, together with fragments from two other chapters. The draft chapter, section 3 of this paper, was written as a result of the passage of the Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001, in particular the parts of that Act that relate to beneficiary income of minors. Section 2 of the paper discusses the meaning of "settlor" in the Income Tax Act. The terms "settlor" and "settlement" are of pivotal importance in the architecture of the minor beneficiary regime. Section 4 backgrounds the relationship between the trust regime in the Income Tax Act and the company tax imputation system and explains how the Act integrates imputation credits and the minor beneficiary regime. Because the paper is to become a chapter from a proposed book on the taxation of trusts in general it omits certain cross-references that will in due course appear in the book. Thus, for example, the paper does not attempt to explain some of its more abstruse references rules that apply to trusts with international connections.

The need for rules relating to the taxation of beneficiary income of minors comes about as a result of a policy on the part of the New Zealand government to adopt a mildly progressive schedule of income tax rates in place of the former relatively flat scale. Since the 2000-2001 fiscal year the rates for individuals have progressed from 19.5 per cent for incomes up to \$38,000, 33 per cent for incomes from \$38,001 to \$60,000, and 39 per cent for incomes over that sum.

One consequence of this change was that it became much more worthwhile than in the past for parents to channel income to their children via trusts, with a view to that income being taxed at the

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lower rates that children ordinarily enjoy, (since children generally have relatively low taxable incomes).

#### **1.2 Special rate for minors**

Parliament responded by enacting the Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001, which taxes the income of most beneficiaries of trusts who are minors at 33 per cent. Logic might have suggested 39 per cent, being the rate that most affected parents would otherwise have paid on income diverted to their children. Parliament chose 33 per cent mainly for reasons of administrative convenience, which are explained later in this paper.<sup>2</sup>

The idea of taxing some income of children at a flat rate of 33 per cent is deceptively simple. To fit such a policy into a modern income tax statute has been a remarkably complex operation. This working paper attempts an exegesis of the rules that were needed. The next paragraphs describe several of the structural features of the Income Tax Act 1994 that had to be taken into consideration and outlines the rules that Parliament enacted in response.

#### **1.3 Problems and solutions**

First, the Act does not impose particular rates of tax on particular dollars of the income of an individual. Instead, people add their total income and calculate the tax on that total. One can work out an average rate of tax on each dollar, or a marginal rate on the last dollar, but there is no provision for taxing income of a particular type at a particular rate. The Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001 overcomes this problem by, instead, taxing minor beneficiaries' income to trustees, who do pay tax at a flat rate.

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<sup>2</sup> §3.2, below.

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Secondly, although the solution of taxing the income in question to trustees is effective, it contains its own problems. For instance, if the income in question is a dividend accompanied by an imputation credit, does the credit go to the trustee or to the beneficiary? This and other problems required their own rules.<sup>3</sup>

Thirdly, broadly speaking the policy of the minor beneficiary regime is to prevent families from spreading the income of their primary earners to children who enjoy lower rates of tax. The policy is not to ratchet up the rates of tax on children's income just because they derive it via trusts. As a result, there must be exceptions for income from testamentary trusts, from trusts established to hold compensation payments, and from a number of other sorts of trusts.<sup>4</sup> In turn, there must be counter-exceptions to prevent families from taking a free ride by adding funds to such privileged trusts. The end result is a regime of considerable but inevitable complexity.

#### **1.4 Trust settlors as the connecting factor**

The problems of identifying income of minor beneficiaries that is to be taxed at 33 per cent, and then of ring-fencing beneficiaries' income from trusts that is to be exempt from the regime, presented a challenge. The drafters opted to use the identity of settlors as the factor that would identify trust income as within or outside the regime. That decision meant defining "settlor" with some care, and required adding special rules to the definition that would operate within the context of the minor beneficiary regime. For this reason, this working paper begins by describing the settlor definition rules in the Income Tax Act. It uses some paragraphs from an earlier chapter of the proposed book, before embarking on the minor beneficiary regime proper.

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<sup>3</sup> See §4.3.

<sup>4</sup> See §3.10 and §3.11

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## **2. Settlers**

### **2.1 Policy**

Generally speaking, the identity of the settlor is not a factor in the taxation of a trust. Once property has been transferred the settlor drops out of the picture and the law taxes income produced by the property of the trust, either to the trustee or to the beneficiary. (The relevant rules are set out in the paragraphs that follow.) In respect of settlors the taxation of trusts largely reflects the legal position. That is, the identity of settlors is rarely important for purposes of trustee law, and broadly speaking taxation law takes the same approach.

This general approach of taxation law ignores an important economic fact: that while a trustee is not in *law* the agent of either settlor or beneficiary, from an *economic* point of view trustees sometimes do act as the agents of their settlors. For instance, a settlor may transfer property to a trustee to divide the income and the corpus between the settlor's grandchildren in due course. In principle the settlor could make the division personally, when the time comes. However, the settlor appoints a trustee to do the work, perhaps for fear of not living long enough, or perhaps for fear that creditors may otherwise attack the corpus. The short point is that although in law the settlor cannot direct the trustee, in an economic sense the trustee stands in the position of the settlor as the settlor's agent.<sup>5</sup>

In principle, New Zealand tax policy tries to follow economic considerations rather than legal form, but where there is a close parallel between economics and law the law tends to prevail for tax purposes. That approach is true of the taxation of trusts for the most part: as long as income is taxed either to the trustee or to the beneficiary fiscal policy is sufficiently satisfied.

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There are two areas in New Zealand trust taxation law where Parliament is not satisfied that taxation by reference to beneficiary and trustee alone is sufficient. The first is where beneficiaries under sixteen years of age derive income from trusts established by relatives. The second is where foreign elements are involved. In these areas the rules take into account the connection between the settlor and the trust or the beneficiary. They are discussed in the proposed book.

#### **2.2 Settlor: definition**

As explained above, where the identity of the settlor is relevant to the trust taxation rules the reasons relate to fiscal policy rather than to tax law. Reflecting this policy, section OB 1 of the Income Tax Act defines “settlor” in terms that relate to economic substance rather than to legal form. It is not important whether the trust deed names the person in question as the settlor. What matters is the transfer of value to the trust for less than arm’s length consideration. The section OB 1 definition may be summarised as follows, employing its subparagraph numbering. A person is a settlor who, for less than market value:

- makes any disposition to the trust;
- makes any property, including any loan or other financial assistance available to the trust;
- provides any service to the trust; or
- acquires anything from the trust at more than market value.

Each subparagraph applies whether the transaction in question is direct or indirect and whether the transfer of value occurs by one transaction or by a series. Each transaction is a separate settlement. This rule means that if different people effect settlements on a single trust, for tax purposes there can be two or more settlors of the trust in question.

The “financial assistance” paragraph contemplates financial assistance provided by (a) loan, (b) guarantee, (c) granting security,

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or (d) “otherwise”. It would seem that “otherwise” includes assistance by granting credit for the price in the context of a sale.

Another possibility is that trustees may borrow money on behalf of the trust for trust purposes from a third party. In these circumstances the trustees are personally liable for the debt unless there is provision to the contrary. It is common for the trust deed or for the loan contract to exclude trustees’ liability or to limit their liability to the assets of the trust. In the absence of such a provision the fact of trustees’ personal liability would seem to amount to “financial assistance” to the trust. Like granting credit on a sale, such assistance appears to be “otherwise” than by loan, by guarantee, or by the provision of security. The effect is much the same as a guarantee, but formally the trustee is the principal debtor.

A third possibility is that someone, perhaps a trustee or perhaps a relative of a beneficiary, purchases something for the trust and waits some time for reimbursement. Here, too, the purchaser clearly has rendered “financial assistance” to the trust. The Commissioner takes the view that such help is correctly described as a “loan”.<sup>6</sup> It is true that the transaction results in a debt from the trust to the purchaser, but it does not follow that there must have been a loan. The better view is that such financial help is financial assistance provided “otherwise” than by loan, guarantee, or security.

Whether financial assistance falls under one of the three nominate heads of loan, guarantee, or security, or whether it falls under the omnibus “otherwise” has important practical consequences in respect of the application of the minor beneficiary regime, discussed later in this book.<sup>7</sup>

The definition of “settlement” builds on the definition of “settlor, with the result that an action or omission that makes one a “settlor” is itself a “settlement”.

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<sup>6</sup> Inland Revenue Department 13 *Tax Information Bulletin* (2001) issue 5, 31.

<sup>7</sup> §3.8 ff.

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In parenthesis, subparagraph (ii) adds:

... where financial assistance is provided to or for the trust [a] at below market rates or [b] amounts payable in relation to the financial assistance are payable on demand and the right to demand payment is not exercised or is deferred [then in either case] the financial assistance shall be deemed to have been provided to or for the benefit of the trust for less than market value.<sup>8</sup>

Limb [a] of this parenthesis thus says that “below market rates” “shall be deemed to have been ... for less than market value”. Examples might include loans or the provision of credit at low or no interest.

A typical transaction to which limb [b] might apply is a sale on credit with a Marshall clause, that is a clause providing for the payment of interest if demanded. *Marshall v CIR*<sup>9</sup> held that neither a Marshall clause itself nor the failure to demand interest pursuant to the clause amounted to a gift that was dutiable pursuant to the Estate and Gift Duties Act 1968. In contrast, limb [b] makes it clear that for Income Tax Act purposes a person becomes a settlor by extending credit to a trust and failing to demand interest or by deferring a demand for interest.

Another example of the provision of financial assistance to a trust at below market value would seem to occur where the trustee borrows money for the trust with no exclusion of liability. If the trustee can work out what a market rate fee might be and if the trustee charges that fee then the transaction would escape being a settlement under paragraph (b)(ii) of the definition of “settlor”.

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<sup>8</sup> Parenthetical items added.

<sup>9</sup> [1965] NZLR 851 CA.

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The Act modifies some elements of this for purposes of the minor beneficiary regime. Chapter 3 and §3.7 respectively discuss that regime and the modifications

#### **2.3 Settlor: anti-avoidance and nominees**

To add a belt to the several braces of subparagraphs (i) to (iv) of the “settlor” definition, subparagraph (v) is an anti-avoidance rule. It makes anyone a settlor

who acts or abstains from acting or directly or indirectly enters into a transaction or a series of transactions with or in relation to the trust with the effect of defeating the intent and application of this definition.

Section HH 1 of the Income Tax Act both extends and limits the general definition of “settlor” that is described above. First, section HH 1(1) excludes from the definition (a) anyone who acts as the nominee of someone else and (b) anyone who establishes a trust by making a nominal settlement at the request of another. Instead, the nominee’s principal or the person making the request is treated as the settlor.

Treating the principal as settlor can have significant practical effects. It became common in New Zealand and in some other common law jurisdictions for people wishing to establish trusts to procure someone else to do it for them. Thus, a relative or one’s solicitor would establish a trust for one’s children with a donation of a small sum of money. Later (usually not much later) one would transfer wealth to the trust by sale or gift. The reason for the tactic of having a third party create the trust is that some tax or estate duty legislation identified settlors of trusts purely formally, by reference to the person named in the deed as settlor, (or the legislation was thought to operate in that manner). As a result, drafters of trusts tried to avoid making a contact between settlor and beneficiary by employing independent settlors. It was thought that having an independent settlor could avoid rules that might, for example,

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attribute trust income to a parent who settles a trust for an infant beneficiary.

Whatever the success of this kind of scheme at the time, these days independent settlors should be used with caution. Where party A intends to confer a benefit on a trust there is no point in using an independent settlor because the definition of “settlor” discussed in the previous section will catch party A in any event. Where party B intends to benefit a trust for the children of party A it is a mistake for party A to instruct a solicitor to establish the trust by the solicitor making a small donation. By virtue of section HH 1(1), the solicitor drops out as a nominee, and party A, for whom the solicitor acted, becomes a settlor instead. This result does not save B from also becoming a settlor when B transfers property to the trust on favourable terms.

#### **2.4 Indirect settlements via companies and trusts**

Section HH 1 concretizes the terms of the general definition of “settlor” in section OB 1 to make it clear that certain transactions definitely qualify their authors as settlors. Section HH 1(2) concerns indirect settlements via companies, and section HH 1(3) concerns indirect settlements via trusts. The former provides that where a controlled foreign company<sup>10</sup> makes a settlement or is deemed to do so, then any person who at the time had a “control interest” in the company of at least 10 per cent is a settlor. Broadly speaking, such people are New Zealand residents who have 10 per cent or more voting control of the company.<sup>11</sup>

The same subsection, HH 1(2), deploys the meaning of “controlled foreign company” domestically. Where a domestic company would be a controlled foreign company if it were foreign,

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<sup>10</sup> Broadly speaking, a company controlled by five or fewer New Zealand residents. Income Tax Act 1994 s CG 4(1). The Act attributes the income of such companies to their New Zealand controllers. *Id* subpart CG.

<sup>11</sup>*Id* s CG 4(4).

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then its settlements make people settlors if they hold what would amount to control interests in a foreign company.

Section HH 1(3) operates when a trust makes a settlement. In those circumstances, anyone who is a settlor of the first trust is automatically a settlor of the second trust as well. Subsection (3) triggers a chain reaction so that settlors of the first trust remain settlors for unlimited generations of subsequent trusts.

#### **2.5 Acquiring of beneficial rights**

Section HH 1(4) applies to people who acquire rights to have the trustee of an existing trust treat them, or to treat someone else, as beneficiaries of the trust. In these circumstances the person acquiring the rights becomes a settlor, whether or not the rights are exercised. An example of acquisition of such rights could be the process of becoming a protector. Some trusts provide for “protectors”, who have the power to nominate beneficiaries and sometimes to dismiss them.

Section HH 1(4) may be significant in respect of trusts with foreign settlors and/or beneficiaries. If a New Zealand-resident protector is appointed the effect will be to make the trust into a trust with a New Zealand-resident settlor. The result can be to bring the trust into the New Zealand tax system.

Section HH 4(1) applies to people who acquire rights like the rights of protectorship in respect of *existing* trusts. The subsection does not appear to make someone who is nominated as a protector in a constituting trust deed into a settlor, but replacement or additional protectors will be settlors. Accordingly, where it is important to avoid trusts having a New Zealand connection New Zealand residents should not be appointed as replacement protectors or to similar positions. As a precaution, in case the view expressed in the second sentence of this paragraph is wrong, where it is important to avoid a New Zealand connection it is as well not to use New Zealand protectors in constituting deeds, either.

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### **2.6 Limitation of definition of “settlor”**

The section OB 1 definition of “settlor” concludes with two provisos. First, the fact that a person is or will become a beneficiary does not constitute giving or receiving value. Therefore, if, for example, beneficiaries perform some service for a trust in return for a below-market fee the beneficiaries become settlors. The beneficiaries’ service may enhance or save the value that the beneficiaries *qua* beneficiaries will receive from the trust, but this return is not taken into account in computing whether the trust pays market value for the beneficiaries’ services.

Secondly the definition of “settlor” does not apply in respect of unit trusts. The reason is that unit trusts are taxed as companies.

Section HH 1(10) lays down a third exception, which applies to funds that employers may settle to provide retirement benefits for employees. Employers who are resident in New Zealand are deemed not to be settlors in respect of such settlements. This provision ensures that funds that employers settle for employees’ retirement benefits are not brought within the anti-avoidance rules that apply to trusts with international connections.



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## **3. Income of minor beneficiaries**

### **3.1 Introduction**

In 2001, Parliament determined to tax income that children under sixteen derive from trusts at 33 per cent rather than at the individual rates of the children concerned. There are a number of exceptions to this policy, explained in this chapter. Because of the complexity of the legislation that relates to taxing trusts, and to cope with a number of consequential effects, this relatively simple policy change required the insertion<sup>12</sup> into the Income Tax Act 1994 of what amounts to almost a small sub-code of legislation, namely sections HH 3A to HH 3F. Even the definition of “minor” as a child under sixteen is not without complexity.<sup>13</sup> The operation of these sections can be best understood with some knowledge of the policy and history behind them.

### **3.2 Policy and history**

Any income tax system that employs a progressive scale must cope with a tension that is very difficult to resolve. This tension is particularly acute where the tax unit is the individual (as is the case in New Zealand and in most similar countries) rather than the household. On one hand, tax systems generally allow individuals to calculate their tax independently, each applying the progressive scale according to personal circumstances. On the other hand law makers are often concerned to prevent families from reducing their overall tax burden by spreading the income of the primary earner over family members who enjoy lower rates of tax. In this context, trusts offer opportunities to tax planners and present problems to

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<sup>12</sup> Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001, s 20.

<sup>13</sup> Income Tax Act 1994 s HH 3F (2), see §3.6, below.

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law makers. The reason is that the trust is particularly suited for use as a vehicle to spread income from high earners to low earners. People can easily transfer income-producing assets or businesses to trusts where beneficiaries are their children. The income bears tax at lower rates and is used to pay the children's expenses, such as school fees. This position contrasts with parents who pay children's expenses out of, say, their salaries, which have suffered tax at the maximum rate. The minor beneficiary rule is calculated to bring the position of the two groups of parents closer to equality.

New Zealand's response to income-spreading has tended to vary according to the political complexion of the majority in Parliament. In particular, Parliament has been reluctant to see income channelled to infants, taxed in their hands at low rates, but retained by trustees and ploughed back (as an investment on behalf of the infants) into the investments or business of the trust. Between 1968 and 1988 this concern informed the structure of the rules for the taxation of trusts.<sup>14</sup> During that time, broadly speaking the rules imposed a special, higher rate of tax on income that infants derived via fixed trusts and on income that they derived via discretionary trusts if the income was kept within the control of the trustee. Despite the intent and language of the rules there was some scope for people to plan their way around them.<sup>15</sup>

New Zealand began the 1980s with relatively high rates of taxation, reaching 66 per cent. Towards the end of the decade the maximum was half that rate. There were fluctuations in the twelve years from 1988 to 2000, but generally speaking rates were fairly

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<sup>14</sup> Land and Income Tax Act 1954 s 155 ff, replaced by Income Tax Act 1976 ss 226 - 237, discussed J Prebble *The taxation of trusts*, Part I (1980) 25 *Current Taxation* 109-118; Part II id 134-135; Part III id 168-178; J Prebble *Taxation of trusts: the scope of ss 226-237 of the New Zealand Income Tax Act 1976* (1981) 11 *Victoria University of Wellington Law Review* 195-208.

<sup>15</sup> J Prebble, *Constitution of sub trusts to receive income of infant beneficiaries of discretionary trusts* (1981) 9 *New Zealand Universities Law Review* 247-256.

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stable. For instance, from 1990 to 1997 the rate was 24 per cent on incomes up to \$30,875 and 33 per cent on income above that sum. (These rates were mitigated for people who headed low income families.) In effect, during the period in question New Zealand came close to having a flat rate tax system. The result was to minimise the benefits from diverting income from higher to lower earners. This result was reflected in 1988 when Parliament revised the trust taxation regime: rules to discourage income spreading were omitted as supererogatory. That remained the position until 2000, when the tax scale became more progressive: 19.5 per cent up to \$38,000, 33 per cent from \$38,001 to \$60,000, and 39 per cent over that sum. This regime offers considerably greater benefits to people who divert income to non-earning or low-earning children; hence the enactment of sections HF 3A to HF 3F.

### **3.3 Basic structure of the minor beneficiary regime**

Essentially, the minor beneficiary regime divides trusts into five categories, which may for convenience be called: “family”, “independent”, “family innocent”, “mixed”, and “mixed innocent”. (The regime does not use the category names that are used here and these names over simplify the relevant factors). Nevertheless, and at the risk of over-simplification, the category of a trust depends chiefly on whether there is a family connection between any settlor of the trust and any beneficiaries who are minors.

Family trusts, that is, trusts settled by people related to beneficiaries of the trust who are minors, are the primary target of the regime. Minor beneficiary income from family trusts bears tax at 33 per cent. Independent trusts are trusts settled by people who are not related to infant beneficiaries of the trusts. Family innocent trusts are trusts where minor beneficiaries are related to a settlor, but where the trust is not within the mischief that is the target of the legislation; that is, they are not suspected to have a significant, relevant purpose of income splitting. For instance, many

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testamentary trusts are “family innocent”. Independent and family innocent trusts are not caught by the regime.

Mixed trusts are trusts where there have been several settlements, some independent or family innocent, but at least one settlement falls within the target category of family trusts. The legislation provides that one or more settlements by relations have the effect of tainting all other settlements on the same trusts, so that mixed trusts fall under the regime, subject to exceptions to be mentioned in the next paragraph.

Mixed innocent trusts are trusts where a tainting settlement or settlements of the kind just described fall below a *de minimis* threshold. Minor beneficiary income of such trusts escapes the regime. An example of such a settlement is a small loan to a trust by, say, the father of a minor beneficiary. The purpose of the loan is not relevant, but such a loan might occur, for instance, where a trust needs to meet minor expenses but all its investments are in illiquid forms.

#### **3.4 Rate of tax on income of minor beneficiaries**

The policy of section HH 3A(1)(a) appears to assume that most children under sixteen who derive income from trusts in fact derive income that would otherwise have gone to their parents. That is, the rule assumes that parents will have transferred income-producing assets to trusts, with the result of diverting income from parents to beneficiary children and from higher tax rates to lower tax rates. The assumption is that if parents had not transferred these assets they would have derived the income and suffered tax on it at their marginal rates, leaving only the net income to spend on or to give to the children. If most children who derive income from trusts have parents who earn over \$60,000 a year logic might suggest that the appropriate rate to tax the children’s beneficiary income is the maximum marginal rate of 39 per cent, rather than the trustee rate of 33 per cent.

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The solution just suggested would have been vulnerable to simple avoidance action. The reason is that the rate of tax borne by trustees on retained income has remained at 33 per cent. Thus, trustees could simply accumulate income for one year, bearing tax at 33 per cent, and in the following year distribute the income to a minor beneficiary without further impost. It follows that as far as the income of minor beneficiaries is concerned Parliament was limited to a maximum levy of 33 per cent if it was to keep within the overall structure of the trust taxation rules.

The logic of the position just described might suggest that Parliament should simply impose tax at 33 per cent on income derived by minor beneficiaries that they derive via a trust, but that approach would not fit into the personal taxation system. The problem is that individual taxpayers must calculate their personal tax according to the progressive scale. In this calculation, no particular dollar is identified as bearing tax at a particular rate; only the total matters. Singling out a fraction of someone's income for tax at a specific rate cannot be done without changing the system. The drafter's response was to extract income that people derive in their capacity as minor beneficiaries from the rest of their income and to tax it separately, as if it were trustee income, at 33 per cent, as described in the next paragraph.

#### **3.5 Core rule and exemptions**

The minor beneficiary regime applies to income derived by "minors" as beneficiaries of trusts. For this purpose, "minors" are children under sixteen years of age.<sup>16</sup> The core rule of the regime is section HH 3A(1)(a), which provides that if a minor derives beneficiary income:

a trustee of the trust from which the beneficiary income is derived must pay income tax on the

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<sup>16</sup> Income Tax Act 1994 s HF 3(2), discussed below in §3.17

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beneficiary income as if the beneficiary income were trustee income

The effect of section HH 3A(1)(a) is to tax the income in question at the trustee rate, currently 33 per cent, but section HH 3A(1)(a) leaves the income still “beneficiary income” and therefore potentially taxable a second time, in the hands of the beneficiary, at the beneficiary’s personal rate. Section HH 3A(1)(b) avoids this problem by providing that such income “is not gross income of the minor”.

One result of this structure is that in a case where the beneficiary’s personal marginal rate is above 33 per cent the beneficiary might enjoy an advantage. Such an advantage would be rare, considering that the 33 per cent rate on the minor beneficiary’s trust income applies from the first dollar.

There is a *de minimis* exemption from section HH 3A(1)(a) of \$1000 per year.<sup>17</sup> This exemption applies per trust; so it appears to be possible to exploit the exemption by dividing beneficiaries’ income between several trusts.<sup>18</sup> Income saved by the exemption is taxed at the personal rate of the beneficiary in the ordinary way.

There are exceptions, also, for income for two particular kinds of trusts, namely group investment funds and trusts where the trustee is a Maori authority or the Maori Trustee.<sup>19</sup> These trusts will be considered briefly in the proposed book. The exemption presumably reflects the difficulty that these trustees would face in determining whether beneficiaries were subject to the rule. The exception in respect of group investment fund income applies only where the income comes direct from the fund. Where, for example,

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<sup>17</sup> Income Tax Act 1994, s HH 3B.

<sup>18</sup> Cf Inland Revenue Department *13 Tax Information Bulletin* (2001) issue 5, 33, where the Commissioner appears to aver that where the trust in question is constituted of a bank account the trustee need consider only the income of that account in determining whether the minor beneficiary regime applies.

<sup>19</sup> Income Tax Act 1994 s HH 3E(2).

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a trustee of an ordinary family trust has invested in a group investment fund the minor beneficiary regime applies as the income flows through the hands of the trustee. Finally, by way of a compassionate exemption the minor beneficiary regime does not apply to income derived by a minor for whom a child disability allowance is paid under the Social Security Act 1964.<sup>20</sup>

#### **3.6 Credits and debits in trust accounts**

As has been explained, section HH 3A operates indirectly, by taxing minor beneficiary income “as if” it were trustee income, rather than directly by specifying a rate applicable to the income in question. A consequence is that the drafter had to add further provisions in order to confine this “as if” approach to the charging provision only. The preceding section discusses section HH 3A(1)(b) of the Act, one of these consequential provisions.

A second such provision is section HH 3A(2), which relates to the operation of trusts rather than to taxation specifically. Without section HH 3A(2) there might be doubt whether a trustee could debit minor beneficiary tax to the account of the beneficiary in question because the income is taxed as if it were trustee income, not beneficiary income. Section HH 3A(2) says that for the purpose of debiting and crediting accounts within trusts, income tax that the trustee pays on minor beneficiary income is to be treated as paid on behalf of the beneficiary.

If section HH 3A(2) addressed its target explicitly, saying that for trust purposes minor beneficiary income is to be treated as income of the beneficiary, it might be a little clearer, but it is obvious enough that although section HH 3A(c) speaks only in terms of “accounts” it has in mind substantive entitlement.

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<sup>20</sup> Id s HH 3E(1).

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#### **3.7 “Innocent” trusts**

Section HH 3A(1)(a) is framed in broad terms, but, broadly speaking it aims at *inter vivos* trusts established by parents, or, at least, funded by parents. Typically, such trusts split family incomes and take advantage of lower tax rates ordinarily enjoyed by non-earning children. The exceptions to section HH 3A(1)(a) reflect this policy in that the exceptions apply where generally speaking this form of income splitting is not a significant motivation for the formation of the trust in question.

As explained, section HH 3A’s policy is to limit the scope for high income earners to minimise tax by using settlements to divert income to younger members of their families. There is no policy for section HH 3A to apply to other settlements, that is, to settlements that on the face of it are innocent of the purpose of income-spreading. Accordingly, the Act provides that such settlements are not subject to the minor beneficiary rule. The relevant rules are found partly in the definition of “settlor” in section OB 1 and partly in section HH 3C. The Act modifies the usual definition of “settlement” in section OB 1 so that certain transactions that are ordinarily classed as “settlements” are not settlements at all for purposes of sections HH 3C and HH 3D. Secondly, section HH 3C lists certain settlements that while remaining “settlements” escape section HH 3A(1).

#### **3.8 Modified definition of “settlement”**

The modifications to the definition of “settlement” are partly for taxpayer certainty and partly for taxpayer convenience. Most of the modifications relate to paragraph (b)(ii) the definition of “settlor” in section OB 1 of the Act.<sup>21</sup> This definition of “settlor” feeds into the definition of “settlement”. In short, if people engage in transactions that make them “settlors” then the transactions are “settlements”;

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<sup>21</sup> Id, s OB 1, definition of “settlor” para (b)(ii).



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the two definitions share the same terminology, terminology that is located for drafting convenience in the definition of “settlor”. The result is that except that “settlor” refers to persons and that “settlement” refers to transactions there is no substantive difference between the two words as used in the Act. For this reason, the present discussion refers slightly indiscriminately to definitions of “settlor” or “settlement” as convenient.

To understand how the modifications to the definition work, it is necessary first to examine the several kinds of transaction that paragraph (b)(ii) mentions. First, there is lending any property, that is, making “any property available” at below market rates. Secondly, there is a subset of making property available, being “the provision of any financial assistance”. Next, there are four categories of providing financial assistance:

- ❑ loans
- ❑ guarantees
- ❑ provision of security
- ❑ provision “otherwise”

The modifications relate only to the first three categories of “the provision of financial assistance”. That is, there is no modification in respect either of the loan of property other than money or of the provision of financial assistance “otherwise” than by loan, guarantee, or security.

The first two modifications affect loans. First, for purposes of sections HH 3C and 3D, only loans existing on or after 1 April 2002 are included in the definition of “settlement”. That is, although cheap loans ordinarily amount to “settlements”, for purposes of the modified definition all loans that were liquidated before 1 April 2002 may be disregarded. They are not “settlements”. The reason for this provision is that it is not uncommon for trusts to owe money to relations of beneficiaries. Bearing in mind that the new rules came into effect for the 2001-2002 tax year, Parliament wished to give trusts an opportunity to

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reorganise their affairs. Otherwise, even a small loan creates a “settlement” that attaches to the trust for all of its life. Secondly, settlements effected by loans at below market interest are caught only if the interest falls below the rate specified<sup>22</sup> each year for determining whether an employer’s loan to an employee amounts to a fringe benefit for tax purposes. This provision enables lenders to be certain whether their loans amount to settlements.

The third modification relates to financial assistance by the provision of guarantees or security in respect of a loan contracted by a trust. Such assistance does not render the provider a “settlor” so long as the guarantee or security is not called upon.

Fourthly, although provision of services at less than market value ordinarily amounts to a settlement, where the services are incidental to the operation of the trust those services do not amount to a settlement, even if gratuitous. The statute gives bookkeeping, accounting, and acting as a trustee as examples of services that may be incidental to the operation of a trust.

The 2001 amendments<sup>23</sup> contain two limbs that mitigate the effect of the definition of “settlor” for purposes of the minor beneficiary regime. The first are the modifications to section OB 1 itself that are discussed in the preceding paragraphs. The second mitigating limb was inserted as section HH 3D of the Act. Broadly speaking, section HH 3D provides that certain transactions that are settlements by virtue of the section OB 1 definition but that fall below specified value thresholds may be disregarded for purposes of deciding whether the trusts in question are thrown into the minor beneficiary regime. These transactions are considered in §3.15.

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<sup>22</sup> In the Income Tax (Fringe Benefit Tax, Interest on Loans) Regulations that are current from time to time.

<sup>23</sup> Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001.

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#### **3.9 “Settlements” that are not saved**

Paragraph (a)(i)(B) of the definition of “settlor”, inserted by the 2001 amendments, gives relief only in respect of *loans* that are no longer in existence after 1 April 2002. As explained in the previous section, the relief was designed to give trusts a grace period to rearrange their affairs after the enactment of the minor beneficiary regime in 2001.

Forms of financial assistance other than loans attract relief only if they amount to uncalled guarantees or unenforced securities. Any other financial assistance to a trust, whenever it was granted, and even if terminated before 2001, makes the person who provides the assistance a settlor. For this reason, the examples of financial assistance mentioned in §2.2 require re-examination. These examples were the provision of credit, borrowing by trustees, and purchase of property for trusts with delayed reimbursement.

Paragraph (b)(ii) of the definition of “settlor” concludes its list of kinds of financial assistance with the word “otherwise”. It appears to follow that only transactions that reasonably clearly fall within “by way of loan, guarantee, [or] provision of security” that can take advantage of reliefs that relate to loans, guarantees, or the provision of security. There is no need to stretch the meaning of these words because “otherwise” capably covers the rest of the field. The credit element of a sale on credit to a trust and purchasing something for a trust on the understanding of reimbursement are economically equivalent to granting loans. Borrowing by a trustee whereby the trustee’s personal obligation amounts to financial assistance to the trust is economically equivalent to a guarantee. But the first two are not “loans” because no money passes from the creditor to the debtor to create the obligation and the second is not a “guarantee” because the trustee is the principal debtor, not a guarantor. These transactions, then, are examples of financial assistance provided “otherwise”.

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It appears to follow that if someone sells property on credit to a trust in, say, 1985, (the credit being at less than market rates) even if the price is paid off by 1995, the provision of the credit makes the vendor a “settlor” of the trust for ever. The same transaction may make the trustees who buy the property also “settlers”, unless the trustees’ liability in respect of the debt is appropriately limited, because the trustees assist the trust financially by undertaking personal liability. The Commissioner takes the view that purchasing for cash and later obtaining reimbursement is not just economically equivalent to making a loan but *is* making a loan,<sup>24</sup> but it is submitted that this is another example of financial assistance provided “otherwise”, which makes the purchaser a “settlor” indefinitely. Likewise, trustees who borrow money for a trust without limiting their liability would appear to be and to remain “settlers”.

The 2001 amendments to the definition of “settlement”, so far as the amendments relate to making property available to trusts, are limited to cases where the transaction in question amounts to the provision of financial assistance. As explained in the preceding paragraphs, the amendments afford relief in respect of only some kinds of financial assistance. However, there is no relief at all in respect of other settlements that come about by virtue of the loan of property, or, in terms of the Act, by virtue of making “any property available” to a trust.<sup>25</sup> Suppose, for example, that in 1995 an aunt lends her tractor without charge to a farming trust that includes her nephews among its beneficiaries; or suppose that the aunt allows the trust to depasture its stock on one of the aunt’s paddocks for a few days, again without charge. The result appears to be that there is a settlement by the aunt by virtue of the definition of “settlor”. The 2001 amendments do not relieve this transaction from being a

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<sup>24</sup> Inland Revenue Department 13 *Tax Information Bulletin* (2001) issue 5, 31.

<sup>25</sup> Income Tax Act 1994 s OB 1, definition of “settlor” para (b)(ii).

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settlement even though the value of the loan may have been quite modest. Section HH 3D(1)(c) provides a *de minimis* threshold for loans that have a total value of less than \$1000 on any day of the trust's income year, but in this context "loans" refers only to loans that amount to financial assistance. The loan of a tractor and making stock feed available do not seem to qualify. There is some irony here, in that if the aunt gave her tractor to the trust the transaction could potentially qualify for an alternative *de minimis* threshold, discussed in §3.14 and §3.15.

#### 3.10 Independent and other "innocent" settlements

Section HH 3C's list of settlements that do not trigger the minor beneficiary regime includes settlements by parties who are not related to or guardians of the beneficiary or who are not associated with parties who are related to or guardians of the beneficiary.<sup>26</sup> (§3.19, below, considers the meaning in this context of "guardians", "relatives" and "associated persons".)

On the other hand, settlements by relatives, guardians, or associated persons are not subject to the minor beneficiary rule if the settlor is:

- acting on behalf of someone else,<sup>27</sup> or
- required by court order to pay damages or compensation to the minor,<sup>28</sup> or
- someone against whom there is a protection order under the Domestic Violence Act 1995<sup>29</sup> and the beneficiary in question is a protected person under that Act.<sup>30</sup>

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<sup>26</sup> Id s HH 3C(1)(a).

<sup>27</sup> Id s HH 3C(1)(b).

<sup>28</sup> Id s HH 3C(1)(c).

<sup>29</sup> Id s HH 3C(1)(d).

<sup>30</sup> Id s HH 3C(2)(a). Subsections (2) and (3) of s HH 3C contain one or two other restrictions on this limitation.

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#### **3.11 Trusts established by will or on intestacy**

The general rule is that income of trusts established by will or otherwise as a result of the death is not subject to the minor beneficiary rule.<sup>31</sup> This rule is subject to an exception, which is itself subject to a reverse exception.

The exception is that minors must have been born before or within twelve months after the date of death in order to benefit from the rule.<sup>32</sup> The exception is curious at first sight. The explanation appears to be that the “established by will” principle that takes income out of the reach of the minor beneficiary rule extends to trusts that are established by court variations of will trusts. Rich (or, at least, high income) people who are income beneficiaries of such trusts might find it worthwhile to promote court variations of will trusts to cause the trusts to skip their (and possibly another) generation, thus passing income on to a younger and poorer generation that is able to deploy its lower marginal tax rates. In economic substance, such a generation-skipping exercise could be seen as tantamount to transferring income-producing assets to trusts in order to spread tax liability, which is the mischief against which the minor beneficiary regime is targeted. Nevertheless, as drafted the exception does not frustrate a court variation to skip a generation within a testamentary trust if the new beneficiaries were born within 12 months of the death of the testator.

By itself, the “born within 12 months” exception might appear to cause unfairness within families. For instance, a child alive at the testator’s death would not be subject to the minor beneficiary rule, but siblings born over a year after the death would suffer the higher rate of tax. Hence the reverse exception, which says that if one brother or sister enjoys the standard, personal rate of tax by virtue

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<sup>31</sup> Id s HH 3C(1)(e).

<sup>32</sup> Id s HH 3C(1)(e)(i).

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of timely birth, then all enjoy their personal rates rather than the special minor beneficiary rate.<sup>33</sup>

#### **3.12 Mixed trusts: trusts with several settlements**

As is apparent from these paragraphs, the minor beneficiary regime divides income from trusts that distribute income to minor beneficiaries into two categories: income that is caught by the regime and that is therefore taxed at 33 per cent, and income that is treated as ordinary beneficiary income and taxed at the personal rate of the beneficiary. As explained, it is broadly speaking the identity of the settlor that determines a trust's category.

It is common for trustees to receive several settlements to be held on the same trusts. Some such settlements may be caught by the regime and some may enjoy one or other of the exemptions. These trusts may be called "mixed trusts". Parliament's solution is to provide in section HH 3C(1) that, "section 3A does not apply to beneficiary income derived by a minor from a trust if all settlements" qualify to enjoy one or more of the exemptions. That is, a mixed trust falls under the minor beneficiary regime even if most of the corpus comes from settlements by independent parties and only a small part comes from settlements by relatives.

Section HH 3C(1) does not always operate in as draconian a fashion as may appear at first sight. Take, for example, a will trust under which minor beneficiaries enjoy tax at their personal rates. Suppose that a relative of the beneficiaries settles funds on the same trust with the same trustees. It does not follow inexorably that income of the will trust that goes to the minor beneficiaries must be taxed at the special 33 per cent rate.

The reason is that strictly speaking every settlement creates a new trust, even if the settlement is on the same terms and on the same trustees as a previous settlement. Theoretically, therefore,

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<sup>33</sup> Id s HH 3C(1)(e)(ii), which extends to half-siblings.

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there can be but limited scope for section HH 3C(1) to apply, because if there is more than one settlement there must be more than one trust.

Accordingly, so long as the trustees can keep the funds and income of the two settlements separate each settlement creates its own trust. The income of one settlement is subject to the ordinary rules that apply to beneficiary income, while the income of the other is subject to the minor beneficiary rate. Again strictly speaking, even if the trustees cannot keep the funds of the two trusts separate there remain two trusts. The problem is not whether the two trusts exist, but how to identify them. This situation, on the face of it an intermingling of funds from two trusts, does not necessarily involve a breach of trust because each trust has the same terms and same beneficiaries and, one assumes, the trustees exercise their discretion in the same manner in respect of both.

The considerations in the last paragraph offer clues as to a sensible interpretation of section HH 3C(1). The drafter appears to assume that if trustees of two trusts that have been formed by separate settlements on the same terms allow the funds to intermingle there is only one trust as a matter of law. As explained, this assumption seems wrong, but practically speaking there would in this situation be only one trust to all intents and purposes. If one makes this assumption there is a sensible interpretation for section HH 3C(1), to wit: "If trustees keep funds apart they may be taxed separately, but if funds are mingled there is only one trust for tax purposes. If as a result of any settlement a part of the income of that trust would be subject to the minor beneficiary regime, then all of the income is so subject."



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This position is more or less confirmed by section HH 1A, inserted in 2001 by the same amendment that inaugurated the minor beneficiary regime itself.<sup>34</sup> Section HH 1A reads:

For the purpose of this subpart, if a settlement is made on a trust and further settlements are made on the same terms, a trustee of the trust may treat all settlements as one trust.

Presumably, the trustee “may” alternatively treat each settlement as constituting a separate trust. If the trustee opts to treat the trusts as a conglomerate, and if any one of the settlements attracts the minor beneficiary regime in respect of the income of that settlement, then the regime applies to all of the income of the conglomerate trust that goes to minors.

The preceding discussion has assumed that where there are two or more settlements on the terms of a single trust the settlements are conventional, such as transfers or sales of property. In such circumstances it is theoretically possible to keep the various trusts separate. In other circumstances, where a transaction creates a deemed settlement on an existing trust pursuant to the extended definition of “settlement” in section OB 1<sup>35</sup> it may be a practical impossibility to keep the funds of the two trusts separate. For example, consider a trust where the property consists of a dwelling and a portfolio of shares. If someone paints the dwelling free of charge the painter becomes a settlor by virtue of subparagraph (iii) of the definition of “settlor”, (provision of services for less than market value) but it would be impractical to calculate the fraction of the income of the trust that relates to this settlement. Here, there is “one trust” to all intents and purposes.

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<sup>34</sup> Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001.

<sup>35</sup> See §2.2,

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#### **3.13 Contamination of ordinary trusts by trusts subject to the minor beneficiary regime**

The combined effect of the rules described so far is that a trust that is outside the ambit of the minor beneficiary regime could be thrown into the regime by being infected, perhaps inadvertently, by a relatively unimportant transaction. For instance, suppose that there is a will trust where a number of minor beneficiaries, grandchildren of the testator, qualify for their beneficiary income to be taxed at their personal rates. Suppose that the trust is temporarily short of funds and suppose that a son of the testator, father to some beneficiaries, uncle to others, lends the trustee money on other than arm's length terms.

In these circumstances, the son is a "settlor" of the trust pursuant to paragraph b(ii) of the definition of "settlor" in section OB 1 of the Act, and has therefore made a "settlement on the trust."<sup>36</sup> Because the son is a relative of the minor beneficiaries the will trust can no longer qualify for exemption from the minor beneficiary regime: the problem is that not all of the trust's settlements qualify for to escape from section HH 3A, as discussed in §3.7 and §3.11.

#### **3.14 Partial immunisation of some trusts**

Section HH 3D contains some partial remedies for the, as it were, overflow consequences of the minor beneficiary regime that are discussed in the preceding paragraphs. It begins by dividing settlements into those that are (a) "of the type referred to in section HH 3C" and (b), others, not of this type. The first group are settlements described earlier as "innocent", that is, most testamentary settlements and other settlements that are not subject to the minor beneficiary regime,<sup>37</sup> described earlier as settlements

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<sup>36</sup> See §2.2.

<sup>37</sup> See §3.7 and §3.11.

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that create “independent” and “family innocent” trusts.<sup>38</sup> Type (b) are all others, that is, settlements where beneficiary income is potentially subject to the minor beneficiary tax rates. Broadly speaking, section HH 3D says that certain type (b) settlements of limited value will be treated as “innocent”.

An example illustrates the policy of section HH 3D. Suppose there is a testamentary trust, say a farming trust, where the minor beneficiaries were alive at the death of the testator. The minor beneficiary regime does not apply to the income of the trust. Suppose that the uncle of the minor beneficiaries gives an old tractor, worth only two or three thousand dollars the trust. Without special provision, the result would be to throw the whole of the trust into the minor beneficiary regime.

The modified definition of “settlement” discussed in §3.7 applies for purposes of the exercise described in the previous paragraph. That is, there is no “settlement” at all in cases where interest on a loan is at least at the threshold for fringe benefit tax purposes, or where a guarantee or security has not been called up, or where services supplied to a trust are only services that are ancillary to the trust’s operation. If these circumstances obtain, therefore, (and assuming that there are no other settlements that contaminate the trust) it is not necessary to call on section HH 3D to save the income of the trust from the minor beneficiary regime.

Where it applies, the *modus operandi* of section HH 3D is, as it were, to sterilise certain type (b) settlements so that where a number of settlements are administered as one trust the minor beneficiary regime does not bite. This result obtains so long as the only settlements involved are type (a) settlements or sterilised type (b) settlements.

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<sup>38</sup> See §3.3.

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#### **3.15 Below-threshold settlements**

Sterilised type (b) settlements can be of two kinds, defined by subparagraphs (i) and (ii) of the definition of “settlor”, namely dispositions of property and loans or other financial assistance respectively, in each case being at less than market value,<sup>39</sup> bearing in mind the modified definition of “settlement” that applies in the context of section HH 3D.<sup>40</sup>

Each kind of settlement must remain below a ceiling value to take advantage of section HH 3D. For dispositions of property at less than market value the total allowed is \$5000 in any one group of settlements administered as one trust. The aggregate is calculated at the end of the trust’s income year,<sup>41</sup> but valuation is done as at the date of the settlement or settlements in question.<sup>42</sup> That is, trustees are not obliged to revalue such settlements year by year. For loans or other financial assistance the total value of all settlements must be under \$1000, measured on any day of the trust’s year.<sup>43</sup>

As explained, section HH 3D relief is available only in respect of settlements that are dispositions of property or financial assistance. It does not give relief for settlements under subparagraphs (iii) or (iv) of the definition of “settlement”, by provision of services at less than market value or by paying too much for the receipt of trust property or services. That is, a subparagraph (iii) or (iv) settlement by a relative or associate of a minor beneficiary locks the trust into the minor beneficiary regime even if subparagraph (i) and (ii) settlements remain below their respective ceilings.

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<sup>39</sup> See §2.2

<sup>40</sup> Above and see §3.7

<sup>41</sup> Income Tax Act 1994 s HH 3D(1)(b).

<sup>42</sup> Id s HH 3D(2).

<sup>43</sup> Id s HH 3D(1)(c).

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#### **3.16 Provision of services by relatives**

Section HH 3D(3) reads:

This section does not apply if services are provided to a trust by a relative of a legal guardian of a minor or by a person associated with the relative or the legal guardian.

The effect of subsection (3) is to deny the benefits of subsection (1) to trusts where relatives provide services whether or not the services are remunerated at market rates. Its operation is best explained by reference to an example. Suppose the godfather of a minor (that is, a non-relative) settles property on trust for the benefit of the minor. Income from the trust is not subject to the minor beneficiary regime because the settlement was made by a person who is neither a relative nor a legal guardian of the minor.<sup>44</sup> The result is the same if the godfather first settles a nominal sum in order to create the trust and follows the nominal settlement with the major settlement that is proposed, or if the godfather procures his solicitor to effect the nominal settlement.

If the minor's father then works for the trust (that is, provides services to it, in terms of subsection (3)) income from the trust remains outside the minor beneficiary regime because the provision of fully remunerated services is not a "settlement".

Suppose, however, that before the godfather makes his settlement the father helpfully establishes the trust with a nominal donation. On the assumption that the father is acting on his own account and not as nominee of the godfather, this nominal donation makes the father a settlor by virtue of paragraph (b)(i) of the definition of "settlor". The father is also a "settlor" if he procures his solicitor to make the nominal settlement, by virtue of section HH 1(1).<sup>45</sup> The result is that the trust is a mixed trust and is subject

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<sup>44</sup> Income Tax Act 1994 s HH 3C(1)(a), see §3.10.

<sup>45</sup> See §2.3.

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to the minor beneficiary regime unless it is saved by section HH 3D(1). In fact, it probably is saved, assuming that the father's nominal settlement is valued at less than \$5000, as explained in §3.15.

Suppose, however, that the father works for the trust for full remuneration. The father's work triggers subsection (3), being the provision of services by a relative. In turn, subsection (3) withdraws the comfort of section HH 3D(1), with the result that the father's nominal settlement taints the whole trust.

This result is curious when compared with the case where the godfather is responsible for both the nominal and the substantive settlement. In that case, the father's fully remunerated services have no effect on the tax status of the trust. In contrast, these fully remunerated services trigger the consequences of the father's nominal initial settlement, those consequences being the bite of the minor beneficiary regime.

The example just discussed reveals that the policy of the legislation is not that relatives' provision of fully remunerated services should trigger the minor beneficiary regime. It is only when such provision occurs in the context of a trust where a relative has made some other settlement (but a settlement of a non-material amount) that the regime comes into play.

For completeness, note that subsection (3) is not relevant where a relative provides services that are remunerated at less than market rates, or where a relative makes a disposition of property or a loan to a trust (apart from dispositions or loans below the threshold values). In such circumstances, if the godfather or any other non-relative is rash enough to make a disposition to the trust the income from the disposition will be caught along with any income that arises from the other settlements just mentioned. That is, the trust in question is a mixed trust that section HH 3D(1) cannot save.

The result seems to be that section HH 3D(3) will operate principally where people have made a mistake. For instance, if the

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godfather makes all the settlements on the trust in question, expecting that the father will work for the trust, the minor beneficiary regime does not apply. But if circumstances are changed by having the father helpfully establish the trust himself, then the regime will apply.

This arbitrary-looking regime is mitigated in some circumstances by section HH 3D(4), which reads:

In subsection (3), services do not include services that are incidental to the operation of the trust, such as bookkeeping or accounting services or those provided in being a trustee.

That is, if the father's only services to the trustee are as trustee or bookkeeper or accountant, even if unremunerated, subsection (3) remains dormant. Accordingly, continuing the example that has been discussed, in the event that the father creates the godfather's trust with an initial nominal settlement that nominal settlement is saved by section HH 3D(1)(a)(i) and income from the godfather's settlement remains outside the minor beneficiary regime (on the assumption that there are no other tainting settlements in play).

#### **3.17 Examples of “settlement” transactions**

§3.8 explains that the legislation contains two limbs that mitigate the effect of the definition of “settlor” and “settlement” for the purposes of the minor beneficiary regime. The first limb, discussed in §3.8, comprises modifications to the definitions in section OB 1 of the Act. The second limb comprises section HH 3D's dispositions in respect of below-threshold settlements, discussed above. Some examples may illustrate the intersecting effect of the two limbs.

Suppose an aunt is disposed to confer a benefit on a trust where the beneficiaries include her under sixteen-year-old nephews. Suppose that the bulk of the corpus of the trust comes from a testamentary settlement and that all minor beneficiaries were alive

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at the death of the testator. That is, fundamentally the trust is one that should be outside the minor beneficiary regime. The following transactions are all “settlements” according to the unmodified definition of the term. They would therefore throw the trust into the minor beneficiary regime unless they are saved by one or other of the two limbs. Some are saved by the section OB 1 modifications and some by section HH 3D, and some are not saved. The examples are:

- ❑ Aunt guarantees or provides security for a loan. The transaction is saved by the modifications to the definition unless the guarantee or the security is called up.<sup>46</sup>
- ❑ Aunt lends \$20,000 in 1998 that is refinanced by a bank loan in February 2002. The transaction is similarly saved because the aunt’s loan did not exist on or after 1 April 2002.<sup>47</sup>
- ❑ Aunt lends \$500 in 2002. The transaction is saved by section HH 3D(1)(c), assuming there are no other loans that bring the total above the \$1000 threshold.
- ❑ Aunt lends \$50,000 in 2002 at interest that is pegged to the fringe benefit tax rate. The transaction is not a “settlement” because the 2001 modifications to the definition of “settlor” mean that such a loan is not “for less than market value”.<sup>48</sup>
- ❑ The trust runs a farm. Aunt lends her tractor gratuitously from time to time. The transaction is caught by the definition of “settlor”. It is not saved by any modification of the definition because the modifications apply only to the provision of

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<sup>46</sup> Income Tax Act 1994 s OB 1 definition of “settlor” para (a)(ii), inserted by s 39(13) of the Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001.

<sup>47</sup> Income Tax Act 1994 s OB 1 definition of “settlor” para (a)(i)(B), inserted by s 39(13) of the Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001.

<sup>48</sup> Income Tax Act 1994 s OB 1 definition of “settlor” para (a)(i)(A), inserted by s 39(13) of the Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001.



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financial assistance, not to lending property “for less than market value”.<sup>49</sup> Even if the values of the loans of the tractor are minimal, section HH 3D(1) does not save the transaction. The reason is that section HH 3D’s \$5000 threshold applies only to dispositions of property, not to loans,<sup>50</sup> and the \$1000 threshold applies only to loans of money or the provision of other *financial* assistance.<sup>51</sup>

- The trust runs a farm. Aunt is a neighbour. She sells a paddock to the trust on credit, with price payable on demand (which is deferred) and interest payable at fringe benefit tax rates if demanded. The granting of credit is a “settlement”, being financial assistance provided “otherwise” than by loan, guarantee or security and involving an on-demand obligation that is deferred.<sup>52</sup> None of the modifications to the definition of “settlor” refers to financial assistance provided “otherwise” and the possibly relevant section HH 3D(1) threshold applies only to loans. The result is that the pegging of the interest rate to the fringe benefit tax rate is of no avail to the beneficiaries.<sup>53</sup> The minor beneficiary regime applies. It does not matter how long ago the sale occurred or whether the price left owing was liquidated before 1 April 2002.<sup>54</sup>

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<sup>49</sup> Income Tax Act 1994 s OB 1 definition of “settlor” para (b)(ii),

<sup>50</sup> Income Tax Act 1994 s HH 3D(1)(a)(i) and (b).

<sup>51</sup> Income Tax Act 1994 s HH 3D(1)(a)(ii) and (c).

<sup>52</sup> Income Tax Act 1994 s OB 1 definition of “settlor” para (b)(ii),

<sup>53</sup> *Pace* Income Tax Act 1994 s OB 1 definition of “settlor” para (a)(i)(A), inserted by s 39(13) of the Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001.

<sup>54</sup> *Pace* Income Tax Act 1994 s OB 1 definition of “settlor” para (a)(i)(B), inserted by s 39(13) of the Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001.

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- Aunt acts as trustee gratuitously. The transaction is saved by a modification to the definition, “settlor by provision of services”.<sup>55</sup>
- Uncle, aunt’s husband, donates \$4000. The transaction is saved by section HH 3D(1)(c), assuming there are no other donations that bring the total above the \$5000 threshold.
- Combining the last two examples, uncle donates \$4000 *and* aunt acts as trustee gratuitously. Uncle’s donation *is* a settlement, and must rely on section HH 3D(1)(c), but by virtue of the modification of the definition aunt’s services are not a settlement.<sup>56</sup> Nevertheless, as “provision of services” aunt’s trusteeship potentially disqualifies uncle’s donation from taking advantage of the section HH 3D(1)(b) threshold of \$5000. By reverse exception aunt’s trusteeship does not disqualify uncle’s donation because in this context “services” does not include service as a trustee.<sup>57</sup>
- Altering the last example, uncle donates \$4000 *and* aunt arranges for the trustee to invest in a fund that aunt manages. Aunt charges fees at full market rates. Again, uncle’s donation *is* a settlement, and must rely on section HH 3D(1)(c). By virtue of the unmodified definition aunt’s services are not a settlement.<sup>58</sup> Nevertheless, as “provision of services” aunt’s fund management disqualifies uncle’s donation from taking advantage of the section HH 3D(1)(b) threshold of \$5000.<sup>59</sup> The combination of uncle’s and aunt’s transactions throws the trust

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<sup>55</sup> Income Tax Act 1994 s OB 1 definition of “settlor” para (a)(iii), inserted by s 39(13) of the Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001.

<sup>56</sup> *Idem*.

<sup>57</sup> Income Tax Act 1994 s HH 3D(4).

<sup>58</sup> By inference from Income Tax Act 1994 s OB 1 definition of “settlor” para (b)(iii), which applies only where services are provided “for less than market value”.

<sup>59</sup> Income Tax Act 1994 s HH 3D(3).

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into the minor beneficiary regime. This result is hard to reconcile with the policy of the Act in that uncle's donation is below the \$5000 threshold and aunt charges full fees for services that she provides. Nevertheless, the regime certainly bites.<sup>60</sup>

- Slightly modifying the last example, uncle donates \$4000 *and* aunt arranges for the trustee to invest in a fund that aunt manages. In this modification, aunt waives her fees. Uncle's donation remains a settlement, and must rely on section HH 3D(1)(c). Aunt's services are also a settlement because they are gratuitous.<sup>61</sup> Neither the 2001 modifications nor section HH 3D saves the aunt's transaction. Accordingly, aunt's settlement brings the trust under the regime. Moreover, as a "provision of services" aunt's fund management disqualifies uncle's donation from taking advantage of the section HH 3D(1)(b) threshold of \$5000.<sup>62</sup> The result is that in this example each of uncle's and aunt's transactions independently throws the trust into the minor beneficiary regime.

#### 3.18 "Minors"

For the purposes of sections HH 3A to HH 3F (but not for other purposes) a "minor" is a child who is a New Zealand resident and who is under sixteen years of age on the balance date of the trust that makes a relevant distribution of beneficiary income to the minor. Confining the regime to New Zealand residents and allowing non-resident minor beneficiaries to enjoy their personal tax rates is at first sight curious. Considering that the regime is

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<sup>60</sup> See a similar example, with a similar result, in Inland Revenue Department 13 *Tax Information Bulletin* (2001) issue 5, 34 (example 4).

<sup>61</sup> Income Tax Act 1994 s OB 1 definition of "settlor" para (b)(iii), provision of services "for less than market value".

<sup>62</sup> Income Tax Act 1994 s HH 3D(3).

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essentially an anti-spreading measure one would have thought that spreading to non-resident beneficiaries would be an equal mischief to spreading to resident beneficiaries, though of course there are many more of the latter. The reason may relate to a wish to minimise compliance work on the part of trustees, who no doubt find it easier to keep track of the birthdays of residents than of those of non-residents.

#### **3.19 Minors and “balance date”**

As to the choice of date as the marker for age measurement, the Act does not contain a definition of “balance date” that applies for general purposes, though clause 2 of Schedule 13 Part A defines “balance date” for purposes of that Part. Part A relates to dates for the payment of provisional tax, that is, advance payments of tax on business profits and other income that is not subject to withholding at source. The definition is:

“balance date” in relation to income tax payable by a taxpayer in an income year or other period, means the date of the annual balance of the taxpayer’s accounts for that year or other period, being a year or other period for which the taxpayer is required by this Act or the Tax Administration Act 1994 to furnish a return of income.

That is, for purposes of Schedule 13 Part A, “balance date” means what one would expect, the last date of a taxpayer’s financial year, being the date up to which taxpayers make up their accounts for both profit reporting and tax purposes. This also is the meaning employed in the Tax Administration Act 1994.<sup>63</sup>

No doubt, the Commissioner would expect the same meaning to obtain in respect of sections HH 3F(2). Nevertheless, there is an argument that trustees could, if they wished, change what they call

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<sup>63</sup> Tax Administration Act 1994, ss 38 and 119.

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their “balance date” to a date that would yield maximum advantage to beneficiaries who are about to celebrate their sixteenth birthdays. No doubt, trustees could not simply label a date after a sixteenth birthday as “balance date” without more, but trustees who made accounts up to that date could reasonably argue that it was their balance date. Such a course would not necessarily mean changing the times of payment of provisional tax, nor would it mean changing the date to which the trust makes up its accounts for tax purposes. Nevertheless, the compliance costs involved would make the exercise worthwhile only rarely.

#### **3.20 “Guardians”, “relatives” and “associated persons”**

§3.7 explains that certain settlements on trusts with minor beneficiaries are exempt from the minor beneficiary regime because they are not caught by the policy of the regime. To summarise, settlements by non-relatives qualify for the exemption because they do not entail the kind of income splitting that is the target of the regime. Further, settlements in relation to damages payments or protection orders in respect of domestic violence are outside the scope of the regime, even if made by relatives of relevant minor beneficiaries. To achieve these policies while avoiding the creation of loopholes the drafter had to define “relative” and to provide for settlements by people who might stand in the position of relatives, such as guardians and people associated with relatives. The relevant definitions are in section HH 3 F. Section HH 3F(3) reads:

In sections HH 3A and HH 3D, relative, in relation to a person (person A), means another person (person B) connected with person A by blood relationship, marriage, or adoption and includes the trustee of a trust under which person B has benefited or is eligible to benefit.

Section HH 3F(4)(a) expands this definition to explain that relevant blood relationships are those up to and including the fourth degree.

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Section HH 3F(4)(b) and (c) apply the rules in respect of relationship by marriage and adoption. Curiously, section HH 3F(4)(d) provides that “In subsection (3) ... persons are connected by guardianship if one is a guardian of the other”. The curiosity is that in defining “relative”, section HH 3F(3) extends relevant connections to marriage and adoption, but not to guardianship. The result is that section HH 3F(4)(d) is a *brutum fulmen*.

There is even greater curiosity when words relating to relationships by blood, marriage, and adoption are excised from section HH 3F(3). Then, in respect of trusts, the rule reads, “... relative, in relation to a person (person A) means another person (person B) and includes the trustee of a trust under which person B ... is eligible to benefit.” The problem is that to be person A one does not need any connection with anyone. Literally, it would seem that anyone who is a beneficiary of a trust (person B) is a relative of anyone else (person A), which cannot be correct. It is possible that Parliament intended to say that trustees shall be treated as if they were relatives of their beneficiaries, but this explanation seems hardly more plausible.

As to “guardian”, section HH 3F(1) follows the definition in section 3 of the Guardianship Act 1968. In broad terms, a “guardian” under this definition is someone with rights and duties similar to those of a parent. The minor beneficiary regime treats such a guardian in the same manner as it treats relatives. That is, settlements by such guardians generally do not qualify for exemption from the regime.

A number of statutes use “guardian” in senses that are different from that described in the preceding paragraph. For example, section 110 of the Children, Young Persons, and their Families Act 1989 contains several references to guardians appointed for children in the interests of their care or protection. Section HH 3C(1) provides that such “guardians” are not guardians as section HH

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3C(1) uses the word. The result is that settlements by such people are treated as being by independent persons.

In exempting settlements by strangers from the minor beneficiary regime,<sup>64</sup> section HH 3C in general withholds the benefit of the exemption from settlements by relatives or legal guardians or by persons associated with a relative or legal guardian of the minor in question. The regime does not have its own definition of “associated person” for this purpose. Instead, it relies on the general tests in section OD 7, which defines when two persons are associated with one another. Under section OD 1 a partner and any member of the partnership are “associated”, as are a company and anyone who controls 25 per cent of the company. Where two people are associated and one of them is a nominee of someone else, then the nominee’s associated status affects the principal. Section OD 1 contains further provisions that, broadly speaking, cause it to operate where associated person status can be described indirectly rather than directly.

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<sup>64</sup> See §3.7.

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### **4. Beneficiaries and the imputation system for companies**

#### **4.1 Introduction**

New Zealand operates a full imputation system for the taxation of companies and shareholders. Section ME 6 of the Income Tax Act 1994 empowers companies to attach tax credits to dividends that they pay to shareholders. Section LB 2 allows shareholders to use these credits to offset income tax liability on the dividend and on other income if there is a surplus credit.

The Act takes it for granted that trustees pass the benefit of imputation credits on to beneficiaries along with beneficiary income that flows through the trust to beneficiaries, and passes straight to the issue of how imputation credits must be apportioned when trustees' income from mixed sources flows through to beneficiaries.

#### **4.2 Apportionment of imputation credits**

Section LB 1(1) requires that imputation credits that flow through a trust to beneficiaries must be apportioned according to a formula set out in section LB 1 (3). The effect of the formula is to spread the benefit of imputation credits evenly over all distributions to beneficiaries in a particular year. To illustrate, suppose that trustees distribute to beneficiaries a sum that in aggregate is made up partly of dividends that enjoy imputation credits and partly of, say, current year business profits, partly of business profits accumulated from earlier years, and partly of original trust capital. The trustees may determine by resolution that, for example, beneficiary A, a New Zealand resident, shall have all the dividends, and that the distributions to beneficiaries B and C come from the other sources mentioned. One reason for favouring A in this manner could be that beneficiary B is a tax exempt charity and beneficiary C is a non-resident who is unable to make use of New Zealand imputation



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credits in her home country. Section LB 1 (3) frustrates this strategy by deeming A, B, and C to share the dividends, and consequently the imputation credits, in proportion to their respective shares of the trustee's distributions for the year. This apportionment rule applies in the same manner whether credits reach beneficiaries by virtue of the terms of fixed trusts or pursuant to the decision of a trustee of a discretionary trust.

This apportionment rule is subject to section HH 6, which deems trust distributions to be made from different sources in the following order: current year income; income from past years; current year capital profits; capital profits from past years; and, finally, trust corpus.

#### **4.3 Apportionment when the minor beneficiary regime applies**

Chapter 3 describes the minor beneficiary regime, which causes most income derived by minor beneficiaries to be taxed as if it were trustee income and not as beneficiary income, as explained in §3.5. This treatment poses problems for apportionment of income between beneficiaries. For instance, how does one allocate benefits such as imputation credits when some income that belongs to a beneficiary is treated for some purposes as belonging to the trustee? The Act addresses some of these possible problems.

For apportionment purposes, the potential difficulty with imputation credits and dividend withholding payment credits is that section HH 3A(1)(b) says that income caught by the minor beneficiary rule "is not gross income of the minor".<sup>65</sup> Without more, it would follow that the minor in question could not take the benefit of an imputation credit attached to a dividend that for trust law purposes flowed to the minor via the trust. The Act's remedy is to say that in these circumstances section HH 3A(1)(b) does not apply<sup>66</sup> and that the apportionment formula described in §4.2

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<sup>65</sup> See §3.5.

<sup>66</sup> Income Tax Act 1994 s LB 1(1)(ab).

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operates normally. That is, the minor beneficiary income in question goes into the calculation as income derived via the trust by the relevant beneficiary in the relevant tax year.

Once a credit is calculated as described, the trustee, not the beneficiary, takes the benefit of the credit and sets the credit against liability for tax on trustee income.<sup>67</sup> This process makes sense because it is the trustee that has paid the tax on income subject to the minor beneficiary regime.

There are no statutory provisions other than those just described for dealing with apportionment problems that may arise in other contexts when there is minor beneficiary income that is taxed to the trustee. Since such income is not gross income of the beneficiary it appears that benefits such as foreign tax credits that may be attached to the income must be taken within the trust, and cannot be passed on to minor beneficiaries.

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<sup>67</sup> Income Tax Act 1994 s LB 1A.