CROSS BORDER TAXATION OF TRUSTS: A REVIEW OF THE USE OF FOREIGN TRUSTS AND THE INTERACTION BETWEEN THE TAX LAWS GOVERNING TRUSTS IN THE UNITED STATES AND NEW ZEALAND

by

AMBER VINK

(Under the Direction of Professor Walter Hellerstein)

ABSTRACT

This paper examines the interaction between United States and New Zealand tax laws applying to non-grantor, discretionary, accumulation trusts. The use of trusts for asset protection and tax planning is prolific in the United States and New Zealand. The United States discourages the use of trusts, whereas New Zealand encourages trust arrangements, through available income splitting benefits and its attractive foreign trust regime. This paper explains the tax laws pertaining to trusts in the United States and New Zealand and considers the tax impact on persons who may have their financial or family interests spread between the two countries. Particular emphasis is placed on the utility of the New Zealand foreign trust for U.S. persons. Finally, observations are made about whether the conceptually pure U.S. approach to taxation of foreign non-grantor trusts is to be preferred over the administrative simplicity inherent in New Zealand's trust regime.

INDEX WORDS: Trusts, Taxation, Foreign Trusts, Grantor, New Zealand, Settlor, Beneficiaries.

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AMBER VINK

LL.B. (Hons.), The University of Canterbury, New Zealand, 2002

B.A., The University of Canterbury, New Zealand, 2002

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AMBER VINK

Major Professor: Walter Hellerstein

Second Reader: Lisa Milot

Electronic Version Approved:

Maureen Grasso
Dean of the Graduate School
The University of Georgia
May 2008

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CHAPTER 1

INTRODUCTION

A. Purpose of the Study

Globalisation has become an accepted part of our reality. With technological advances, mobility of funds, people, and assets has become generally unimpeded and borders increasingly irrelevant. Despite these trends, all too often tax planning is undertaken without due regard to the possibility of future changes in residency. This paper addresses the issues that may arise when the affairs of taxpayers become caught in the tax nets of two relatively sophisticated taxation jurisdictions.

Business and employment is undertaken across many countries and individuals often hold bank accounts in several different locations. This environment has led to a range of tax planning practices designed to minimise exposure to tax. Such measures include the use of foreign trusts to hold assets and accumulate income outside of the taxpayer's country of residence. In this paper, the interplay between New Zealand's foreign trust regime, which is generally regarded as attractive to non-New Zealand taxpayers wanting to isolate income producing assets in a trust, and the U.S. tax laws applying to foreign trusts is examined. The approach of the United States to foreign trusts is strict and operates to deny many of the benefits the New Zealand foreign trust regime offers to taxpayers in other jurisdictions.

The use of trusts to hold investment assets is relatively commonplace and in many ways advantageous in New Zealand. By applying these usual tax planning tools to U.S. persons newly resident in New Zealand, New Zealand tax and legal advisors may be unwittingly exposing their clients and their beneficiaries to significant adverse tax consequences in the United States. This paper attempts to identify the issues involved so that appropriate action can be taken to reduce the exposure to the various levels of trust taxation in both jurisdictions.

B. Expected Observations

This paper is intended to provide an understanding of the issues that taxpayers may face when moving from one tax jurisdiction to another or when otherwise setting up trusts with a mix of beneficiaries or trustees resident in New Zealand and the United States. It was expected that what may appear to be a relatively straight forward asset planning arrangement in New Zealand may have significant adverse tax implications for the trust's U.S. beneficiaries in certain situations. A thorough understanding of the laws pertaining to the taxation of trusts in the United States and in New Zealand is provided so that the interplay between those rules can be explored.

It is expected that the income tax advantages of the New Zealand foreign trust regime, which are available to foreign settlors in many jurisdictions, will be shown to be much less advantageous to U.S. persons, due to the application of strict U.S. tax laws applying to such trusts. This conclusion reflects an overall expected observation that the United States discourages its taxpayers from using trust arrangements and especially discourages the use of foreign trusts.

It is further expected that the U.S. method of taxing accumulated trust income, although ostensibly punitive, provides a more conceptually pure and robust approach to trust taxation than the simpler approach adopted in New Zealand.

C. Introduction to New Zealand

General Introduction

New Zealand is a small but relatively sophisticated nation located in the South Pacific. It has a unicameral Parliament and, in a practical manner, the Prime Minister, who is the leader of the party voted into government, wields most of the responsibility for running the nation. New Zealand is part of the British Commonwealth and the Queen of England is the official Head of State, although this has become ceremonial only. New Zealand has a population of approximately 4.24 million.[1] The local currency is the New Zealand Dollar which has gained significant ground against the U.S. Dollar over the past few years.[2]

New Zealand has been a tourist destination for U.S. residents for many years. 214,507 U.S. residents visited New Zealand in the year ended December 2005[3] and a total of 3,674 U.S. residents arriving in New Zealand in the year ended December 2005 intended to stay in New Zealand for 12 months or more.[4]

While still minor in number, the trend towards shifting residency is a growing phenomenon with a number of multi-national corporations allowing employees to transfer their country of residence with increasing ease. In this context, an examination of the interaction between New Zealand and U.S. tax laws presents a case study of some of the issues that arise when transferring one's tax affairs to a new country of residence.

New Zealand's Tax Climate

New Zealand has two main taxes, income tax and goods and services tax ("GST"), which is an indirect tax eventually borne by the final consumer of goods and services. New Zealand has adopted a residency and territorial based system of income taxation with income taxed on a gross basis with adjustments for allowable deductions. New Zealand does not impose a generally applicable capital gains tax, although in some circumstances, capital gains may be re-characterised as income and taxed accordingly.

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[1] DEPARTMENT OF STATISTICS NEW ZEALAND. Estimate for September 2007 quarter *available at* http://www.statistics.govt.nz (last visited at 17 November 2007).

[2] U.S.$ 1 was worth N.Z.$ 1.285 as at Dec. 15, 2007, N.Z.$ 1.410 as at Dec. 15, 2005 and N.Z.$ 1.945 as at Dec. 15, 2002, *see* http://www.oanda.com/convert/classic (for currency conversions).

[3] DEPARTMENT OF STATISTICS NEW ZEALAND, Overseas Visitor Arrivals by Country of Residence for the year ended December 2005, *available at*

http://www.stats.govt.nz/NR/rdonlyres/FF45C870-E441-44E6-9BBE-323A03AA68D4/0/Table201.xls (last visited at Dec. 15, 2007).

[4] DEPARTMENT OF STATISTICS NEW ZEALAND, *Characteristics of Permanent and Long Term Migrants per Country for the year ended December 2005*, *available at*

http://www.stats.govt.nz/NR/rdonlyres/10C64A74-5A53-4280-9174-B34ED066F14D/0/Table902.xls.

Stamp duty and estate duty have been abolished although gift duty is payable on gifts made in any 12 month period that have an aggregate value of more than NZ$27,000. Gift duty only applies to gifts made by persons who are domiciled in New Zealand and to gifts of property situated in New Zealand. Gift duty payable on gifts that exceed the NZ$27,000 exemption value is payable by the donor on a sliding scale reaching up to 25 percent for gifts exceeding NZ$72,000. In practice, many donors will "loan" property to a trustee or donee on interest free terms,[5] and forgive the debt owing at the rate of NZ$27,000 per year until the whole debt is extinguished.

The Inland Revenue Department ("I.R.D.") is the New Zealand equivalent of the U.S. Internal Revenue Service ("I.R.S.") and is responsible for the collection and assessment of tax. Ultimate responsibility lies with the Commissioner of Inland Revenue ("the Commissioner"). The standard income year is from 1 April to 31 March of each year although companies and certain other taxpayers may apply to use a different income year if desired.

The principal tax legislation is the Income Tax Act, 2004 (N.Z.) ("the Act")[6], which imposes income tax on income derived by New Zealand residents and on income otherwise sourced from New Zealand. The Tax Administration Act 1994 provides the administrative requirements for the collection and assessment of tax, including dispute procedures. The Taxation Review Authority Act 1994 establishes the Taxation Review Authority which is the tribunal that will usually first hear a taxation dispute case if litigation is commenced.

GST is imposed under the Goods and Services Tax Act, 1985 (N.Z.) and gift duty is imposed pursuant to the Estate and Gift Duties Act, 1968 (N.Z.). There are some relevant

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[5] Although an interest free loan may itself be regarded as a gift, such loans are often structured in a manner that gift duty will not be payable. This can be achieved by ensuring that the loan is repayable on demand or subject to interest if demanded, in accordance with the principles in Rossiter v CIR (1976) 2 N.Z.T.C. 61,197 and Re Marshall [1965] N.Z.L.R. 851, respectively.

[6] The Act is the product of an ongoing major rewrite project designed to simplify the legislation. The Income Tax Act, 2004 (N.Z.) superseded the Income Tax Act, 1994 (N.Z.) and applies from the 2006 income year (in most cases from 1 April 2005). Parts A to E of the Income Tax Act, 1994 (N.Z.) were rewritten and the remaining provisions of the Income Tax Act, 1994 (N.Z.) re-enacted. The Income Tax Act, 2007 (N.Z.) was passed on 1 November 2007 and comprises all parts of the Income Tax Act, 2004 (N.Z.) in its rewritten form. The Income Tax Act, 2007 (N.Z.) applies from 1 April 2008. The rewritten legislation is generally not intended to change the policy of the legislation.

regulations applying to tax laws, such as the Income Tax (Withholding Payments), 1979 (N.Z.), but generally New Zealand does not develop new tax laws through the issue of regulations. The I.R.D. has a limited ability to make determinations on certain issues and these have a binding effect on taxpayers.

The I.R.D. frequently issues public rulings and interpretation statements. These publications contain the Commissioner's view on a particular law and indicate how the I.R.D. will apply those laws to a particular set of facts. However, a taxpayer is not bound to follow these statements if they believe the law should correctly be interpreted in a different manner. It is generally observed that the I.R.D. have entered into a period of intense audit activity, spurred on by recent successes in the courts. This climate of suspicion and distrust by the I.R.D. means that taxpayers need to become increasingly wary about the level of tax risks they are willing to accept when contemplating entering into aggressive tax structures.

D. Use of Trusts

Introduction to the Use of Trusts

The use of trusts as an asset protection tool is prevalent in modern society, both in New Zealand and the United States. A trust involves the divestment of assets by a person and reliance on the trustee to act in accordance with the instructions given in relation to those assets. A trust does not have a separate legal personality but is a direction made by a person, the settlor or grantor, to another person or persons, the trustee, to hold legal title to certain of the first person's assets "in trust" for a third person or group of persons.

One definition of a trust is that used by Pettit, who improves on the definition of a trust proffered by Underhill:

> A trust is an equitable obligation, binding a person (who is called a trustee) to deal with property over which he has control (which is called the trust property) *either* for the benefit of persons (who are called the beneficiaries or *cestuis que trust*) of whom he may himself be one, and any one of

> whom may enforce the obligation, *or for a charitable purpose, which may be enforced at the instance of the Attorney General, or for some other purpose permitted by law though unenforceable.*[7]

A trust is created when the settlor transfers property to the trustees to hold for the benefit of the beneficiaries. Legal title in the property is transferred to, and held by, the trustees, who act in a fiduciary capacity in relation to the beneficiaries and the beneficiaries hold the equitable interest in the property so transferred.

In English common law, the creation of a trust requires three certainties to be met: the certainty of intention, the certainty of subject matter and the certainty of objects. These requirements simply mean that there must be a clear and unequivocal intention to cede legal title in the assets over to the trustees, the property being transferred must be clearly identifiable and the beneficiaries must be readily ascertainable. The American system, being derived from the English common law, adopts the same essential principles. These are summarised by Bogert:

> Thus there are three requirements to create a valid private trust. These are (1) an expression of intent that property be held, at least in part, for the benefit of one other than the settlor; (2) at least one beneficiary for whom the property is to administered by the trustee; and (3) an interest in property which is in existence or is ascertainable and is to be held for the benefit of the beneficiary.[8]

A trust may be inter vivos, testamentary or constructive. This paper deals only with the former, trusts created during the life of the settlor, primarily as a tax planning and creditor protection tool.

A trust that is a sham or otherwise has no "substance, utility or purposes" will be disregarded for tax purposes in both the United States, under the principles established in *Zmuda v. Commissioner*[9], and in New Zealand.[10]

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[7] PHILLIP PETTIT, EQUITY AND THE LAW OF TRUSTS at 23 (7th ed. 1993) (citing and improving the definition in UNDERHILL and HAYTON, LAW OF TRUSTS AND TRUSTEES at 13 (14th ed. 1899)) (italics original).

[8] GEORGE BOGERT, TRUSTS at 5 (6th ed. 1987).

[9] 79 T.C. 714, 719 (1982). *See also* REV. RUL. 90-106, 26 C.F.R. 1.671-1.

The trust deed may confer upon the beneficiaries a fixed entitlement to income or capital of the trust or it may give the trustees discretion. Commonly, trusts are established as life interest trusts, meaning that a trustee is directed to pay the income from the trust assets to a certain beneficiary for life, and upon the death of that beneficiary, pay the capital to another beneficiary. Often, when trusts are used as tax planning devices, the trustees are given discretion to accumulate income or distribute income or capital to any one of the beneficiaries at any time. It is these discretionary accumulation trusts, or complex trusts, that are the focus of this paper.

Use of Trusts in the United States

The tax laws of the United States distinguish between three basic types of trust. These are the simple trust, the complex trust and the grantor trust.[11] A simple trust is governed by Subpart B of the Code[12] and is one in which the trustee is required to distribute all income of the trust currently "with no distributions of corpus or charitable gifts."[13] A complex trust permits the trustees to accumulate income or distribute corpus of the trust. Such a trust is governed under Subpart C of the Code.[14] The third type of trust, the grantor trust, is governed under subpart E of the Code.[15] U.S. tax law draws a distinction between revocable and irrevocable trusts. A revocable trust is one in which the assets can be recalled and vested in the settlor or grantor at will. Where a grantor of a trust retains a power of revocation, or certain other prescribed powers in relation to the trust, the trust will be treated as a grantor trust, with the effect that the grantor will be regarded as the owner of the trust and income received by the trust will be taxed as

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[10] Snook v London & West Riding Investments Ltd [1967] 2 Q.B. 786; [1967] 1 All E.R. 518 and NZI Bank Ltd v Euro-National Corporation Ltd [1992] 3 N.Z.L.R. 528. *See also* discussion in DAVID SIMCOCK, *The Taxation of Trusts*, 13 N.Z. Jnl. Tax Law & Pol. 20 (2007) at 21.

[11] MICHAEL D. ROSE AND JOHN C. CHOMMIE, FEDERAL INCOME TAXATION (3rd ed. 1988), ¶ 8.05.

[12] 26 U.S.C. §§ 651, 652.

[13] ROSE & CHOMMIE, *supra* note 11, ¶ 8.05.

[14] 26 U.S.C. §§ 661-664.

[15] 26 U.S.C. §§ 671-679.

income of the grantor with all appropriate deductions being attributed to the grantor. There is no comparable provision in New Zealand law.

In 1996 Congress passed the Small Business Job Protection Act of 1996[16] ("1996 Act"), which substantially amended the laws applying to the taxation of offshore trusts. The changes were "designed to narrow planning opportunities, counteract tax avoidance and evasion, and enhance compliance."[17] In particular, the 1996 Act provided a new definition of "foreign trust" which produced a default assumption of foreignness in relation to trusts. Prior to this change, "the classification of a trust as "domestic" or "foreign" generally depended on a subjective analysis of all relevant facts and circumstances to determine whether the trust was more like a resident or non-resident alien individual."[18] The 1996 Act also removed any advantages that could be obtained by treating a non-U.S. grantor as an owner of trust property under the grantor trust rules and changed the interest charge on throwback taxes payable on accumulation distributions from foreign trusts to a more punitive regime. The 1996 Act effectively removed all remaining benefits that could be derived by U.S. persons by the use of offshore trusts, the majority of benefits having already been removed by the enactment of the Tax Reform Act of 1976. Consequently, there are relatively few taxation benefits that can be derived by U.S. persons structuring their affairs through foreign trusts.

Notwithstanding the tax rules discouraging the use of foreign trusts, the Statistics of Income Studies reported: "For 2002, U.S. persons gratuitously transferred property valued at $2.2 billion to foreign trusts, while foreign non-grantor trusts reported $311 million of distributions to U.S. persons."[19] In addition: "foreign trusts with at least one U.S. owner had

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[16] PL 104-188 (1996).

[17] DEAN C. BERRY, ELLEN K. HARRISON, MICHAEL J. A. KARLIN, AND ADINA T. SPIRO, Foreign *Trusts and Gifts: Part 1: Definitions of Foreign and Domestic Trusts and Reporting/Penalties*, 8 J. Int'l Tax'n 346, 348 (1997).

[18] *See id.* at 349.

[19] LISSA REDMILES, *Statistics of Income Studies of International Income and Taxes*, I.R.S. Statistics of Income Bulletin (Summer 2006).

almost $15 billion in assets and earned a total net income of $359 million."[20] The use of foreign trusts by U.S. persons is not negligible. Figures for 1998 show foreign trusts located in New Zealand with a U.S. owner had assets totaling almost $27 million.[21] For 2002, U.S. persons transferred nearly $2,190 million to foreign trusts and New Zealand trusts with U.S. persons as owners had assets totaling almost $75 million.[22] This shows that the use of New Zealand trusts is an arrangement of growing importance to U.S. persons.

Foreign trusts may still be useful for persons resident in the U.S. in limited ways. Uses for foreign trusts have been identified to include situations where the foreign trust is settled by a non-U.S. grantor and will not have U.S. beneficiaries or if the foreign trust is established by a U.S. grantor for the benefit of foreign beneficiaries, none of which are ever likely to become U.S. persons.[23] Other uses may include situations involving foreign life insurance trusts, protection against foreign exchange risks and change of law or to allow investment in arrangements only offered to non-U.S. persons.[24] In addition a foreign trust "may be a practical solution if a relationship with a U.S. trustee would be less convenient than a relationship with a non-U.S. trustee."[25]

Turner identifies 12 primary goals of estate planning. These include maximizing control and minimizing the cost and complexity of estate settlement.[26] The use of foreign trusts to ensure that assets do not form part of a grantor's estate for probate purposes is well recognised.[27] Despite most tax benefits from the use of foreign trusts having been removed for

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[20] *See id.*

[21] DANIEL S. HOIK, *Foreign Trusts, 1998*, I.R.S. Statistics of Income Bulletin (Fall 2001).

[22] DANIEL S. HOIK, *Foreign Trusts, 2002*, I.R.S. Statistics of Income Bulletin (Summer 2005).

[23] *See* DENIS A. KLEINFELD AND EDWARD J. SMITH, LANGER ON PRACTICAL INTERNATIONAL TAX PLANNING (4th ed. 2001) at § 52:3.1; RICHARD M. ANDRADE AND ROBERT C. LAWRENCE III, *Foreign Trusts Settled by United States Persons U.S. Federal Income Tax Issues*, 290 PLI/Est 171, 171 (2000); and BRIAN R. BASSETT, *New Regs. On the Tax Effects of Funding 'Outbound' Foreign Trusts*, 29 Est. Plan. 113, 119 (2002).

[24] ANDRADE & LAWRENCE, *supra* note 22 at 171.

[25] BASSETT, *supra* note 22 at 119.

[26] GEORGE TURNER, REVOCABLE TRUSTS (4th ed. vol. 1, 2001), figure 2-2 at § 2-1.

[27] *See* KLEINFELD & SMITH, *supra* note 22.

trusts created by U.S. persons, Turner suggests that "the benefit of using the Revocable Living Trust over another type of trust is that it provides the opportunity for the family to eliminate the probate system in its entirety."[28] Any form of trust, foreign or domestic, provided it is properly settled, can enable a grantor to arrange his or her affairs so that ownership of his or her assets is not dependent on the life or death of the grantor.

The benefits of a foreign trust largely stem from the fact that the grantor cedes all his or her legal interests in the property being transferred. Trust assets cease to be owned by the transferor and do not form part of his or her estate for probate purposes. In most cases the assets will also not be available to meet claims by the transferor's creditors. These advantages are available to both New Zealand and U.S. residents and provide a useful tool in succession planning and asset protection. Apart from the establishment of a foreign trust without U.S. beneficiaries, these benefits are largely independent of the taxation consequences of establishing a trust and for that reason will not be considered further. However, they do go to show that some benefits remain available for certain U.S. persons who may be seeking advantages other than tax benefits.

Use of Trusts in New Zealand

The use of trusts for asset protection and taxation benefit purposes is prolific in New Zealand. The Reserve Bank of New Zealand estimates that, in 2001, 7.7 percent[29] of all "economic units"[30] used a trust to hold assets and that the aggregate total value of assets held in trust is approximately NZ$435 billion.[31]

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[28] TURNER, *supra* note 25, at § 2-6.

[29] PHIL BRIGGS, RESERVE BANK OF NEW ZEALAND, *Family Trusts: Ownership, Size and their Impact on Measures of Wealth and Home Ownership*, DP2006/06, 3 (2006) *available at* http://www.rbnz.govt.nz/research/discusspapers.

[30] *See id.* An economic unit is a non-partnered individual or a couple.

[31] *See id.*

There are three main reasons for the use of trusts in New Zealand: asset protection, estate planning and taxation benefits. By ceding legal title to the assets, a settlor of a trust may put his assets beyond the reach of his creditors, or in the case of the infirm, elderly or incapacitated, beyond the reach of the government.[32] Secondly, a trust gives the settlor power to control the disposition of the assets even after his death. For example, a settlor may give an income interest to his or her spouse for life but still ensure that the residual interest vests in his children. Lastly, and most importantly, a trust provides numerous taxation benefits in New Zealand.

By placing income producing assets in a trust, the settlor can effectively transfer income from him or herself to persons that may be taxed at a lower marginal tax rate. The top personal income tax rate in New Zealand is currently 39 percent and applies to all income derived during any income year that exceeds NZ$60,000. Beneficiary income is taxed at the beneficiary's marginal tax rate which may be as low as zero percent in the case of a charity or 19.5 percent for a person with income of less than NZ$38,000 in any given tax year. This income splitting advantage was curbed in 2001 with respect to minor beneficiaries in certain circumstances. Distributions to minor beneficiaries (under 16 years on the balance date of the trusts) will now be taxed at the trustee income tax rate of 33 percent.[33] There are certain exemptions to the minor beneficiary rule, for example a de minimis exemption for distributions of less than NZ$1,000 per year[34] and for distributions from trusts settled by persons not related to the minor beneficiary[35].

Income can be accumulated within the trust and taxed at the trustee rate of 33 percent then distributed tax free. If a settlor in the highest marginal tax bracket is also a beneficiary of

[32] There are several exceptions to this rule which are beyond the scope of this paper.

[33] Income Tax Act, 2004 (N.Z.), section HH 3A.

[34] *See id.* at section HH 3B.

[35] *See id.* at section HH 3C.

the trust, the use of that trust can effectively result in a tax saving of six percent on the income from the transferred assets.

New Zealand does not have a capital gains tax or inheritance or estate tax. There is however gift tax imposed on transfers of property worth more than NZ$27,000 in each tax year. Settlors will often loan property to a trust and then engage in a gifting program that enables them to write off NZ$27,000 as a gift each year until the debt is extinguished.

An additional benefit is anonymity. Currently New Zealand does not require registration of foreign trusts, unless they derive income from New Zealand. A New Zealand resident trustee of a foreign trust will be required to disclose the existence of the trust but does not need to give details identifying the settlor or beneficiaries.[36] Generally, trusts are regarded as irrevocable in New Zealand.[37]

New Zealand and the United States are common law countries and both recognize the legal concept of trusts.[38] However, the laws that each country has developed to ensure taxation of income derived by trusts differ in many respects. In particular, the classification of the trust's residency status is quite distinct. In New Zealand the residence of the settlor is the deciding factor as to whether trust income will be taxed on a worldwide basis.[39] In the United States residency turns on the control and supervision of the trust.[40] It was expected that, by analysing the interaction between these two sets of rules in the context of individuals moving between New Zealand and the United States, we would find that what was considered advantageous in one country may lead to unintended consequences in the other.

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[36] Tax Administration Act, 1994 (N.Z.), section 59B, as modified by Taxation (Depreciation, Payment Dates Alignment, FBT and Miscellaneous Provisions) Act, 2006 (N.Z.), section 221. If the foreign trust has an Australian settlor that fact must also be disclosed. *See also* I.R.D. Form 607, *available at* http://www.ird.govt.nz/resources/file/eb66494d37818f1/ir607.pdf.

[37] *See* TAXATION IN NEW ZEALAND: REPORT OF THE TAXATION REVIEW COMMITTEE, at ¶ 679 (Wellington, New Zealand, (1967)) where it is noted : "Possibly the only serious disadvantage that can arise from the formation of a trust and the transfer of property to it, is that a trust, once created, cannot be revoked."

[38] Despite its common law origins, the concept of a common law trust has generally been incorporated into legislation in each state in the United States.

[39] Income Tax Act, 2004 (N.Z.), section HH 4(3).

[40] 26 U.S.C. § 7701.

CHAPTER 2

TAXATION OF TRUSTS

A. Residence

In both New Zealand and the United States, the liability of a person to taxation depends on the residency of the person deriving the income and the source of the income. Trusts pose an interesting exception to the general rules regarding residence. Determining the residence of a trust for tax purposes is by no means a straightforward operation. In both New Zealand and the United States, the taxation of trust income depends on a combination of factors including the residency of each of the settlor or grantor, the trustees and the beneficiaries. It is therefore necessary to have a clear understanding of the basic tests of residency applying to both individuals and companies before considering the rules relating to residency of trusts generally.

Individuals

An individual will be resident in New Zealand if he or she has a permanent place of abode in New Zealand, whether or not he or she also has a permanent place of abode outside New Zealand.[41] An individual will also be deemed to be resident in New Zealand if he or she is personally resident in New Zealand for an aggregate of 183 days in any 12-month period.[42] A person can only lose their New Zealand tax residency if they are physically absent from the country for at least 325 days in any 12-month period and cease to have a permanent place of abode in New Zealand.[43]

The term "permanent place of abode" is not defined in the Act. The I.R.D., drawing from case law on the issue, has identified several factors that will be relevant to whether a person has a permanent place of abode in New Zealand. These include the relevant period of

[41] Income Tax Act, 2004 (N.Z.), section OE 1(1).

[42] *See id.* at section OE 1(2).

[43] *See id.* at section OE 1(3).

association with New Zealand, continuity and duration of presence and durability of association.[44]

The United States adopts the term "United States person" for the purposes of applying their income tax legislation. The term "United States person" is defined in §7701(a) of the Code as including "a citizen or resident of the United States." An individual who is not a resident is regarded as an "alien." An alien person is resident in the United States if they satisfy the "green card" test or the "substantial presence" test.[45] The "green card" test refers to persons who are lawful permanent residents of the United States and therefore hold a registration card known as a "green card."

Unlike New Zealand, the residency test based on physical presence in the United States traverses more than a 12 month period. The "substantial presence" test applies to any individual person who is physically present in the United States on at least 31 days during the current year and 183 days during the three year period including the current year and the two immediately preceding years. For the purposes of calculating the 183 days, it is necessary to count all of the days that the individual is present in the United States in the current income year, one third of all of the days that the individual is present in the year immediately preceding the current year, and one sixth of the days that the individual is present in the year immediately preceding the year before the current year.[46]

Given the different tests applying to individuals, it is clear that the case of dual residency can arise with relative ease. For example, a person need only have a permanent place of abode in New Zealand and spend more than 183 days in the United States in one year to be regarded as resident in both New Zealand and the United States for tax purposes. Dual residency, in the case of an individual, is dealt with under Article 4(2) of the Convention between

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[44] INLAND REVENUE DEPARTMENT, *Determining a Person's Permanent Place of Abode,* Tax Information Bulletin, vol. 7, n. 1, 10 (1995).

[45] 26 C.F.R. § 301.7701(b)-1.

[46] 26 C.F.R. § 301.7701(b)-1(c).

New Zealand and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income,[47] which records the double tax agreement in force between the United States and New Zealand (the "DTA"). The tie-breaker provision in the DTA lists a series of tests to determine the residency of a dual resident individual. An individual will first be deemed to be a resident of the State where he has a permanent home available to him.[48] If a permanent home is available in both States, the person will be resident in the State in which his personal and economic ties are closer.[49] If residency can still not be determined, it will be necessary to look to whether the person has an habitual abode in one of the States.[50] If the person has a habitual abode in both States or neither of them he will be deemed to be resident in the State of which he is citizen.[51] Finally, if the matter cannot be determined under any of these methods, the decision will be settled by mutual agreement between the competent authorities of New Zealand and the United States.[52]

Companies

A company is resident in New Zealand if it is incorporated in New Zealand, has its head office in New Zealand, has its centre of management in New Zealand or control of the company by its directors is exercised in New Zealand.[53]

A company is a United States person if it is a "domestic corporation."[54] A corporation will be "domestic" if it is created or organized in the United States or under the law of the United States.[55]

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[47] Convention for the Avoidance of Double Taxation, Jul. 23, 1982, U.S.-N.Z., 32 U.S.T. 1949.

[48] *Id.* at Article 4(2)(a).

[49] This concept is referred to as a person's "centre of vital interests." *Id.*

[50] *Id.* at Article 4(2)(b).

[51] *Id.* at Article 4(2)(c).

[52] *Id.* at Article 4(2)(d). The "competent authority" for the United States is the Secretary of the Treasury or his delegate and for New Zealand is the Commissioner of Inland Revenue or his delegate. *See* TREASURY DEPARTMENT TECHNICAL EXPLANATION, *U.S.- New Zealand: 1982 Income Tax Convention* (Doc 93-30994) (May 24, 1983).

[53] Income Tax Act, 2004 (N.Z.), section OE 2(1).

There are no clear guidelines in the DTA applying to dual resident companies. Where a company is resident in both New Zealand and the United States, the residency of the company, for the purposes of the DTA, will be determined by mutual agreement.[56]

Residence of Trusts in New Zealand

Technically, there is no definition of a New Zealand resident trust. The income from trust property is taxed in the hands of the trustees, or the beneficiaries, personally, subject to the rules relating to the residence of the settlor and the characterisation of the trust as qualifying, non-qualifying or foreign.[57]

Colloquially, a trust will be treated as resident in New Zealand for tax purposes if at any time a settlor of the trust is resident in New Zealand. Due to the absence of a definition of a New Zealand resident trust, this test of trust residency can be inferred from the rules contained in sections HH 4(3), HH 4(3A) and HH 4(3B) of the Act. In some cases the residence of the trustee will still be determinative of how a trust will be taxed. For example, the withholding tax rate applying to interest paid to a trustee will depend on whether the trustee is resident in New Zealand or non-resident. Where amounts of non-resident withholding income[58] are derived by a resident trustee and a non-resident trustee jointly, the higher resident trustee withholding tax rate of 33 percent will apply.[59]

Foreign income derived by a non-resident trustee will not be taxable in New Zealand unless, at the time the foreign income is derived, any settlor of the trust is resident in New

[54] 26 U.S.C. § 7701(a)(30)(C).

[55] 26 U.S.C. § 7701(a)(4); 26 C.F.R. § 301.7701-1; and 26 C.F.R. § 301.7701-2.

[56] *Supra* note 46 at Article 4(3).

[57] Under the Income Tax Act, 2007 (N.Z.), a trust, other than a charitable trust, will be a "complying trust", a "non-complying trust" or a "foreign trust". *See* Income Tax Act, 2007 (N.Z.), sections HC 9 to HC 12. A complying trust is the same, in substance, as a qualifying trust under the Income Tax Act, 2004 (N.Z.).

[58] Non-resident withholding income generally refers to interest, dividends and royalties paid by a New Zealand resident person to a non-resident.

[59] Income Tax Act, 2004 (N.Z.), section NG 1.

Zealand.[60] Where a settlor of the trust is resident in New Zealand, the trustee will be deemed to be a New Zealand resident for the purposes of calculating the taxable income of the trustee.[61] Conversely, if a New Zealand resident trustee derives a foreign sourced amount in any tax year, that amount will be exempt income if no settlor of the trust is resident in New Zealand during that tax year.[62] These rules together provide the basis for the settlor based residency test for trusts in New Zealand.

In New Zealand, a trust can be a qualifying trust, a foreign trust or a non-qualifying trust.[63] A unit trust[64] is treated as a company[65] and is therefore beyond the scope of this paper.

A "qualifying trust" receives concessionary taxation treatment and can in some ways be regarded as equivalent to a New Zealand resident trust. The term "qualifying trust" is defined to mean:[66]

> (a) for a trust that is not a superannuation fund, and for a distribution that is made by the trustee of the trust, and for a time, means a trust if, in the tax years in the period starting with the tax year in which a settlement was first made to, for the benefit of, or on the terms of, the trust and ending with the tax year in which the distribution is made, all the trustee's obligations for the trustee's income tax liability for the tax years have been satisfied at the time and –
>
> (i) no amount of trustee income was only non-resident withholding income; or
>
> (ii) neither section BD 1(2) (Income, exempt income, excluded income, non-residents' foreign income, and assessable income) nor HH 4(3B) (Trustee income) has applied to

[60] *Id.* at section HH 4(3)(a). Note that section HH 4(3) of the Income Tax Act, 2004 (N.Z.) also applies to income derived by the trustee if the trust is a superannuation fund or if any trustee of the trust was resident in New Zealand during the income tax year and the trust is a testamentary or inter vivos trust where any settlor of the trust died while resident in New Zealand at any time.

[61] *Id.* at section HH 4(3A). Note that the section provides that the trustee will be deemed not to be a non-resident for certain purposes of the Income Tax Act, 2004 (N.Z.) and will be deemed to be a resident for other purposes of the Income Tax Act, 2004 (N.Z.), including the international tax rules. For the purposes of explaining the trust rules, it is sufficient to understand that the trustee will be liable to tax as a New Zealand resident on foreign sourced income.

[62] *Id.* at section HH 4(3B). Note that there are exceptions if the trust is a superannuation fund or a testamentary or *inter vivos* trust where the settlor of the trust died resident in New Zealand at any time.

[63] Note that the terms "complying trust" and "non-complying trust" are used in the Income Tax Act, 2007 (N.Z.) to replace "qualifying trust" and "non-qualifying trust". See *supra* note 56.

[64] As defined in Income Tax Act, 2004 (N.Z.), section OB 1.

[65] Income Tax Act, 2004 (N.Z.), at section HE 1.

[66] *Id.* at section OB 1, definition of "qualifying trust".

the trustee of the trust to exclude from income an amount derived from outside New Zealand; and

(b) includes a superannuation fund

A trust will therefore be a qualifying trust if the trustee has filed its New Zealand tax returns and paid tax on its New Zealand and foreign sourced income as if the trustee were a person resident in New Zealand and had derived that income.

The major benefit of qualifying trust status is that accumulated income and capital gains can be distributed to beneficiaries in later income years as exempt income so that no further tax will be payable on that income.[67] It is this device that enables the six percent income tax saving on accumulated income for persons on the highest marginal tax rate. The six percent saving represents the difference between the tax that would be payable by the beneficiary if he or she derived the income directly, and the 33 percent trustee tax rate.

Despite not having any express definition of a domestic or resident trust, a trust may be a foreign trust for New Zealand tax purposes. A "foreign trust" under section OB 1 of the Act must not have had any settlor resident in New Zealand at any time from the date of settlement until the date of distribution. It is therefore possible to have a foreign trust with New Zealand trustees and beneficiaries although any income derived by such a trust from sources in New Zealand will be subject to tax on that New Zealand sourced income under the ordinary source rules. The unusual nature of the foreign trust definition, in particular, that it allows for the trustees of the trust to be resident in New Zealand, gives rise to certain advantages relative to other jurisdictions.

The final category of trust in New Zealand is the "non-qualifying trust." A non-qualifying trust is defined in the legislation simply to mean a trust, which is not a qualifying trust, a foreign trust or a unit trust.[68] Distributions of accumulated income and capital gains from non-qualifying

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[67] *Id.* at section HH 3(5).

[68] *Id.* at section OB 1, definition of "non-qualifying trust".

trusts are taxed at a punitive rate of tax. It is therefore advisable to avoid non-qualifying trust status.

Residence of Trusts in the United States

Trusts in the United States will either be foreign or domestic trusts for tax purposes. Prior to the enactment of the 1996 Act, the residence of a trust for U.S. tax purposes was dependent on a subjective analysis of the trust. Now, a trust must meet strict objective tests about how the trust is managed and controlled in order to be classified as a U.S. domestic trust. A trust will be a United States person, and thus a U.S. domestic trust, provided it meets both the court test and the control test set out in §7701(a)(30)(E) of the Code. Any trust other than that described in §7701(a)(30)(E) is a foreign trust.[69] There is a clear bias towards a trust being classified as foreign, unless the trustees can clearly show that the test for treatment as a U.S domestic trust can be met.

If a trust is a foreign trust, as defined in §7701(a)(31)(B), it will, under §641(b), be treated as a non-resident alien individual who is not present in the United States. This means that, under §2(d) the taxes imposed by §1 (which imposes tax generally) and §55 (which imposes the alternative minimum tax), will apply only as provided in §§871 or 877.

Section 872(a) provides the general rule that:

> In the case of a nonresident alien individual, except where the context clearly indicates otherwise, gross income includes only—
>
> (1) gross income which is derived from sources within the United States and which is not effectively connected with the conduct of a trade or business within the United States, and
>
> (2) gross income which is effectively connected with the conduct of a trade or business within the United States.

[69] 26 U.S.C. § 7701(a)(31)(B).

Section 871 imposes tax at the rate of 30 percent on fixed or determinable annual or periodic ("FDAP") income from U.S. sources that is not effectively connected with the conduct of a trade or business within the United States. This may be subject to any limit on the rate of tax imposed under an applicable double tax agreement. Income derived that is effectively connected with a trade or business conducted within the United States is taxed at the same rates, under §1 and §55, as applies to United States residents.[70]

Section 7701(a)(30)(E) and (31)(B) define whether a trust is domestic or foreign. Section 7701(a)(30)(E) includes in the definition of a United States person:

> any trust if –
>
> (i) a court within the United States is able to exercise primary supervision over the administration of the trust, and
>
> (ii) one or more United States persons have the authority to control all substantial decisions of the trust.

The U.S. tax laws illustrate a preference for classification of trusts as foreign, except in very particular circumstances. A trust may be a foreign trust in the United States notwithstanding that it may have a U.S. grantor, U.S. beneficiaries and all of its assets located in the United States. If one foreign person has the ability to control a substantial decision of the trust then the trust will not satisfy the test and will be a foreign trust.[71]

The regulations expand upon the statutory definition and elucidate further upon what are respectively termed the "court test" and the "control test" components of the §7701(a)(30) definition. Treasury regulations state that a trust is a U.S. person "on any day that the trust meets both the court test and the control test."[72] Such a trust is termed a "domestic trust."[73]

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[70] There are some exceptions to these rules, for example under 26 U.S.C. § 871(i) no tax is imposed on dividend income received from a domestic corporation meeting the 80 percent foreign business requirements of 26 U.S.C. § 861(c)(1).

[71] *See* discussion in CARLYN S. MCCAFFREY, ELLEN K. HARRISON AND ELYSE G. KI.R.S.CHNER, *US Taxation of Foreign Trust, Trusts with Non-US Grantors and their US Beneficiaries*, SG018 ALI-ABA 317, 328 (2001).

[72] 26 C.F.R. § 301.7701-7(a)(2).

[73] 26 C.F.R. § 301.7701-7(a)(2).

Whether or not the court test and the control test are met will be determined by looking at the terms of the trust and the applicable law.[74]

The Court Test

The regulations provide a safe harbour for the court test. A trust will satisfy the court test if:

> (i) the trust instrument does not direct that the trust be administered outside of the United States; (ii) the trust in fact is administered exclusively in the United States; and (iii) the trust is not subject to an automatic migration provision…[75]

An automatic migration provision that is triggered when a U.S. court attempts to assert jurisdiction of a trust will cause the trust to fail the court test. However, if a trust will only migrate from the United States "in the case of foreign invasion of the United States or widespread confiscation or nationalization of property in the United States" then the automatic migration provision will not apply.[76]

Treasury Regulation §301.7701-7(c)(3) provides several definitions pertaining to the court test safe harbor. These include the term "court" which "includes any federal, state, or local court."[77] "Primary supervision" means that "a court has or would have the authority to determine substantially all issues regarding the administration of the entire trust…notwithstanding the fact that another court has jurisdiction over a trustee, a beneficiary, or trust property."[78] "Administration" of the trust means "the carrying out of the duties imposed by the terms of the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax return, managing and investing the assets of the trust, defending the trust from suits by creditors, and determining the amount and timing of distributions."[79]

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[74] 26 C.F.R. § 301.7701-7(b).

[75] 26 C.F.R. § 301.7701-7(c)(1).

[76] 26 C.F.R. § 301.7701-7(c)(4)(ii).

[77] 26 C.F.R. § 301.7701-7(c)(3)(i).

[78] 26 C.F.R. § 301.7701-7(c)(3)(iv).

[79] 26 C.F.R. § 301-7(c)(3)(v).

A trust will satisfy the court test safe harbour even if it is silent as to where the trust is to be administered, provided that no disqualifying automatic migration applies and the general administration of the trust is carried out in the United States.

The governing law of the trust deed is irrelevant for the purposes of determining whether or not the court test is met. This may be because "while a test based on the governing law of a trust may have provided a brighter line than the Court Test does, it would not have served the I.R.S.'s purpose in treating as domestic trusts only those trusts which have a substantial connection to the U.S."[80]

The Control Test

The control test must also be satisfied in order to ensure that a trust is treated as a U.S. domestic trust. For the control test to be satisfied, "one or more United States persons must have the authority to control all substantial decisions of the trust."[81] The regulations define a "United States person" as "a person within the meaning of §7701(a)(30)."[82] A "substantial decision" is defined to mean non-ministerial decisions that persons are authorized to make under the terms of the trust deed and applicable law.[83] Ministerial decisions are described as those such as bookkeeping and the collection of rents. Substantial decisions are described as including decisions relating to the distribution of income of corpus, selection of beneficiaries, winding up of the trust, removal or replacement of trustees and investment decisions.[84]

Whether or not U.S. persons control the substantial decisions of the trust will generally depend on the terms of the trust deed. For example, where there are three trustees appointed to a trust, two are U.S. citizens and the third is a non-resident alien, the trust will satisfy the

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[80] BERRY ET AL. *supra* note 15, at 352.

[81] 26 U.S.C. § 7701(a)(30)(E)(ii).

[82] 26 C.F.R. § 301.7701-7(d)(1)(i).

[83] 26 C.F.R. § 301.7701-7(d)(1)(ii).

[84] 26 C.F.R. § 301.7701-7(d)(1)(ii).

control test if trust decisions can be made by majority vote but not if they require unanimous agreement.[85] The control test will be satisfied only if substantial decisions can be made by U.S. persons alone. Where there is a need to refer to a foreign trustee, such as the case where trust decisions require unanimity or if the foreign trustee has a power of veto, then the control test will not be satisfied.

There is a 12-month window available to replace a trustee in any case where the trust has inadvertently ceased to satisfy the control test. This may apply where a U.S. person who has authority to control the substantial decisions of the trust loses his or her U.S. residency, dies or otherwise becomes incapacitated. Where a suitable replacement is made within the 12 months, the trust will be treated as having satisfied the control test at all times. If the failure to satisfy the control test is not corrected within the 12-month period, the trust will be treated as having lost its status as a domestic trust from the date of the inadvertent change.[86]

The control test requirement marks a significant distinction between the test of residency for trusts as between New Zealand and the United States. The control test is, in essence, a residency test based on the residence of the trustees. In contrast, in New Zealand, it is possible to have a qualifying trust essentially treated as resident for New Zealand tax purposes notwithstanding that all substantial decisions of the trust are made by non-resident persons.

Dual Residence

The different tests applied to determine a trustee's liability to taxation on trust income will mean that it is quite possible that a trust could be regarded as a domestic trust for U.S. tax purposes while also being treated as a qualifying trust in New Zealand. If this situation arises, it will be necessary to consider the impact of the United States/New Zealand DTA. For the purposes of

[85] 26 C.F.R. § 301.7701-7(d)(1)(v), Examples 1 and 2.

[86] 26 C.F.R. § 301.7701-7(d)(2)(i).

the DTA, a “person”, as defined in Article 3, includes a “trust”. Article 4 of the DTA defines a “resident of a Contracting State” to be:

> any person who, under the laws of that State, is subject to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature, provided however, that:
>
> (a) this term does not include any person who is subject to tax in that State in respect only of income from sources in that State, nor does it include a person who is subject to tax in that State by reason of citizenship but who is not resident in that State; and
>
> (b) in the case of income derived or paid by a partnership, an estate, or trust, this term applies only to the extent that the income derived by such partnership, estate or trust is subject to tax in that State as the income of a resident, either in its hand or in the hands of its partners or beneficiaries.

The United States will refuse to recognize a trustee of a New Zealand foreign trust which is not subject to tax on the worldwide income of the trust as a result of there being no New Zealand resident settlor of that trust. The effect of this definition is to prevent a trustee of a trust from obtaining the benefit of treaty protection in circumstances where the trustee is not, in its capacity as trustee, taxed as a resident. Income derived by such a trustee from U.S. sources therefore will be subject to the full rate of withholding tax on FDAP, where applicable, and cannot rely on the trustee’s New Zealand residency to have that income tax reduced to the applicable DTA limits, if that income will not be subject to tax in New Zealand. This feature is peculiar to the United States/New Zealand DTA and does not appear in the double tax treaties entered into between New Zealand and most other countries.

A trust may have a New Zealand resident settlor, and be subject to taxation in New Zealand on its worldwide income, and also satisfy the court and control tests so that it is taxed as a U.S. domestic trust in the United States. Despite the specific reference to trusts in Article 4(1), this situation does not appear to be governed by the DTA. One possibility is that the residence of the trustee as a separate entity is looked at so that the relevant tie-breaker provisions applying to individuals or companies, as applicable, will be used to determine which country has the primary taxing authority. This approach would be difficult to apply where there are several trustees all from different jurisdictions (although in such a case it is unlikely that the control test will be satisfied for the purposes of U.S. domestic trust status). The alternative is to rely on the default provision in Article 4(3) which, in the absence of any other provision applying to determine the tie-breaker for trust, requires the competent authorities of the Contracting States to endeavor to settle the question, and determine how the DTA will apply to such trust, by mutual agreement.[87] One would expect that it would be relatively rare for a New Zealand settlor to establish a U.S. domestic trust and have to invoke the mutual agreement procedures, especially given the ease of which a trust will be regarded as foreign in the United States.

B. The Trust's Creator

The terms "settlor" and "grantor" are used interchangeably throughout this paper. Broadly, both terms refer to the person who establishes the trust. Where more than one person settles property on the terms of the trust, all of those persons who contribute property or money to the trust will be regarded as settlors or grantors of the trust.

Treasury regulations define the term "grantor" to include "any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer…of property to a trust."[88] A gratuitous transfer is defined in Treasury Regulation §1.671-2(e)(2) as "any transfer other than a transfer for fair market value." In this respect the term "grantor" can be considered analogous to the New Zealand concept of settlor. The term "settlement" and "settlor" are defined in section OB 1 of the Act as:

> **settlement**, in…the trust rules…
>
> (a) means –

[87] *Supra.* note 46 at Article 4(3).

[88] 26 C.F.R. § 1.671-2(e)(1).

(i) an act or failure to act on the part of a person that has the effect of making the person a settlor; or

(ii) a transaction or series of transactions that a person enters into and that has the effect of making the person a settlor; and

(b) includes a settlement that a person is treated as making because the person is treated as being a settlor of the settlement

settlor, —

(a) in…the trust rules…for a trust other than a unit trust, —

(i) means a person who makes, or has made at any time, a disposition of property to or for the benefit of the trust or on the terms of the trust for less than market value:

(ii) means a person who makes, continues to make, or has made at any time, any property available to or for the benefit of the trust for less than market value, including the provision of financial assistance whether by way of a loan, a guarantee, the provision of security, or otherwise; for the purposes of this subparagraph, if financial assistance is provided to or for the benefit of the trust at below market rates, or if amounts payable for the financial assistance are payable on demand and the right to demand payment is not exercised or is deferred, the financial assistance is treated as having been provided to or for the benefit of the trust for less than market value:

(iii) means a person who provides, continues to provide, or has provided at any time, a service to or for the benefit of the trust for less than market value:

(iv) means a person who acquires, or has at any time acquired, or obtains the use of, or continues to obtain the use of, or has at any time obtained the use of, any property of the trust or any service provided by the trustee of the trust for greater than market value:

(v) includes a person who is treated as a settlor by section HH1 (Interpretation):

(vi) includes a person 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 paragraph:

(b) for the purposes of paragraph (a), —

(i) it is immaterial whether the person acts directly or indirectly or by 1 transaction or by a series of transactions:

(ii) "series of transactions" means any number of transactions, whether related, connected or otherwise:

(iii) the fact that a person is or will become a beneficiary of the trust does not constitute the giving or receiving of value:…

The definition of settlor is drafted particularly widely in the New Zealand legislation. New Zealand case law has held that where a loan is provided with interest payable on demand, then no gift duty will be payable notwithstanding that interest may not have been demanded in any particular year, or at all.[89] This mechanism is commonly used in New Zealand to lend funds to a trust, effectively on an interest free basis. Subparagraph (a)(ii) of the definition of "settlor" is designed to combat this practice by ensuring that loans made on such terms will not be regarded as being made at full market value and will result in the lender being treated as a settlor of the trust for tax purposes.

Nominee Settlors

Where a person "creates or funds a trust on behalf of another person"[90], the U.S. Treasury regulations will treat both persons as grantors of the trust but the person who did not make a gratuitous transfer will not be treated as an owner of the trust.[91] This also applies in the case where a person is reimbursed within a reasonable period of time[92], as in the case of a lawyer that establishes a trust on behalf of a client.[93] A similar concept applies in New Zealand where,

[89] Re Marshall (Deceased), CIR v Public Trustee [1965] N.Z.L.R. 851.

[90] 26 C.F.R. § 1.671-2(e)(1).

[91] 26 C.F.R. § 1.671-2(e)(1).

[92] 26 C.F.R. § 1.671-2(e)(1).

[93] 26 C.F.R. § 1.671-2(e)(1), Example 3.

in the case of a person who makes a settlement on trust as nominee of another person, that other person will be deemed to be the settlor and the nominee will not.[94]

The practice in New Zealand is to settle a trust with a nominal sum of money. The person who makes the settlement is regarded as the settlor of the trust, subject to the nominee settlor rules discussed above. However, where the family home is then sold into the trust with a debt back to the vendor, the vendor will also be regarded as a settlor unless market value consideration is payable on that loan on commercial terms (and not payable only on demand for the reasons discussed above.)

United States Grantor Trust Rules

One significant difference between the United States and New Zealand tax regimes with respect to trusts is the application of the grantor trust rules in the United States. Despite this difference, the settlor based tax regime in New Zealand and the grantor trust rules stem from the same basic principles.

In New Zealand, it is generally accepted that trusts are irrevocable. As was recognised by the Consultative Committee that considered the tax regime for trusts in 1998: "The point of trusts, however, is that the ownership nexus is severed, except to the extent that the settlor retains a claim over the settled property in the form of outstanding debt."[95] Legal title in the trust assets vests absolutely with the trustee. This is so even if the settlor retains a residual beneficial interest in the trust property. Until legal title is transferred back to the settlor, the trustee will still be regarded as the legal owner of that property. Provided the trust is properly constructed, and the three certainties are met, then income from trust property will either be taxed in the hands of the beneficiary or the hands of the trustee, depending on when that income is distributed.

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[94] Income Tax Act, 2004 (N.Z.), section HH 1(1).

[95] Original emphasis. INTERNATIONAL TAX REFORM: PART 1 – REPORT OF THE CONSULTATIVE COMMITTEE ON FULL IMPUTATION AND INTERNATIONAL TAX REFORM (Wellington, New Zealand (1988)), at Appendix 4 ¶ 2.8.

Unlike New Zealand, the United States taxes persons who retain effective control of the assets they have purportedly transferred to a trust as if the transfer had not happened. Under the grantor trust rules, a person may be deemed to be the owner of a trust, or portion thereof, so that any income derived and any deductions allowed will be attributable to that grantor, or other owner, rather than the trust as a separate entity.[96]

The Regulations elucidate the rationale behind the grantor trust rules by suggesting that the principle underlying Subpart E is:

> in general that income of a trust over which the grantor or another person has retained substantial dominion or control should be taxed to the grantor or other person rather than to the trust which receives the income or to the beneficiary to whom the income may be distributed.[97]

The grantor trust rules apply to treat a person as owner of the portion of the trust in a number of different situations. Subject to certain exceptions, these include the portion of the trust which in which the grantor retains a reversionary interest.[98] The grantor will also be deemed to own the portion of the trust of which the beneficial enjoyment of the corpus, or the income from the corpus, is subject to the power of disposition by the grantor, without the approval or consent of any person with a substantial beneficial interest in the trust.[99] If the grantor retains certain administrative powers, such as the power to deal with the trust property without fully adequate consideration[100] or to borrow the corpus or income of the trust without adequate interest or security[101] then the grantor will be deemed to be the owner of the portion of the trust to which that power relates. Finally, the grantor trust rules will also apply if the grantor retains a power to revoke the trust[102] or where the income of the trust is required to be applied

[96] 26 U.S.C. § 671.

[97] 26 C.F.R. § 1.671-2(b).

[98] 26 U.S.C. § 673.

[99] 26 U.S.C. § 674.

[100] 26 U.S.C. § 675(1).

[101] 26 U.S.C. § 675(2).

[102] 26 U.S.C. § 676.

for the benefit of the grantor or the grantor's spouse either currently or in the future.[103] The 1996 Act changed the law so that, subject to limited exceptions, the grantor trust rules will not apply to foreign trusts.[104] The strict conduit treatment afforded to trusts under the grantor trust rules is unmatched in New Zealand.

Settlor Based Trust Regime

New Zealand bucks the international trend by taxing trust income based on the residence of the settlor. The reasons for adopting the settlor based trust regime are, in many respects, similar to the reasons behind the United States grantor trust rules. However, in some ways the settlor regime has questionable legitimacy in international law due to the fact that, in some circumstances, it can result in persons becoming liable to tax in New Zealand notwithstanding that the income may not have a New Zealand source and the legal owner of that income may not be resident in New Zealand for tax purposes. This anomaly has been addressed in the Income Tax Act, 2007 (N.Z.), so that new section HC 25 confirms that such trustee income will be taxable notwithstanding the usual rule which ensures that foreign sourced income derived by non-residents is not taxable in New Zealand. The Rewrite Project Team responsible for drafting the rewritten trust rules in the Income Tax Act, 2007 (N.Z.) noted that "the link is intended to assist the reader identify that this rule overrides a core concept of the Act: taxation on the basis of both source and residence."[105]

It is therefore useful to understand the background behind New Zealand's settlor regime for taxation and to consider further whether the rationale behind the system provides sufficient explanation for breaching the source and territorial rules for taxation of income.

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[103] 26 U.S.C. § 677.

[104] 26 U.S.C. § 672(f).

[105] I.R.D. POLICY ADVICE DIVISION, REWRITE PROJECT TEAM, *Rewriting The Income Tax Act, Exposure Draft, Part H, Commentary, Draft Subpart HC: Trusts,* (2005).

A report issued by the Taxation Review Committee in October 1967[106] recognized the proliferation of inter vivos family trusts in New Zealand and expressed concern about tax avoidance through the "fragmentation of income through a trust"[107] and by claiming of certain tax exemptions available to beneficiaries and trustees. The Taxation Review Committee was particularly concerned "about the inequities in tax burdens that result from the use of family trusts to fragment income."[108] It was the Taxation Review Committee that recommended using a flat rate to tax trustee income, with the safeguarding provision that the basic rate applying to individuals should be used in any case where the individual's rate is higher than the trustee rate.[109] This principle applies to beneficiary income but has not been extended to apply to distributions of accumulated trust income in the case of domestic based trusts. The Taxation Review Committee also suggested aggregating the income from trusts for unmarried children up to age 16 with the income of the parent who established the trust.[110] It took more than three decades for the government to be concerned enough about the fiscal impact of income splitting within the family to introduce this measure in the form of the minor beneficiary rules.

The next major review of the trust rules took place in 1987. In that year a Consultative Document on International Tax Reform ("1987 Consultative Document") was issued by the government and first proposed that the taxation of foreign income earned through non-resident trusts would be treated in a similar manner to income earned through foreign companies. The 1987 Consultative Document formed the basis of New Zealand's controlled foreign company regime and, at the time, it was proposed that foreign trusts should fall under the same rules. If the proposals had been adopted, foreign trusts would have become subject to the branch equivalent tax rules so that an interest in a foreign trust would be treated as if it were a foreign

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[106] TAXATION IN NEW ZEALAND: REPORT OF THE TAXATION REVIEW COMMITTEE (Wellington, New Zealand, (1967)).

[107] *Id.* at ¶ 679.

[108] *Id.* at ¶ 681.

[109] *Id.* at ¶ 686.

[110] *Id.* at ¶ 689.

branch. Income would be taxed currently whether or not it was distributed during the income year. These proposals were designed to eliminate the deferral of New Zealand tax on foreign income earned by New Zealand residents through foreign trusts.[111]

It was proposed that, in order to eliminate ambiguity, a trust would be a New Zealand resident if any trustee of the trust were resident in New Zealand at the end of the accounting year.[112] A non-resident trust was therefore to be defined as a trust that did not have a New Zealand resident trustee at the end of the trust's accounting year. The difficulties inherent in identifying beneficiaries in a foreign trust and taxing a New Zealand resident beneficiary's interest in the foreign trust were acknowledged. The proposed rules were therefore based on the contribution of assets to the foreign trust by any New Zealand resident settlor. In this respect, the proposed solution largely resembled the U.S. grantor trust rules. The value of the contribution to the trust was to be the difference between the market value of the property transferred and the consideration received from the trust in respect of that property. Certain specific rules were to be devised to apply to financial assistance given to foreign trusts and for indirect transfers to foreign trusts. Once an interest had been established, the New Zealand resident would be required to recognise income on a branch equivalent or comparative value basis. These methods of accounting for foreign income form part of the controlled foreign company and foreign investment fund rules in New Zealand law. Under the branch equivalent method, the New Zealand resident is deemed to derive income equal to their percentage share of the net income from the entity calculated in accordance with New Zealand's tax laws. If it is not possible to gather enough information to apply the branch equivalent method, the comparative value method can be used. This effectively taxes the increase or decrease in the market value of the interest from the start of the income year to the end of the income year. In

[111] CONSULTATIVE DOCUMENT ON INTERNATIONAL TAX REFORM (Wellington, New Zealand (1987)).

[112] *Id.* at ¶ 4.3.

effect, the comparative value method taxes unrealized capital gains, which is somewhat unusual given that New Zealand does not have a generally applicable capital gains tax.

In March 1988 the Consultative Committee on Full Imputation and International Tax Reform ("1988 Committee"), chaired by Arthur Valabh, reported back to the government on the 1987 Consultative Document.[113] The method of determining residency of a trust by reference to the residence of the trustees was rejected. In particular, the 1988 Committee rejected the notion that the settlor should be taxed in New Zealand on the basis that the beneficiaries were hard to identify and the trustees were not resident in New Zealand. It was stated:

> This approach ignores the legal relationship between a settlor and a trustee since the former has no right to the income of the trust. Indeed, the whole point of a trust is to ensure that property and the income it produces is legally divested by a settlor. In reality, however, a settlor often has substantial influence over the trustee, usually on an informal basis though there may be specific provision in the trust deed, and in practice if not in law, may be able to wind up the trust and take back the property.[114]

The solution proposed by the 1988 Committee forms the basis of New Zealand's current trust taxation regime. It was the 1988 Committee that determined that the residency of a trust would be based on the residence of the settlor and that income earned by non-resident trustees of trusts settled by New Zealand residents would be taxed in New Zealand.[115] The problems with enforcement were to be addressed by ensuring that the New Zealand resident settlor had a residual liability to pay tax if the non-resident trustee failed to do so.[116]

New Zealand's regime, based on the residence of the settlor, can be contrasted against both the Australian and the United Kingdom systems which treat trusts as resident in the respective jurisdiction based on the residence of the trustee. However, in many respects the

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[113] INTERNATIONAL TAX REFORM: PART 1 – REPORT OF THE CONSULTATIVE COMMITTEE ON FULL IMPUTATION AND INTERNATIONAL TAX REFORM (Wellington, New Zealand (1988)).

[114] *Id.* at ¶ 5.2.1.

[115] *Id.* at ¶ 5.2.2.

[116] Income Tax Act, 2004 (N.Z.), section HH 4(4).

settlor regime is quite closely aligned with that of the United States, which places a great deal of emphasis on the residence of the grantor when applying specific trust tax rules. In some ways, both countries fail to actually define the residency of the trust based on the residence of any particular person. In the United States, the court test and the control test must be satisfied and in New Zealand there is no specific test that applies to determine whether any given trust is actually New Zealand resident. However, as discussed above, the application of the court test does indicate that there must be a control by United States persons over the trust before a trust will be regarded as domestic trust for U.S. tax purposes. This control requirement is more akin to a trust residency test based on the residency of the trustee than applies in New Zealand.

Taxing a trust based on the residence of a settlor poses some interesting jurisdictional questions. The rationale behind the 1998 Committee's decision to tax trust income based on the residence of the settlor, with the result that foreign sourced income derived by a New Zealand resident trustee of a trust with non New Zealand resident settlor was that:

> [T]his is the appropriate treatment since such income has no definite connection with New Zealand apart from the existence here of the of the trust administrator (who will, however, have no beneficial interest in the income).[117]

The trustee does, however, have a legal interest in that income, by virtue of his or her position as trustee. The settlor, on the other hand, has neither a legal interest nor, in cases where he or she is not also a beneficiary under the trust, a beneficial interest. The settlor cedes legal title to the property when it is settled upon the trust. The settlor either receives market value for the property or is subject to gift duty on the value of the property that is given to the trustee to the extent it exceeds the value of consideration received. If the property transferred by a settlor would be taxable in the hands of the settlor if not for the transfer, then the amount transferred will be income to the trustee.[118] The settlor has no further control of the asset. It is

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[117] *Supra* note 112 at ¶ 5.2.5.

[118] Income Tax Act, 2004 (N.Z.), section HH 1(7) and section OB 1, definition of "corpus".

therefore questionable why the income from that asset should continue to be taxed in New Zealand, based on whether or not the settlor is a resident in New Zealand.

The grantor trust rules in the United States get around the jurisdictional problem by deeming the grantor to be the owner of a portion of a trust in certain circumstances. As a deemed owner of the assets, the United States can then tax income derived in respect of the portion of the trust owned by the U.S. person. Other than the grantor trust rules, a trust in the United States will only be subject to taxation on its worldwide income if it satisfies the court and control tests and is therefore treated as a U.S. person.

New Zealand achieves the same result by deeming a non-resident trustee to be resident in New Zealand in any income year where the trustee derives foreign sourced income that would be subject to income tax in New Zealand if derived by a New Zealand resident and any settlor of the trust is resident in New Zealand,[119] although using a deemed residency provision is a debatable approach to asserting taxing rights on persons not otherwise connected to New Zealand.

The U.S. grantor trust rules and the New Zealand settlor based taxation regime are very similar. They both identify the settlor or grantor as determinative for the purposes of recognising income. Where control is not completely ceded by the grantor, the United States attributes income to a resident grantor, but not to a non-resident grantor, except in certain circumstances. New Zealand acknowledges that the settlor is no longer the true legal owner and taxes the trustees accordingly but deems them to be resident in New Zealand if the settlor is resident in New Zealand, thereby satisfying the jurisdictional requirements, in order to apply New Zealand's tax laws to the income derived.

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[119] *Id.* Sections HH 4(3)(a), HH 4(3A).

C. Distributions of Current Income

Both the United States and New Zealand recognise the conduit nature of the trust structure and attempt to tax the income derived from trust assets in the hands of the beneficiary to which that income is attributed. In the United States, the trustee is allowed a deduction for income derived and distributed to beneficiaries in the current year. In New Zealand, the same result is achieved by taxing current year income in the hands of the beneficiaries directly and exempting the trustee from such income altogether.

Distributions of Current Year Income – United States

The income of every trust or estate is taxed at the rates set out in §1(e) of the Code whether or not the income is to be distributed currently or accumulated for distribution in a future year.[120] The tax rates applying to trust income range from 15 percent for income less than $1,500 to 39.6 percent for income over $7,500. The low threshold at which the top tax rate applies appears to be indicative of a general policy to discourage the use of trusts as a vehicle through which to channel income. This can be compared to the $250,000 threshold at which the top tax rate will apply to individuals in most circumstances.[121]

A trust that is required to distribute all of its income currently will be permitted a deduction for the amount that is required to be distributed[122] and that amount will be treated as gross income of the beneficiary whether or not the amount is actually distributed.[123]

A trust that permits the trustees to accumulate income, distribute income currently or distribute corpus of the trust is referred to as a complex trust[124] governed by subpart C of the

[120] 26 U.S.C. § 641.

[121] *See* 26 U.S.C. § 1(a), (b) and (c) but note the exception for married individuals filing separate returns in 26 U.S.C. § 1(d) for whom the top tax rate applies to income over $125,000.

[122] 26 U.S.C. § 651.

[123] 26 U.S.C. § 652. This discussion effectively ignores Subpart B of the Internal Revenue Code (26 U.S.C. § § 651 and 652) which deals only with simple trusts that are permitted to distribute current income only. No such distinction is made between simple and complex trusts in New Zealand and the current trend is to give the trustees the discretion to accumulate income as well as distribute current earnings to the beneficiaries.

Code. If the trust is able to distribute income currently or accumulate income for distribution in future years, then it will be entitled to deduct both the amount that is required to be distributed currently and also any other amount that is properly paid or credited for such taxable income year.[125] For both a simple trust and a complex trust, the amount of the allowable deduction must not exceed the distributable net income ("DNI") of the trust.[126]

The DNI is computed under §643(a) and as modified by §661(c).[127] DNI is defined to mean the taxable income of the trust, before taking into consideration the deductions for distributions to beneficiaries allowed under §§651[128] and 661[129] and before taking the personal exemption deduction permitted under §642(b).[130] The DNI of a U.S. domestic trust does not include gains from the sale or exchange of capital assets that comprise the corpus of the trust and are not "paid, credited, or required to be distributed to any beneficiary during the taxable year."[131] Capital gains, however, are included for the purposes of determining a foreign trust's DNI for the taxable year.[132]

Under §643(b) the term "income" is defined as "the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law." Extraordinary dividends and taxable stock dividends are excluded from both the definition of DNI of a simple trust[133] and the definition of income[134] where the trustee, acting in good faith, determines that such dividends are attributable to the corpus of the trust.

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[124] 26 C.F.R. § 1.661(a)-1 states that "A trust to which Subpart C is applicable is referred to as a "complex" trust in this part."

[125] 26 U.S.C. § 661(a)(1).

[126] 26 U.S.C. §§ 651(b), 661(a).

[127] 26 C.F.R. § 1.661(a)-2(a).

[128] 26 U.S.C. § 651 permits a deduction to the trust for amounts required to be distributed from a simple trust that is required to distribute all of its income currently in much the same way as 26 U.S.C. § 661 permits deductions for amounts required to be, or actually, distributed from a complex trust.

[129] 26 U.S.C. § 643(a)(1).

[130] 26 U.S.C. § 643(a).

[131] 26 U.S.C. § 643(a)(3).

[132] 26 U.S.C. § 643(a)(6)(C).

[133] 26 U.S.C. § 643(a)(4).

[134] 26 U.S.C. § 643(b).

If a beneficiary receives, or is entitled to receive, a distribution to which §661 applies, then §662 operates to include certain amounts in the gross income of the beneficiary. Under §662(a)(1) income that is required to be distributed currently will be included in the gross income of the beneficiary whether or not those amounts are actually distributed or not. The exception to this rule is where the amount that must be distributed exceeds the DNI of the trust. In this case, the amount to be included in the beneficiary's gross income is the amount "which bears the same ratio to distributable net income…as the amount of income required to be distributed currently to such beneficiary bears to the amount required to be distributed currently to all beneficiaries."[135] Beneficiary income cannot therefore exceed the DNI of the trust. Where amounts are required to be paid out of income or the corpus of the trust, the amounts paid out of the income will be included in the beneficiary's gross income.[136]

Also included under §662(2) is any other amount properly paid, credited, or required to be distributed currently to a beneficiary for the taxable year. Again, if the amount of income required to be distributed plus all other amounts properly paid or credited or required to be distributed to all beneficiaries, exceeds the DNI, then the amount included in each beneficiary's gross income is determined as a pro rata share of the total distribution to all beneficiaries.

The character of the amounts included in gross income of the beneficiaries is determined under §662(b). Distributions retain the same character in the hands of the beneficiary as they did in the hands of the trust and income derived from each distinct source will be allocated proportionately, unless the trust instrument specifically allocates different classes of income to different beneficiaries.

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[135] 26 U.S.C. § 662(a)(1).

[136] 26 C.F.R. § 1.662(a)-(2)(c).

Distributions of Current Year Income – New Zealand

In New Zealand, current year income is either beneficiary income or trustee income, it cannot be both. This stands in contrast to the U.S. approach, which treats all income derived by the trustee as taxable, with a deduction allowed for distributions made in the current year. Both methods achieve the same objective, that is currently distributed income will only be taxed once, in the hands of the beneficiaries.

Beneficiary income comprises income derived by the trustee of a trust that is distributed to the beneficiaries of the trust during the income year in which it was derived or within six months after the end of the income year in which it was derived.[137] Income distributed as beneficiary income is taxed in the hands of the beneficiary at the beneficiary's marginal tax rate, although the trustee has a liability to satisfy that income tax liability as agent for the beneficiary.[138] Marginal tax rates in New Zealand range from 19.5 percent for a person who derives less than NZ$38,000 in an income year, to 39 percent for a person that derives over NZ$60,000 in an income year. Distributions of beneficiary income made to charities may be exempt from taxation.

In 2001 the government enacted specific laws reducing the benefit of income splitting through family trusts. Under section HH 3A of the Act, income derived by a minor beneficiary in certain circumstances is subject to tax as if it were trustee income. A minor is defined as a person under 16 years of age as at the balance date of the trust making the distribution.[139] The effect of the new rules is that income paid from a trust to a person under 16 years will be subject to tax at 33 percent regardless of whether the marginal tax rate of the minor beneficiary would have been less than 33 percent or not. These rules are targeted at income splitting through family trusts and will not apply where all settlements made on the trust are made by persons

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[137] Income Tax Act, 2004 (N.Z.), section OB 1, definition of "beneficiary income."

[138] *Id.* at section HH 3(2).

[139] *Id.* at section HH 3F(2).

who are not relatives, legal guardians or associated persons of the minor. Exceptions also apply for certain settlements made pursuant to court orders and wills.

Essentially, even under New Zealand legislation all income of a trustee must be "derived" by the trustee.[140] The fact the trustee is the person who derives the income means that the position between the U.S. treatment and the New Zealand treatment is based on the same principles. In New Zealand, the trustee derives all of the trust income, however, where he derives that income as agent of the beneficiary, the trustee is taxed as agent, rather than, as the with the U.S. position, being treated as having derived it personally but then being allowed a deduction for the distribution made.

Regardless of the mechanics of the taxation, it is clear that only one person, the trustee or the beneficiary, can be taxed upon that income. This proposition is supported by the Court of Appeal decision of *Commissioner of Taxes v. Luttrell*[141] in which it was held that income of an estate could not be taxed in the hands of the trustee during the period that the estate was being wound up and also in the hands of the beneficiary who finally received that income. To tax both the trustees and the final recipient would be to impose double taxation. This case confirms that "once income has been taxed in the hands of a trustee, it cannot be taxed again later when it is paid out to the beneficiary."[142] This principle of a single level of taxation will not necessarily prevent a beneficiary from being required to pay additional tax where his or her marginal tax rate is higher than that of the trustees.[143] The principle of a single level of taxation is addressed slightly differently in the context of distributions of accumulated income, discussed below.

Generally, income derived by a trustee in New Zealand retains its character in the hands of the beneficiary. There are some exceptions to this rule in relation to certain tax attributes of

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[140] *See* JOHN PREBBLE, *Taxation of Trusts: The Scope of Sections 226 to 233 of the Income Tax Act 1976,* 11 V.U.W.L.R. 195, 199 (1981).

[141] [1949] N.Z.L.R. 823 (C.A.).

[142] *Supra* note 140 at 201.

[143] Commissioner of Taxes v Luttrell [1949] N.Z.L.R. 823 per Finlay J; *see* s*upra* note 140 at 205.

income derived by the trustee, most notably in the context of imputation credits or dividend withholding payment credits attached to dividends. A beneficiary is only entitled to use the proportion of imputation credits or dividend withholding payment credits that reflects the proportion that their distributions from the trust during the income year bears to the total of all distributions of both capital and income made by the trust to all beneficiaries of the trust during the income year.[144] This means that it is not possible for a trustee to allocate tax credits by distributing dividend income to a beneficiary who is better placed to use them while distributing income from other sources, without such tax credits attached, to other beneficiaries during the same income year. To a certain extent these rules achieve the same result as applies in the United States pursuant to §661(b) which determines that the character of income distributed by a trust will be determined on a pro rata basis.

Despite the slightly different mechanics of taxing income currently distributed to beneficiaries of a trust, both New Zealand and the United States adhere to the same concept, that currently distributed trust income is taxed once, and retains the same character, in the hands of the beneficiaries.

D. Distributions of Accumulated Income

Often, a trustee will be permitted or even required to retain and accumulate net income derived in a current income year for distribution to beneficiaries of the trust in a future income year. The tax treatment of distributions of accumulated income from trusts differs considerably between New Zealand and the United States. In both countries there is a concept of qualifying distributions, which allows a certain level of imputation of tax paid by the trustee in the relevant jurisdiction. However, the application of such method of imputation is applied differently in each case. Where New Zealand operates a blanket exemption to such income in the hands of the beneficiary, the United States requires that such distributions of accumulated income be

[144] Income Tax Act, 2004 (N.Z.), section LB 1(3).

allocated to the relevant year in which the income can be said to have arisen and applies the relevant tax plus, in the case of foreign trusts, a deemed interest rate, to ensure that the correct rate of tax is paid by the beneficiary (taking account of any tax paid by the trustee in the relevant period). This greater level of precision effectively eliminates any potential income splitting or deferral benefits that can be provided by accumulating income in the hands of a trustee rather than the beneficiary.

In New Zealand, under section HH 4 of the Act, a trustee is required to satisfy the tax liability in respect of the taxable income of the trust. Trustee income is defined as all income of the trust that is not beneficiary income. Trustee income is the gross income of the trust that is accumulated in the trust rather than distributed currently to the beneficiaries. Income tax is paid on trustee income at the rate of 33 percent.[145] Capital gains derived by a trustee generally are not subject to tax in New Zealand.[146]

The taxation consequences of subsequent distributions of accumulated income from the trust will depend on the classification of the trust. In New Zealand, a trust can be a qualifying trust, a foreign trust or a non-qualifying trust.[147]

A qualifying trust is defined to be a trust where the trustee's income tax liability has been satisfied at all times since the first settlement was made on the trust, and where no amount of trustee income has been only non-resident withholding income. The trustee must also not have derived income that has been exempt from taxation in New Zealand as an amount of income

[145] *Id.* at schedule 1, part A, clause 4.

[146] Certain capital gains derived from land transactions and from speculative transactions where the trustee purchases property with the intention of resale, as part of a profit making undertaking, or as part of a business in dealing in the property, will be recharacterised as income and taxed accordingly. Unrealised gains on interests in certain foreign investment funds, controlled foreign companies, financial arrangements and foreign shares may also be taxed, although this is treated as attributed income and is not the subject of a separate capital gains tax regime.

[147] A unit trust, as defined in the Income Tax Act, 2004 (N.Z.), section OB 1, is treated as a company under section HE 1 of that Act and is therefore beyond the scope of this paper.

derived from foreign sources by a non-resident person, or by a resident trustee of a trust that has no settlor resident in New Zealand.[148]

Provided there is a New Zealand resident settlor of the trust and the trustees return income from worldwide sources for New Zealand tax purposes, a trust is likely to be a qualifying trust notwithstanding that some of the trustees or beneficiaries are not resident in New Zealand. Qualifying trust status is generally preferred from a New Zealand tax perspective.

In order to be a foreign trust for New Zealand tax purposes there must have been no settlor of the trust resident in New Zealand at any time from the date that the first settlement was made on the trust, or from 17 December 1987, whichever is the later.[149] A non-qualifying trust is a trust that is neither a qualifying trust nor a foreign trust.[150]

As well as beneficiary income, beneficiaries of a trust are also required to include any taxable distributions, other than taxable distributions from a non-qualifying trust, as income in the income year.[151] Distributions made from a qualifying trust, other than beneficiary income, are expressly excluded from income of a beneficiary and are therefore not subject to any further taxation.[152]

Taxable distributions made from a non-qualifying trust are excluded from income of a beneficiary because they are subject to a punitive rate of tax, currently set at 45 percent[153] and therefore do not form part of the income tax calculation for the person.[154] A taxable distribution is a distribution of trust property that is neither beneficiary income nor corpus of the trust. The concept only applies to distributions from foreign trusts and non-qualifying trusts. It generally represents accumulated trustee income and certain capital gains. Capital gains derived by non-

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[148] Income Tax Act, 2004 (N.Z.), section OB 1, definition of "qualifying trust".

[149] *Id.* at section OB 1, definition of "foreign trust".

[150] *Id.* at section OB 1, definition of "non-qualifying trust".

[151] *Id.* at section HH 3(1).

[152] *Id.* at section HH 3(5).

[153] *Id.* at schedule 1, part A, clause 8.

[154] *Id.* at section HH 3(4).

qualifying trusts are included in the taxable distribution. This exacerbates the impact of the punitive taxation rate on distributions from such trusts.

Section HH 6 of the Act provides the ordering rules for distributions from a trust. The income derived by the trustee in that income year is first distributed as beneficiary income.[155] Where the distribution exceeds the income derived by the trustee in the current year, the distribution will be deemed to consist of income derived by the trustee in earlier income years.[156] When this income is exhausted, the distribution will be made from capital gains of the trustee in the current income year less any capital losses made in the current income year[157], then capital gains less capital losses of the preceding income years[158] and finally the corpus of the trust.[159] The ordering rule does not apply to distributions from a qualifying trust[160] but is otherwise analogous to that contained in the regulations for Subpart D of the Code which states that an accumulation distribution is deemed to consist of undistributed net income, then undistributed capital gain and finally corpus.[161]

Distributions of Accumulated Income From Foreign Trusts

The rules for distributions of accumulated income from foreign trusts to U.S persons are considerably more complex than distributions from foreign trusts to beneficiaries resident in New Zealand. Distributions of accumulated income from foreign trusts in New Zealand are received as taxable distributions and taxed at the beneficiary's marginal tax rate. This approach reflects the fact that New Zealand is unlikely to have taxed the income in the hands of the trustee prior to the distribution of the income. There is, in New Zealand, no rule that prevents persons from

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[155] *Id.* at section HH 6(1)(a).

[156] *Id.* at section HH 6(1)(b).

[157] *Id.* at section HH 6(1)(c).

[158] *Id.* at section HH 6(1)(d).

[159] *Id.* at section HH 6(1)(e).

[160] *Id.* at section HH 6(2)(a).

[161] 26 C.F.R. § 1.665(a)-0A(a)(2).

accumulating income in low tax jurisdictions and obtaining a benefit by deferring the tax payable in New Zealand until the date of distribution. Most capital gains derived by trustees of foreign trusts can be distributed to New Zealand resident beneficiaries tax-free. There is an exception for capital gains derived from transactions with persons associated with the trustee. Such gains will form part of the taxable distribution for New Zealand tax purposes.[162]

There is no ability for a beneficiary of a foreign trust to utilise a tax credit for income tax paid by the trustees in respect of a taxable distribution, unless that tax is imposed as a withholding tax on that distribution itself.[163] For example, if the foreign trust derived interest income from a U.S. source, that interest income would be subject to withholding tax in the United States. The amount of that withholding tax will not be permitted as a tax credit to the beneficiary, unless that interest income were distributed currently and taxed as beneficiary income (in which case the gross amount of the distribution, prior to the deduction of U.S. withholding tax would be taxable). If that income is accumulated by the trustees, the amount distributed to the beneficiary loses its character and is taxed in full as a taxable distribution when paid to a New Zealand beneficiary. In a practical sense that amount would have been reduced by the withholding tax paid by the trustees so that only the net amount would be available to distribute as a taxable distribution and be subject to tax.

Where a foreign trust has derived income from New Zealand sources, the distribution of that New Zealand sourced income to a foreign beneficiary may also be taxable in New Zealand. This is because income derived by a beneficiary under any trust, so far as the income of the trust fund is derived from New Zealand is deemed to have a New Zealand source.[164] It is questionable whether such distributions by foreign trusts to foreign beneficiaries are ever targeted by the I.R.D., given the enforcement problems and the fact that such income would

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[162] *Id.* at section OB 1 definition of "taxable distribution".

[163] Income Tax Act, 2004 (N.Z.), section LC 1(2).

[164] *Id.* at section OE 4(1)(p).

have already been taxed in the hands of the trustee. This provision can be compared with the situation under U.S. law, where an accumulation distribution made by a foreign trust to a non-resident alien from U.S. sourced income can be taxed under U.S. law.[165]

This relatively simplistic method of taxing distributions from foreign trusts, in the hands of the beneficiaries at their current tax rate when distributed to the relevant beneficiary, can be contrasted with the level of precision that is achieved under the United States throwback rules.

The United States has enacted laws which make the use of foreign trusts unpopular and generally obsolete in terms of obtaining tax advantages. Based on the New Zealand tax laws explained above, a person not resident in New Zealand could establish a foreign trust in a tax haven country and accumulate income, paying low or zero tax in the income year in which the income is derived. When the trustees finally decide to distribute that income to the trust's New Zealand beneficiary, the distribution will be treated as a taxable distribution from a foreign trust for New Zealand tax purposes. The income will be included in the beneficiary's income tax return for the income year and taxed at the beneficiary's ordinary marginal tax rate. A timing advantage therefore arises to that New Zealand beneficiary as they have successfully deferred the payment of tax on that income and obtained the time-value benefit of the amount of tax payable between the date the income was derived in the tax haven and the date of distribution.

Prior to the Tax Reform Act of 1976, U.S. persons could obtain a deferral benefit by creating a foreign trust provided that they gave up all control and interest in the assets transferred provided that neither the grantor nor his or her spouse were a beneficiary of the foreign trust.[166] This tax deferral mechanism was eliminated by the introduction of §679, which created a new grantor trust rule applying to a U.S. person who establishes a foreign trust with U.S. beneficiaries. If the trust has one or more U.S. beneficiaries then the grantor is treated as

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[165] 26 U.S.C. § 667(e). *See* example provided in NORMAN H. LANE AND HOWARD M. ZARITSKY, FEDERAL INCOME TAXATION OF ESTATES AND TRUSTS (3rd ed. 2001), ¶ 6.06[6][d], Example 6-54.

[166] *See* KLEINFELD & SMITH, *supra* note 22 at §52:2.1.

owning that part of the trust that relates to the property transferred and all income derived in respect of that trust property is taxed in the hands of the grantor.

In addition, the "throwback rules" contained in Subpart D of the Code apply to distributions of accumulated income from foreign trusts, which, together with the interest charged on the deferred tax liability, effectively eliminate any benefit that could otherwise be attained in relation to accumulating income in foreign trusts. Any income accumulated in a foreign trust that is not taxed in the hands of a U.S. grantor is subject to a non-deductible interest charge in order to deter the deferral of repatriating foreign sourced trust income. These rules also apply to accumulated capital gains derived by a foreign trust and not taxed in the hands of a U.S. grantor. Such capital gains lose their character and are treated as ordinary income in the hands of U.S. beneficiaries.[167] Consequently, no timing advantage is available under U.S. tax laws.

A foreign non-grantor trust is, for the purposes of U.S. tax, taxed as a non-resident alien individual who is not personally present in the United Sates[168] and is subject to tax on gross income derived from sources within the United States that is not effectively connected with the conduct of a trade or business within the United States and on gross income that is effectively connected with the conduct of a trade or business within the United States.[169] Income that is effectively connected to a U.S. trade or business is taxed at the ordinary rates as set out in §1(e) of the Code. Income derived by a trust which has a U.S. source but which is not attributable to a U.S. trade or business will be taxed as FDAP income at the flat rate of 30 percent[170] and may be subject to withholding under §1441(a). In most cases, the withholding tax on U.S. sourced income not related to a U.S. trade or business which is distributed to a New

[167] 26 U.S.C. §§ 643(a)(6), 667(e).

[168] 26 U.S.C. § 641(b).

[169] 26 U.S.C. § 872(a).

[170] 26 U.S.C. § 871(a).

Zealand trustee or New Zealand resident beneficiary of a trust will be reduced by application of the DTA applying between New Zealand and the United States.

Grantor Trust Rules Applying to Foreign Trusts Established by Non-U.S. Persons

The U.S. taxation of trusts will depend upon whether the trust is regarded as a grantor trust or not. While the focus in this paper is on foreign non-grantor trusts, it is necessary at this point to consider the nature of the grantor trust rules that may apply to a foreign trust.

Under the grantor trust rules, a person may be deemed to be the owner of a trust, or portion thereof, so that any income derived and any deductions allowed will be attributable to that grantor as owner, rather than the trust as a separate entity.[171]

Generally, in the case of a foreign trust, the grantor rules will not apply. Code §672(f)(1) states that subpart E, relating to grantor trusts, only applies if its application would result in United States income "being currently taken into account (directly or through 1 or more entity) under this chapter in computing the income of a citizen or resident of the United States." Provided a non-U.S. person establishes the foreign trust, §672(f)(1) will generally prevent the application of the grantor rules to the trust.

A foreign trust, or portion thereof, may still be regarded as a grantor trust under §672(f)(2) if the grantor retains the right to re-vest legal title in the trust property in himself absolutely without the consent of any other person,[172] if the only amounts distributable from that trust, or portion thereof, are distributable only to the grantor and his or her spouse[173] or if the trust is a compensatory trust.[174] Using New Zealand as an example, it is not usual for a trust deed to reserve a power of revocation to the settlor, although in many cases the settlor and or his or her spouse will retain some beneficial interest in the trust fund. Provided that the

[171] 26 U.S.C. § 671.

[172] 26 U.S.C. § 672(f)(2)(A)(i).

[173] 26 U.S.C. § 672(f)(2)(A)(ii).

[174] 26 U.S.C. § 672(f)(2)(B).

beneficiaries form a wider class of persons than just the grantor and his or her spouse, then these exceptions to the general rule should rarely apply.

Caution must be taken where a U.S. beneficiary of a foreign trust transfers property to the foreign grantor of that trust. Under §672(f)(5) if the grantor is a foreign person and would be treated as the owner of the trust but for the application of §672(f)(2), then where any U.S. beneficiary of that trust makes a transfer, either directly or indirectly, to the foreign person, that U.S. beneficiary will be treated as the owner of that portion of the trust that represents the property transferred. Where no U.S. beneficiary has transferred property to the grantor, then the trust will be a foreign non-grantor trust.[175]

Grantor Rules Applying to U.S. Grantors of Foreign Trusts

The Taxpayer Relief Act of 1997 modified §679 of the Code by strengthening the rules applying to U.S. persons who make transfers to foreign trusts and "made the use of foreign trusts for U.S. beneficiaries by grantors who are U.S. persons far less attractive than before and often inadvisable."[176] Code §679 provides that where a foreign trust is established by a U.S. person, and that trust has a U.S. beneficiary, then the transferor is treated as the owner of the portion of the trust attributable to the property so transferred.[177] Rather than relying on the level of the grantor's control over a trust, as applies to the domestic grantor rules, the application of §679 turns merely on whether there is a transfer by a U.S. person to a foreign trust and whether there is a U.S. beneficiary of that foreign trust.

Direct, indirect and constructive transfers to a foreign trust will all trigger the application of §679.[178] Under Treasury Regulation §1.679-3(d)(1) a constructive transfer includes any assumption or satisfaction of a foreign trust's obligation to a third party. An indirect transfer is

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[175] 26 C.F.R. § 1.672(f)-1(a).

[176] EDMUND W. GRANSKI, JR., *Federal Taxation of Foreign Trust: Coping with a Complex Regime*, 25 Est. Plan. 243, 245 (1998).

[177] 26 U.S.C. § 679(a)(1).

[178] 26 C.F.R. § 1.679-3(a).

treated as a transfer if made by an intermediary "made pursuant to a plan one of the principal purposes of which is the avoidance of United States tax."[179] A principal purpose of tax avoidance is deemed to exist in any case where the U.S. person is related to the beneficiary or has such other relationship that would suggest that he or she would make a transfer to the foreign trust unless that U.S. person can prove that the intermediary has a relationship that would establish a reasonable basis that the intermediary would make a transfer to the foreign trust, that the intermediary acted independently and that the intermediary complied with any applicable reporting requirements.[180]

Transfers of property for fair market value are excluded from the purview of §679[181] unless that fair market value consideration consists of a obligation of, or the guarantee of an obligation by, the trust, any grantor, owner, or beneficiary of the trust or any person related to the grantor, owner, or beneficiary of the trust.[182] The regulations soften the impact of this exception by providing that only obligations of related parties that are not "qualified obligations" will be disregarded for the purposes of §679.[183] A "qualified obligation" is one that is reduced to writing,[184] the term does not exceed five years,[185] all payments are denominated in U.S. dollars,[186] the yield to maturity is between 100 and 130 percent of the applicable federal rate under §1274(d) on the day on which the obligation is issued,[187] the transferor agrees to an extension on the statute of limitations with respect to an assessment in respect of the obligation[188] and the transferor reports the status of the loan on Form 3520 for every year that

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[179] 26 C.F.R. § 1.679-3(c)(1).

[180] 26 C.F.R. § 1.679-3(c)(2).

[181] 26 U.S.C. § 679(2)(B).

[182] 26 U.S.C. § 679(a)(3). For the purposes of this section, a related person under 26 U.S.C. § 679(a)(3)(C)(iii) is described in 26 U.S.C. § 643(i)(2)(B).

[183] 26 C.F.R. § 1.679-4(c).

[184] 26 C.F.R. § 1.679-4(d)(i).

[185] 26 C.F.R. § 1.679-4(d)(ii).

[186] 26 C.F.R. § 1.679-4(d)(iii).

[187] 26 C.F.R. § 1.679-4(d)(iv).

[188] 26 C.F.R. § 1.679-4(d)(v).

the loan is outstanding.[189] If the transferor receives a qualified obligation from the related trust, that qualified obligation will be taken into account for the purposes of determining whether or not the related trust has provided fair market value for the property transferred.

There is a default presumption that a trust, to which a U.S. person has made a transfer, will have a U.S. beneficiary unless one of the statutory exceptions applies. A trust will be treated as having a U.S. beneficiary under §679(c) unless:

(a) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a U.S. person, and

(b) if the trust were terminated at any time during the taxable year, no part of the income or corpus of such trust could be paid to or for the benefit of a U.S. person.[190]

If a trust acquires a U.S. beneficiary and becomes taxable as a grantor trust under §679, the grantor becomes taxable for the current year income plus all of the UNI of the trust (or the relevant portion thereof, as applicable) as at the end of the preceding year.[191] It is therefore important that, if a U.S. person settles a foreign trust, they explicitly prevent U.S. persons from being entitled to income or corpus of the trust in order to prevent the application of the grantor trust rules to the trust.

If §679 applies to treat a U.S. transferor as the owner of a part of a foreign trust, §684 will not apply upon the transfer of property to that foreign trust. If §679 ceases to apply, for example because the last remaining U.S. resident beneficiary loses their U.S. residency, then §679 will cease to apply from the first day of the U.S. grantor's taxable year in which there is no longer a U.S. beneficiary. The loss of grantor trust status will mean that the U.S grantor is deemed to have made a transfer of property to the foreign trust on the first day of the first

[189] 26 C.F.R. § 1.679-4(d)(vi).

[190] 26 U.S.C. § 679(c)(1).

[191] 26 U.S.C. § 679(b).

taxable year that the trust is not treated as having a U.S. beneficiary and will be required to recognise any capital gain on that deemed transfer in accordance with §684 of the Code.[192]

The capital gain treatment under §684 does not apply if the U.S. transferor is treated as the owner of the trust under §671.[193] Due to the application of §672(f), the only situations in which §671 will apply to a foreign trust is if the trust has a U.S. transferor and a U.S. beneficiary and §679 applies, or if the trust otherwise has a U.S. beneficiary that has directly or indirectly made a transfer to the trust and §672(f)(5) applies to treat that beneficiary as an owner of that part of the trust.

As §679 taxes the U.S. grantor on the foreign trust, he or she is also taxed on the capital gains of that trust. This means that a U.S. person is unable to obtain the benefit of using a New Zealand trust to accumulate capital gains tax free, despite there being no capital gains tax levied in New Zealand. This is consistent with the U.S taxation of foreign trusts generally and provides a clear distinction between the taxation of U.S. domestic trusts and foreign trusts with U.S. beneficiaries. The definition of “DNI” stipulates that the income of a foreign trust includes capital gains and losses, to the extent that those losses do not exceeds such capital gains.[194] Parallels can be drawn in some respects with the taxation of foreign trusts under New Zealand law. For the purposes of taxing distributions from a foreign trust in the hands of a New Zealand resident beneficiary, capital gains lose their status as such and form part of the taxable distribution from any foreign trust, provided that this only applies to capital gains derived from transactions with associated persons.

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[192] 26 C.F.R. § 1.679-2(c)(2).

[193] 26 U.S.C. § 684(b).

[194] 26 U.S.C. § 643(a)(6).

Throwback Rules

Subpart D of the Code deals specifically with distributions of accumulated income and ensures that amounts accumulated and taxed as income of the trust are subject to taxation at the beneficiary level. The purpose of the throwback rules is to allocate undistributed income back to the last preceding income year in which an amount of DNI was not distributed. The distribution may be allocated to several income years to fully account for the previously undistributed income. The distribution is then treated as having been made in the current income year but the income tax liability for the beneficiary is calculated as if it had been distributed in the income year in which the trust income arose.[195]

As discussed above, §661(a)(2) of the Code permits a deduction to the trust for any amount, other than income for the taxable year, that is properly paid or credited or required to be distributed for the taxable year. A distribution of such an amount is permitted as a deduction to the trust to the extent it does not exceed the trust's DNI for the taxable year, reduced by the amounts of income that are required to be distributed currently as stated in §661(a)(1). Any amount under §661(a)(2) that exceeds the DNI less the §661(a)(1) income required to be distributed, will be an "accumulation distribution" as that term is defined in §665(b).

The term undistributed net income ("UNI") is defined in §665(1) to mean the amount by which the DNI of the trust exceeds the sum of the amounts required to be distributed currently plus any other amount properly distributed for such income year and the taxes imposed on the trust in respect of the DNI. Any income derived by a trust during a taxable year will be UNI to the extent it is not required to be distributed and is not actually distributed to the beneficiaries of the trust. If no amount of DNI for the year is retained by the trust, there will be no UNI for that

[195] 26 C.F.R. § 1.665(a)-0A(a)(4). *See* detailed examples of how to calculate tax liability using the throwback rules in LANE & ZARITSKY, *supra* note 163 at ¶ 6.06; MCCAFFREY ET AL. *supra* note 70.

particular year. The "amount of taxes imposed on the trust" includes foreign taxes imposed by a foreign country.[196]

An accumulation distribution can exceed the amount of UNI derived in previous income years. The ordering rule contained in the regulations clarifies that an accumulation distribution is first deemed to comprise the UNI of the trust, then the undistributed capital gain of the trust and then, to the extent the distribution exceeds the UNI and the undistributed capital gain, corpus of the trust. An accumulation distribution of a domestic trust created after 1 March 1984 will not include UNI.[197] Such distributions will therefore not be subject to the throwback rules. UNI is therefore a concept primarily used in dealing with distributions from foreign trusts.

Once it has been ascertained that the distribution from the foreign trust includes an accumulation distribution, it will be necessary to allocate that accumulation distribution to the preceding income years, commencing with the earliest year for which any UNI is remaining.[198] The total of the amounts which are treated as having been distributed by a trust in a preceding taxable year are included as income of the beneficiary. Tax is applied to that amount in accordance with §667. In the case of a foreign trust, this includes an interest charge as calculated under §668 as more fully described below.

The accumulation distribution is allocated to the relevant preceding income years, and the UNI for each relevant income year is deemed to have been distributed to the beneficiary on the last day of each of those income years.[199] The amount of tax that was paid on that UNI on behalf of the trust in each relevant income year is to be added to the deemed distribution amount.[200] Taxes imposed on the trust include, in the case of foreign trusts, "any income, war profits and excess profits taxes imposed by any foreign country or possession of the United

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[196] 26 U.S.C. § 665(d)(2).

[197] 26 U.S.C. § 665(c)(1) and definition of "Qualified Trust" in 26 U.S.C. § 665(c)(2).

[198] 26 U.S.C. § 666(a).

[199] 26 U.S.C. § 667.

[200] 26 U.S.C. § 666(d) and 26 U.S.C. § 666(c) (which require apportionment of the relevant tax imposed on the trust where the accumulation distribution is less than the UNI for the relevant income year).

States".[201] Where distributions are made to more than one beneficiary during the income year, it appears that the UNI should be allocated on a pro rata basis, rather than the earliest years' UNI applying to the first distribution. Lane and Zaritsky note that "neither the Code nor the regulations explicitly so direct" but this "analysis is consistent with the general rules of §661, under which all distributions made during a single year are cumulated and allocated to determine the amount currently taxable to beneficiaries."[202] Allocating the UNI pro rata to distributions throughout the year would also prevent streaming the distributions to the beneficiaries for whom the impact of throwback taxes will be the least.

The tax on the deemed distribution is calculated under §667. For the purposes of determining tax on taxable income for any income year in which a U.S. beneficiary receives a distribution of accumulated income, the taxable income for the year will be calculated in the ordinary manner on taxable income excluding the accumulation distribution, plus an additional amount of throwback tax in respect of the accumulated distribution, plus, in the case of a foreign trust, the interest charge as determined under §668. In order to calculate the throwback tax, the following steps are required:

(a) Determine the number of preceding taxable years of the trust for which deemed distributions have been allocated. For this purpose, in order to avoid the reduction of the average annual accumulation to avoid tax,[203] any income year for which the deemed distribution is less than 25 per cent. of the accumulation distribution divided by the number of preceding taxable years to which the accumulation distribution is allocated will not be taken into account;[204]

(b) Determine the "computation years". These are the three income years remaining after removing the taxable year in which the beneficiary's taxable income was the

[201] 26 U.S.C. § 665(d).

[202] LANE & ZARITSKY, *supra* note 163 at ¶ 6.06[4][b].

[203] *Id.* at ¶ 6.06[6][a].

[204] 26 U.S.C. § 665(d)(3).

highest and the year in which the beneficiary's taxable income was the lowest from the five taxable years immediately preceding the year of the accumulation distribution;

(c) Add to the beneficiary's taxable income for each of the computation years an amount equal to the deemed distribution divided by the relevant number of distribution years (as referred to in (a)); and

(d) Determine the average increase in tax for the computation years by recalculating the tax payable in each of the computation years by including the relevant deemed distribution in taxable income for each year, adding together the increase in tax for each year and dividing by three.

The amount determined under paragraph (d) is sometimes referred to as the "beneficiary hypothetical tax liability".[205] The throwback tax is the excess (if any) of the average increase in tax under paragraph (d), multiplied by the number of income years referred to in (a), less the amount of any U.S. taxes included in the deemed distribution.[206] Foreign taxes which are included in the deemed distribution and added to the taxable income of the beneficiary for any computation year are generally treated as a credit against the increase in tax for each computation year.[207] If the tax paid by the trust matches or exceeds the beneficiary hypothetical tax liability, no amount of throwback tax will be payable. No refund is available if the trust has paid taxes in excess of the beneficiary hypothetical tax liability[208].

The interest charge imposed under §668 applies to distributions from a foreign trust. The interest rate is set at the rate for underpayments under §6621 of the Code and is applied to the period which is "the applicable number of years before the date of the distribution and which

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[205] LANE & ZARITSKY, *supra* note 163 at ¶ 6.06[6][b].

[206] 26 U.S.C. § 667(b).

[207] 26 U.S.C. § 667(d).

[208] 26 U.S.C. § 666(e).

ends on the date of the distribution".[209] The interest rate for the quarter beginning 1 January 2008 has been set at seven percent.[210] For income years since 1 January 1996, the interest is calculated on a daily compounding basis,[211] meaning its impact may be significant. The interest charged is not deductible.[212] The "applicable number of years" is determined under a complicated process designed to provide a weighted test. The UNI for each year is multiplied by the number of years between the year from and including the year to which the UNI relates to but excluding the year of distribution. The products of this calculation are added together and divided by the aggregate UNI,[213] rounded to the nearest half year.[214] For the purposes of the calculation, any year in which the beneficiary receiving the accumulation distribution is not a U.S. citizen or a resident of the United States is disregarded.[215] The interest charge and the partial tax imposed under §667(b) are together limited to the amount of the accumulation distribution.[216]

Where a beneficiary has inadequate information to calculate their actual tax liability under the throwback rules, it is possible to rely on a default method of taxing an accumulation distribution from a foreign trust.[217] Under the default treatment, instead of determining exactly what amounts of UNI are allocated to preceding income years, the U.S. beneficiary can determine a default position based on the average distributions from the trust in the past three income years.[218]

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[209] 26 U.S.C. § 668(a)(2).

[210] IR-2007-193, Nov. 28, 2007.

[211] Prior to 1 January 1996, the interest rate was set at six percent and was not compounded: 26 U.S.C. § 668(a)(6).

[212] 26 U.S.C. § 668(c).

[213] 26 U.S.C. § 668(a)(3).

[214] I.R.S. Form 3520 (2006), line 50.

[215] 26 U.S.C. § 668(a)(4).

[216] 26 U.S.C. § 668(b).

[217] *See* Notice 97-34, 1997-25 IRB 22, section V.B. and Form 3520-A (Annual Return of Foreign Trust with U.S. Beneficiaries). *See also* BERRY ET AL*, supra* note 16; MCCAFFREY ET AL*. supra* note 70.

[218] *See* I.R.S. Form 3520 (2006), line 30 and instructions for Form 3520 available at http://www.irs.gov/instructions/i3520/index.html.

It is worth mentioning §663(a)(1) which may permit non-periodic distributions to be made tax free. A specific gift of a sum of money or property may be made under §663(a)(1) and will not be subject to taxation as a distribution provided that it is paid in not more than three instalments. With careful planning, this section may be used to minimise the exposure to the throwback rules and interest charge applying to accumulated income.[219]

[219] *See* DONALD T. WILLIAMSON AND PHILIP, F. JACOBY*, Accumulation Distributions From Foreign Trusts Can Be Avoided Through Specific Gifts,* 96 J. Tax'n 40 (2002)*;* and ROSE & CHOMMIE *supra* note 11 at ¶ 8.09.

CHAPTER 3

MOVING BETWEEN JURISDICTIONS

It is not uncommon for individuals migrating to New Zealand to first contact a New Zealand based tax adviser for pre-migration planning advice. Such forward planning initiatives, where the home country allows, can afford significant benefits or, at least, can provide an opportunity to restructure investments and trust arrangements so that no unintended consequences arise as a result of the migration. One clear advantage is the ability to transfer significant non-New Zealand assets to a trust while non-domiciled in New Zealand without the imposition of gift duty, thereby avoiding the administration and timing issues associated with gifting programs. All too often, however, new migrants to New Zealand will be lured into the trend of holding assets on trust without any thought to the consequences of such actions in relation to the family member beneficiaries who are left at home. This chapter summarises some of the consequences of a settlor's change of residence from the United States to New Zealand and vice versa.

A. United States to New Zealand

Leaving the United States[220]

A trust will lose its U.S. trust status and become a foreign trust if either the court or control test is no longer satisfied. To this extent, unless the grantor is one of the U.S. persons who controls the decisions of the trust, the change of tax residence of the grantor may not directly impact on the status of the trust for U.S. tax purposes.

Where, as a result of an inadvertent change of status of a trustee, a trust loses its status as a U.S. trust, the trustees have a 12 month grace period to remedy the change, by replacing the trustee or otherwise doing anything necessary to ensure that control over all substantial

[220] A trust with a non-U.S. grantor and U.S. beneficiaries is often referred to as an "inbound trust" and a trust with a U.S. grantor and foreign beneficiaries is often referred to as an "outbound trust". Given the dual jurisdiction focus of this paper, these terms have not been used in this sense to prevent confusion as to whether a trust is "inbound" or "outbound" in reference to New Zealand or the United States.

decisions of the trust is held by U.S. persons. If the change is not made within the 12 month grace period the trust will be treated as having lost its status as a U.S. trust on the first day that the trust failed to satisfy the control test.[221] If a domestic non-grantor trust becomes a foreign trust, the U.S. grantor will, subject to certain exceptions,[222] be treated as having made a distribution of the property that such grantor had transferred to the trust, including any UNI relating to that trust property, to a foreign trust and the foreign trust will be treated as a U.S. grantor trust to the extent of those trust assets and UNI.[223]

The scenario considered here is where a U.S. grantor of a U.S. trust decides to emigrate from the United States and, as a result of his or her emigration, the U.S. domestic trust becomes a foreign trust. Under §684(c), capital gain treatment applies to any domestic trust that becomes a foreign trust. In this case, the trust will be treated as having transferred, immediately before becoming a foreign trust, all of its assets to a foreign trust. Section 684(a) will apply to require recognition of the gain in the amount of the excess of fair market value of the trust assets over the trust's adjusted basis in those assets as if they had been sold at fair market value to the foreign trust. This will apply where the U.S. trust becomes a foreign trust when no person resident in the United States is a grantor of the trust and provided that no part of the foreign trust is treated as owned by another person under §671.[224]

Distributions from the foreign trust will be subject to the tax rules described above. This means that capital gains will form part of the UNI of the trust and all accumulated income will become subject to the throwback rules and interest charge. This can result in a significant additional tax cost on distributions from the trust and is often an unforeseen consequence by migrating grantors who have set up trusts to benefit their U.S. resident relatives.

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[221] 26 C.F.R. § 301.7701-7(d)(2). *See* explanation in MCCAFFREY ET AL. *supra* note 70.

[222] 26 C.F.R. § 1.679-4. The deemed transfer and application of 26 C.F.R. § 679 will not apply if the transfer to a foreign trust is made (a) by reason of the transferor's death, (b) the foreign trust is a foreign pension or deferred compensation trust, (c) the transfer is to a foreign charitable trust, or (d) the transfer is made at fair market value (which, in the case of a related party transfer for a note or other indebtedness must be a "qualified obligation").

[223] 26 C.F.R. § 1.679-6.

[224] 26 U.S.C. §684(c). *See* MCCAFFREY ET AL. *supra* note 70 at 340.

Under §679(a)(5) if a U.S. resident individual transfers property to a domestic trust and the trust subsequently becomes a foreign trust while that person is still alive, §679 will apply and the U.S. transferor will be treated as the owner of that part of the foreign trust that is attributable to the property transferred, plus any undistributed income attributable to that property, if there are U.S. beneficiaries of that trust when the trust becomes a foreign trust.

Entering New Zealand

New Zealand has recently introduced a transitional residence exemption, which is designed to encourage skilled migrants to emigrate to New Zealand. The effect of these exemptions is to delay New Zealand taxation on foreign sourced income derived by new migrants and persons returning to New Zealand after a ten year period of non-residence for a period of four years from the date on which they become resident in New Zealand.[225] This exemption extends to the trusts of new migrants, so that such trusts may remain treated as foreign trusts, notwithstanding that there is a settlor who is resident (under the ordinary tests of residence) in New Zealand. The trustees (or the settlor or a beneficiary) of the trust have 12 months from the expiration of the 48 month transitional resident exemption to elect for the trust to become a qualifying trust.[226] If no such election is made, distributions from the trust will be treated as being made from a non-qualifying trust to the extent they comprise income and gains derived by the trustees after the end of that 12 month election period.

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[225] The exemption applies from 1 April 2006. When originally introduced, the transitional residence exemption applied from the first day of the month in which a person acquired a permanent place of abode in New Zealand. It was intended that this would allow any person who had made a short visit to New Zealand prior to 1 April 2006 but who only migrated to New Zealand after that date to take advantage of the exemption. It was subsequently found that this test was incompatible with provisions in the Income Tax Act, 2004 (N.Z.) which treated a person as resident under both the 183 day test and the permanent place of abode test. *See* TAXATION (ANNUAL RATES, SAVINGS INVESTMENT AND MISCELLANEOUS PROVISIONS) BILL - OFFICIALS' REPORT TO THE FINANCE AND EXPENDITURE COMMITTEE ON SUBMISSIONS ON THE BILL, volume 1 (16 October 2006), 115-116. The test now applies for a period of 48 months from the first day of residence under the normal rules, but there are transitional provisions which will mean that a person who acquired a permanent place of abode on or after 1 April 2006 but who would have been resident under the 183 day test from a day prior to 1 April 2006 may still be eligible for the exemption. See sections 86 and 87 of the Taxation (Savings Investment and Miscellaneous Provisions) Act, 2006 (N.Z.), which amend sections FC 23 and FC 24 of the Income Tax Act, 2004 (N.Z.).

[226] *See* Income Tax Act, 2004 (N.Z.), section HH 2(1), which was amended under the Taxation (Depreciation, Payment Dates Alignment and Miscellaneous Provisions) Act, 2006 (N.Z.) so that the initial 12 month period for election was extended to 12 months after the expiration of the transitional resident exemption, where applicable.

The interplay between the qualifying trust election, the taxation of income in the interim period and the taxation of distributions from such trusts is not entirely clear. Commonly, it is thought that, prior to the expiration of the period allowed to make a qualifying trust election, the trust will be treated as a foreign trust. This is often treated as a permissible deferral mechanism.

A trust with a transitional resident does have a settlor resident in New Zealand, applying the ordinary rules relating to residence. It therefore cannot be a "foreign trust" as defined. Section HH 4(3B) applies to the income of such trust so that if a trustee resident in New Zealand derives any foreign sourced amount, that amount will be exempt income if no settlor of the trust is a New Zealand resident and not a transitional resident. Section HH 4(3B) therefore excludes foreign sourced income during the period of transitional residence but not during the 12 month period that in which the election to become a qualifying trust can be made.

While a trust has a transitional resident settlor and derives foreign source income on which no tax is paid, as a result of section HH 4(3B), the trust will not be a qualifying trust as defined. A distribution of foreign sourced income during this period would be exempt in the hands of a transitional resident under the transitional residence rules. The position is not so clear where the income has a New Zealand source or where the distribution is made to a New Zealand resident who is not a transitional resident. To avoid any uncertainty about whether a distribution of such income is a distribution from a non-qualifying trust, and subject to tax at the rate of 45 percent (whether or not tax has been paid by the trustee on such income in New Zealand), it would be best to ensure that, to the extent possible, all income received during the transitional period is distributed currently as beneficiary income. This would ensure that such income is only taxed once, in the hands of the beneficiary. The other alternative is to have the transitional resident, once they become resident (under the ordinary rules) in New Zealand, establish a new qualifying trust to hold New Zealand sourced income producing assets. There would then be no question about the status of the trust or distributions.

The 12 month election period allowed under section HH 2(1) applies so that a settlor, trustee or beneficiary of the trust may, within 12 months of the transition day (being the day on which a person becomes a New Zealand resident if not a transitional resident or the day on which transitional status is lost but the person continues to be a transitional resident), elect to satisfy the income tax liability in respect of the taxable income of the trustee of the trust.[227] Where such an election is made, for the purposes of distributions from the trust:

> (a) the trust is deemed to be a foreign trust to the extent to which any distribution from that trust consists of income, capital profits, or capital gains derived by the trustee of the trust before the date on which the election was made; and
>
> (b) the trust is deemed to be a qualifying trust to the extent to which any distribution from the trust consists of income, capital profits, or capital gains derived by the trustee of the trust on or after the date on which the election was made if the trustee's obligations under this Act and the Tax Administration Act 1994 in respect of the trustee's liability to income tax in respect of the trustee income derived by the trustee have been satisfied…[228]

The trust is deemed to be a non-qualifying trust if an election is made but the trustee's tax liabilities are not satisfied.[229] The trust will also be deemed to be a non-qualifying trust after the expiry of the 12 month period if no election is made.[230]

In order for a qualifying trust election to be effective under section HH 2(1)(b), the trustee's income tax liability must be satisfied. In the period when the settlor is resident in New Zealand but not a transitional resident, arguably, the worldwide income of the trust will be taxable in New Zealand, as the exemption under section HH 4(3B) will no longer apply. In the case of a non-resident trustee, section HH 4(3) will apply so that the non-resident trustee is deemed to be resident in New Zealand for the purposes of paying tax on foreign sourced income. Section HH 4(3) states that it will be subject to section HH 2 but it is far from clear that

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[227] Income Tax Act, 2004 (N.Z.), sections HH 2(1A) and HH 2(1).

[228] *Id.* section HH 2(1).

[229] *Id.* section HH 2(1)(2)(b).

[230] *Id.* section HH 2(1)(3).

section HH 2 actually keeps such foreign sourced income out of the New Zealand tax net during that election period as section HH 2 only deems such a trust to be a foreign trust in relation to distributions of income derived prior to the election. It may therefore be necessary for a trustee to pay tax on its worldwide income during the 12 month election period in order to qualify for qualifying trust status upon the election being made. If this is the case, it would be better to make the election immediately, so that the trust obtains the benefits of qualifying trust status, rather than delay the election until the end of the 12 month period. This is because distributions of income derived prior to the election being made will be taxed as distributions from a foreign trust, being taxable distributions to the beneficiaries, rather than tax-free distributions from a qualifying trust. This applies notwithstanding that the trustees technically have an obligation to pay tax on the income of the trust during that same period. This analysis contradicts the usual position taken by tax advisors, based on section HH 2, that a trust will be a "foreign trust" and taxed as such until the date of election.[231] The tax deferral benefit that is commonly thought to exist by operation of section HH 2(1) is not without doubt.

B. New Zealand to United States

New Zealand Impact

A trust which at any time has a New Zealand resident settlor is in the peculiar position of never being able to satisfy the definition of "foreign trust", as there was, at some time, a person resident in New Zealand who was a settlor of that trust. That means that, unless the trust is able to retain qualifying trust status, the trust will by default become a non-qualifying trust and distributions to beneficiaries will be taxed at 45 percent.

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[231] *See* JOHN W. HART, *Back to Fundamentals – Non-Resident Trusts and Migrant Rules*, New Zealand Institute of Chartered Accountants (2006) at ¶ 5.2, where in his discussion on inbound individuals he mentions "Such a trust will be treated as a foreign trust (i.e. only liable to tax in New Zealand on locally sourced income) for the period up to 12 months after the date the settlor acquires New Zealand tax residency."

Despite not satisfying the definition of "foreign trust", a trust that no longer has a New Zealand resident settlor will be subject to taxation as if it were a foreign trust. Under section HH 4(3B) of the Act, foreign sourced income derived by the trust at a time when no settlor of the trust is resident in New Zealand are excluded from the income of the trust and are not subject to New Zealand income tax. At first glance this may be considered beneficial, however, the taxation of distributions from such a trust are generally undesirable.

Any trust which takes advantage of the section HH 4(3B) exemption will fail to satisfy the definition of "qualifying trust". As it cannot be a foreign trust and is no longer a qualifying trust, such trust will be a non-qualifying trust. As noted by Hart, "unfortunately the definition of "taxable distribution" does not appear to allow the reserves which were accumulated during the period that the trust was a qualifying trust to be exempted from the taxable distribution definition".[232] Subsequent distributions from the trust will therefore be taxed in the hands of any New Zealand resident beneficiaries at the rate of 45 percent, notwithstanding that such accumulated income may have been taxed in New Zealand when derived by the trustee. No tax credit or other form of imputation is available to acknowledge the tax paid. Distributions of capital gains, which were not taxable in New Zealand if distributed while the settlor was a New Zealand resident, will become taxable in the hands of the beneficiary if distributed after the settlor ceases to be a New Zealand resident. In addition, income that was derived by the trustee, and upon which the trustee paid tax in New Zealand while the trust was a qualifying trust, can be subject to taxation a second time as a taxable distribution in the hands of any foreign beneficiary, under the source rules, which state that a distribution from a trust will have a New Zealand source to the extent that the distribution comprises income sourced from New Zealand.[233] Again there is no recognition of the prior taxation of such amount in the hands of the trustee.

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[232] *Id.*

[233] Income Tax Act, 2004 (N.Z.), section OE4 (1)(p). *See* NEW ZEALAND INLAND REVENUE DEPARTMENT, EXPOSURE

Some practitioners take the view that, if the trustees continue to pay tax on the worldwide income of the trust, the trust will retain its qualifying trust status and distributions can continue to be made tax free to beneficiaries. The difficulty is that there is no basis for this approach within the law. Section HH 4(3B) is not optional. To ignore it and pay tax on foreign sourced income in any case does not solve the problem that that section has applied to exclude foreign sourced amounts from the income of the trust.

One solution, as suggested by Hart,[234] may be to ensure that any qualifying trust does not derive foreign sourced income once the settlor departs New Zealand. This way, section HH 4(3B) will not apply to any income of the trust and the "qualifying trust" definition can still be met. Provided the trustees continue to satisfy their tax obligations in respect of all New Zealand sourced income and that such income is not only non-resident withholding income but is taxed in the hands of the trustees as New Zealand residents (to the extent not taxed as beneficiary income), then the trust should retain its qualifying trust status and distributions of accumulated income can be made tax free to beneficiaries.

Another alternative is to wind the trust up and resettle a new trust as a foreign trust for New Zealand tax purposes, once the settlors have lost their New Zealand residency.[235] This approach is not always commercially desirable, as it will reduce the impact of the asset protection provided by the trust and may require an extended gifting programme, to the extent that the settlors remain New Zealand domiciled.[236]

New Zealand residents who choose to lose their New Zealand residence status in order to receive distributions from a foreign trust or a non-qualifying trust tax free must be wary of section HH 3(3) of the Act. This section contains an anti-avoidance measure which treats any

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DRAFT: PU2869: *Taxable Distributions and Non-Resident Beneficiaries of Foreign Trusts and Non-Qualifying Trusts* (1995), which confirms this view.

[234] *See* HART, *supra* note 228.

[235] *Id.*

[236] *Id.*

trust distributions received by a person who was New Zealand resident and who subsequently becomes New Zealand resident within five years as having been derived by that person on the date on which they reacquired their New Zealand resident status.

United States Impact

The grantor rules applying to foreign trusts are extended to include a foreign grantor who subsequently becomes a U.S. person within five years of making the transfer[237] and, in such a case, the UNI accumulated prior to the U.S. residency start date is also attributed to the property transferred and included as part of the trust property to which the new U.S. resident is deemed to own.[238]

In addition, if there is a U.S. grantor of the trust under §679(a) for the taxable year but §679 did not apply in the preceding taxable year due to the fact that there was no U.S. beneficiary, then under §679(b) the transferor is treated as having income for the taxable year (in addition to his other income for such year) equal to the UNI (at the close of such immediately preceding taxable year) attributable to the portion of the trust that the grantor is deemed to own.

If, in any income year, a trust which was a foreign trust satisfies the court test and the control test and becomes a U.S. domestic trust, a distribution of income accumulated while the trust was a foreign trust will be treated as an accumulation distribution from a foreign trust for the purposes of the throwback rules and the interest charge.[239]

There is a default presumption that a trust, to which a U.S. person has made a transfer, will have a U.S. beneficiary unless one of the statutory exceptions applies. A trust will be treated as having a U.S. beneficiary under §679(c) unless under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for

[237] 26 U.S.C. § 679(a)(4)(A).

[238] 26 U.S.C. § 679(a)(4)(B).

[239] REV. RUL. 91-6, 1991-1 CB 89.

the benefit of a U.S. person, and if the trust were terminated at any time during the taxable year, no part of the income or corpus of such trust could be paid to or for the benefit of a U.S. person.[240]

This means that a New Zealand settlor of a trust who moves to the United States within five years of making the transfer must be careful that his trust deed is amended to ensure that no beneficiary under the trust is a U.S. beneficiary. For example, child beneficiaries that accompany the parent may need to be removed from the trust deed until such time as they cease to be U.S. residents. The determination of whether a trust has a U.S. beneficiary is made "without regard to whether income or corpus is actually distributed to a U.S. person during that year, and without regard to whether a U.S. person's interest in the trust income or corpus is contingent on a future event."[241] If a U.S. person is a member of a class of potential beneficiaries, the trust will be treated as having a U.S. beneficiary.[242] In addition, if the terms of the trust deed can be amended to benefit a U.S. person, then the trust will be treated as if it has a U.S. beneficiary.[243] If the U.S. beneficiary becomes resident in the U.S. more than five years after the date of transfer, they will not be regarded as a beneficiary of the trust for purposes of §679.[244]

Code §684, discussed above, imposes a capital gains tax on transfers made by a U.S. person to a foreign trust. This is designed to ensure that appreciated assets cannot leave the U.S. tax base to be disposed of with no capital gains tax. Given that New Zealand does not have a generally applicable capital gains tax, there is no equivalent rule. Although a detailed discussion of the impact of capital gains taxes is outside the scope of this paper, as a matter of

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[240] 26 U.S.C. § 679(c)(1).

[241] 26 C.F.R. § 1.679-2(a)(2)(i).

[242] 26 C.F.R. § 1.679-2(a)(2)(ii), Example 9 (relating to a residual class of descendents as beneficiaries, one of whom is resident in the US) and Example 10 (relating to a trustee's discretion to distribute to any person pursuing the study of ancient Greek, which can potentially include U.S. residents).

[243] 26 C.F.R. § 1.679-2(a)(4)(ii)(A).

[244] 26 U.S.C. § 679(c)(3).

pre-migration planning, a person who is intending to migrate to the United States may wish to consider transferring assets, which are likely to continue to accumulate in value, to a foreign trust which has no U.S. beneficiaries before becoming a U.S. resident. As noted by Bassett: "Significantly, there is no special rule in §684 for pre-immigration transfers. Hence, a non-resident alien who is to become a U.S. resident should consider making transfers to a foreign trust before becoming a U.S. resident, as long as the trust has no U.S. beneficiaries."[245]

There are clearly several key considerations that a settlor ought to take into account when determining the impact a change of tax residence may have on the taxation of the trust and the treatment of distributions from that trust. Consideration needs to be given to whether beneficiaries should be removed or otherwise excluded from the trust, whether trustees need to be replaced or removed and, in some cases, whether a trust ought to be wound up altogether, prior to changing jurisdictions.

245 BRIAN R. BASSETT, *New Regs. On the Tax Effects of Funding 'Outbound' Foreign Trusts*, 29 Est. Plan. 113, 118 (2002).

CHAPTER 4

ATTITUDES TOWARDS FOREIGN TRUSTS

Fundamentally the United States and New Zealand can be seen to be aligned in their approach to trust taxation, in that both countries regard the residence of the grantor or settlor of a trust as a key determinant to how income of a trust will be taxed. In addition, income distributed currently from a trust to a beneficiary will only be taxed once, in the hands of the beneficiary. Considerable divergence of approach to the taxation of accumulated income is clear. So too, is the attitude towards foreign trusts.

The United States legislation and I.R.S. rhetoric is strongly biased against the use of foreign trusts whereas the use of foreign trusts is prolific in New Zealand and a whole industry has been set up to cater for those that want to take advantage of the arbitrage opportunity that exists between the settlor based taxation of trusts in New Zealand and trustee based taxation common in other jurisdictions. New Zealand courts the attention of wealthy individuals with its attractive foreign trust regime and minimal controls. The opportunities presented by the use of the “New Zealand foreign trust” are unmatched in, and, in fact, not useful to residents of, the United States, due to the rules that the United States has put in place to discourage the use of such vehicles.

The United States approach to taxation of accumulated income provides a clear example that the United States applies a rigorous and principled approach to trust taxation, in contrast to New Zealand’s broad brushed, but administratively simple, approach. It is concluded that in many circumstances, the compliance burden can be justified to ensure that an equitable and robust approach to taxation is secured.

A. U.S. Discrimination

"Just Because It's a Trust, Doesn't Mean It's Trustworthy"[246]

Examples of the U.S. government's attitude towards the use of trusts abound.[247] The title above comes from an I.R.S. publication warning of the dangers of fraudulent trusts and extolling the vigilance of the I.R.S. in stamping out the use of trusts in tax evasion.[248]

The most simple example of the design of tax law policy to deter the use of trusts is the marginal tax rate brackets that apply to trusts. These are set much lower than for any company, individual or married couple, with the top tax rate of 39.6 percent applying to all income over $7,500 whereas an individual can earn up to $250,000 before becoming subject to the same tax rate. In contrast the current rate of income tax applying to trustees in New Zealand is currently 33 percent, lower than the top personal income tax rate of 39 percent.

Another example of the discrimination towards trusts is the inclusion of capital gains in DNI of a foreign trust coupled with the inability to utilise net capital losses[249] and the loss of capital gain treatment for capital gains which are accumulated in the trust and distributed as UNI in later income years.[250] In addition, capital gains will be realised but no capital loss may be recognised by a U.S. person who transfers assets to a foreign trust.[251] A foreign trust is also not able to benefit from grantor trust status, except in very limited circumstances or otherwise

[246] TED. F. BROWN, I.R.S. Assistant Commissioner (Criminal Investigation) IRS Publication, Tax Practitioners Journal (Spring 1998), available at http://www.irs.gov/compliance/enforcement/article/0,,ie=112235,00.html (last visited on Feb 05, 2007).

[247] *See*, *e.g.*, George G Jones and Mark A. Luscombe, *I.R.S. Goes To War Over Trust Abuse*, Accounting Today (October 25, 1999 – November 7, 1999); I.R.S., *Abusive Trust Tax Evasion Schemes (Section IV. Abusive Foreign Trust Schemes)*, available at www.irs.gov/businesses/small/article/0,,id=106540,00.html (last visited on Feb 05, 2007).

[248] Other examples include I.R.S., *Too Good To Be True – Trusts – Should Your Financial Portfolio Include Trusts?,* Pub. 2193(8-2001), Catalog number 24843F; *Too Good To Be True – Recognizing Illegal Tax Avoidance Schemes,* Pub. 3995(5-2002), Catalog number 33989Q.

[249] 26 U.S.C. § 643(a)(3).

[250] 26 U.S.C. § 667(e).

[251] 26 C.F.R. § 1.684-1(a)(2). Capital gains will not be realized to the extent that the foreign trust is treated as owned by a U.S. person: 26 C.F.R. §1.684-2(d), or if the transfer is to an unrelated trust at fair market value 26 C.F.R. §1.684-3(d). A full explanation of capital gains treatment of trust assets is beyond the scope of this paper.

pursuant to §679, which means that no non-U.S. person can benefit from being regarded as the owner of any portion of a foreign trust in circumstances where the United States would be prevented from assessing tax on that income.

The application of the throwback rules and the interest charge on accumulation distributions from a foreign trust is also evidence of the approach taken in the United States to dissuade the use of foreign trusts. Since 1997, the throwback rules do not apply to distributions from a domestic trust but remain for foreign trusts.[252] The impact of this interest charge and the throwback rules in general, is to eliminate any potential benefit that could be obtained by accumulating income in offshore trusts for later distribution to U.S. persons. These features of the U.S. foreign tax regime were "designed to penalize the use of foreign trusts."[253]

Several other features which distinguish the treatment between U.S domestic trusts and foreign trusts for U.S. tax purposes further illustrate this trend towards penalizing the use of foreign trusts. These include treating a loan of cash or marketable securities made from a foreign trust to a U.S. beneficiary as a distribution[254] and deeming a distribution to be made to a U.S. beneficiary when such distribution is made indirectly.[255]

B. New Zealand Encouragement

In this discussion, the term "New Zealand foreign trust" refers to a trust which is treated as a foreign trust under New Zealand tax law (and so will not have a settlor who at any time has been resident in New Zealand) but which has at least one New Zealand resident trustee.

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[252] Taxpayer Relief Act, 1997 § 1131(a), repealing 26 U.S.C. §§ 1491-94 and adding 26 U.S.C. § 684.

[253] KLEINFELD & SMITH, *supra* note 22 AT § 52:2.2.

[254] 26 U.S.C. § 643(i). Note that where the loan is made to a person related to the grantor or beneficiary, the grantor or beneficiary, and not the related borrower, is treated as having received the distribution equal to the value of the loan.

[255] 26 U.S.C. § 643(h).

A global market has developed in New Zealand for the services of New Zealand based trustees of foreign trusts in order to take advantage of the effective arbitrage opportunity between tax laws of a settlor's home jurisdiction, which will often impose tax on resident trustees of a trust, and the New Zealand tax laws, which do not impose tax on a trust income unless a settlor of the trust is resident in New Zealand. Colloquially, such trust is referred to as the "New Zealand foreign trust". There is very little information available about the extent to which such New Zealand foreign trusts are being used, due to the fact that, until recently there were no registration or reporting requirements applying to such trusts.

Three key features of New Zealand's trust taxation regime operate together to make the use of foreign trusts favourable in New Zealand. Firstly, there is no current taxation. Secondly, there is no mechanism for taxing income on an accrual basis or otherwise capturing the timing benefit resulting from deferring repatriation of funds to New Zealand and lastly, despite the recent introduction of minimal reporting and record keeping obligations, generally, anonymity can be preserved.

Despite their differences, the New Zealand approach to foreign trusts in some ways represents an extreme position based on the same rationale as was applied in the United States with the introduction of the court and control tests of trust residence. Referring to the residence tests set out in §7701(a)(30), McCaffrey, Harrison and Kirschner consider that the definition "fulfils the Treasury Department's goal to increase the flexibility of settlors and trusts administrations to decide where to locate and in what assets to invest"[256] and ensures "settlors of foreign trusts would be able to choose whether to administer the trusts in the United States or abroad based on non-tax considerations."[257] In addition "it is understood that one of the principal objectives Treasury sought to achieve by implementing this new definition was to level

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[256] *See* MCCAFFREY ET AL. *supra* note 70.

[257] *Id.* at 328 (citing TREASURY DEPARTMENT, *General Explanation of the Administration's Revenue Proposals,* 25 (February 7, 1995)).

the competitive playing field for trust business between U.S. and foreign institutions…under [current §7701(a)(30)] a foreign person can easily use a U.S. financial institution without creating a domestic trust."[258] In both New Zealand and the United States it is possible and practical to use the services of resident trustees without necessarily becoming subject to the domestic taxation regime. Although, where the United States is concerned, establishing such a structure is unlikely to be beneficial unless no grantor and no beneficiary of the trust is, or is likely to become, a U.S. person.

International pressure, mostly from Australia, caused the New Zealand government to reconsider its position on foreign trusts and resulted in new limited record keeping and reporting requirements applying to foreign trusts.[259] Where a foreign trust is established with a New Zealand trustee, the trustees are now required to alert the I.R.D. to the trust's existence[260] and maintain certain details about the trust's financial position[261], which may be reviewed by the I.R.D. on demand. Certain penalties apply for failure to comply with the requirements, including, in some circumstances, subjecting the trust to New Zealand taxation on its worldwide income.[262] Despite these changes and the general review of foreign trust taxation leading to these changes, the general position that foreign trusts are not taxed on foreign sourced income and that there are no requirements to file returns or otherwise disclose the particulars of a foreign trust or its settlors (with the exception of an Australian settlor, in which case the existence of the Australian settlor, but not his or her name, must be disclosed[263]) remains unchanged. By

[258] *Id.* at 328 (based on conversations with David K. Sutherland, former Associate International Tax Counsel and a principal draftsperson of the new statutory definition).

[259] *See* Taxation (Depreciation, Payment Dates Alignment, FBT and Miscellaneous Provisions) Act, 2006 (N.Z).

[260] Taxation Administration Act, 1994 (N.Z.), section 59B.

[261] *Id*. at sections 22(2)(fb) and (m).

[262] Income Tax Act, 2004 (N.Z.) at section HH 4(3BB).

[263] Taxation Administration Act, 1994 (N.Z.), section 59B(c).

contrast, there are extensive reporting requirements imposed on the U.S grantor and on the U.S beneficiaries of a foreign trust and significant penalties apply for failure to comply.[264]

C. Income Splitting

Trusts can be used for income splitting purposes in a variety of ways. These include:

(a) transferring income producing assets to a trust and allowing persons on lower marginal tax rates to derive the income from that asset as beneficiary income;

(b) where the trustee rate is lower than the top marginal tax rate, allowing the trustee to pay tax on the income and distributing the income in a later income year tax-free; or

(c) obtaining a timing advantage by allowing the trustee to accumulate income at a lower or zero tax rate and then paying the additional tax at the time the income is later distributed to the beneficiary.

The most simple is by transferring income producing assets[265] to an irrevocable trust and allowing the income to be distributed to beneficiaries on a lower marginal tax rate than would have otherwise applied to the transferor if he or she had derived the income directly. This form of income splitting is the least reprehensible, largely because, in order for it to work, the transferor actually must give up his or her ownership of the income producing asset and the right to the income from that asset.

In the United States the operation of the grantor trust rules limits this form of income splitting. If the transferor does not give up his or her rights to the income-producing asset completely, then the asset will be regarded as continuing to be owned by the transferor with the income being taxed to that person on a conduit basis. The New Zealand government has addressed this form of income splitting in a limited manner in the context of intra-family relations

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[264] *See, e.g.,* 26 U.S.C. §§ 6048, 6677.

[265] Note that income from personal exertion cannot be assigned to a trust but will always be taxed to the person whose efforts produced the income.

by ensuring that income derived by a minor beneficiary from a family trust is taxed at the trustee rate of tax and not at the beneficiary's lower marginal tax rate.

In New Zealand, the I.R.D. has also sought to rely on the general anti-avoidance provisions[266] in order to curb this type of income-splitting behaviour. In *Case W33*[267] a taxpayer re-organised his dentistry practice by transferring it to a trading trust and paying himself a salary. The I.R.D. asserted that the re-organisation resulted in tax avoidance. If the dentist had continued the partnership he was previously in, or otherwise had operated as a sole trader, he would have been taxed on all of the profits of his business at the top marginal income tax rate. However, the Taxation Review Authority acknowledged that taxpayers are entitled to re-organise their businesses with good cause and that a trading trust is a legitimate business vehicle. The dentist paid himself a salary of NZ$80,000 in both the 1995 and 1996 income years. Curiously the Taxation Review Authority held that no tax avoidance took place in 1995 but that an element of tax avoidance existed in 1996. The Court held that by 1996 the market salary of a dentist with the expertise and experience of the taxpayer would have been approximately NZ$120,000. The I.R.D. could therefore succeed to the extent of the NZ$40,000 discrepancy between what the taxpayer returned in his personal income tax return and what he should have returned based on a market value salary. While the case was a partial victory for the I.R.D., it can be viewed as a greater victory for the principle that income splitting through trading trusts is legitimate in New Zealand, provided that a person is paid market value for any services provided to the trust.

As discussed throughout this paper, the second form of income splitting that is still readily available in New Zealand for qualifying trusts occurs where the trustee rate of income tax is lower than the top marginal tax rate. In the New Zealand context, the trustee of a qualifying trust would pay 33 percent tax on income derived by the trustee and would later distribute the

[266] Income Tax Act, 2004 (N.Z.), sections BG 1, GB 1.

[267] Case W33 (2004) 21 N.Z.T.C. 11,321.

income tax free to a person on a 39 percent marginal tax rate, without any obligation on the beneficiary to pay the six percent difference. This form of income splitting is not available to a U.S grantor. The trustee rate of tax is generally aligned with the tax rate applying to individuals but each rate applies at a much lower threshold than that applying to individuals.

The third method is where a person can obtain a timing benefit by transferring income-producing assets to a trust. In a domestic context, using the New Zealand qualifying trust example above, this would occur if the beneficiary on the top marginal tax rate were required to pay the additional six percent income tax once the accumulated income was distributed to him or her. In this case a timing benefit would arise by allowing the beneficiary to defer the payment of the additional tax until the date of the distribution from the trust. The value of this benefit may be increased significantly in any case where a trust is able to accumulate income in a foreign jurisdiction that imposes low or no taxes with tax only payable at the beneficiary level in the income year in which the accumulated income is distributed. This timing advantage is available to New Zealand beneficiaries of a foreign trust.

It has been a policy goal of the United States to "prevent the use of a trust as a separate tax entity to shift the burden of the tax on trust income from higher bracket beneficiaries to the lower bracket trust."[268] The resulting throwback rules are clearly more complex than the system of taxation in New Zealand which still permits effective income splitting except to the extent provided by the minor beneficiary limitation.

[268] *See* ROSE & CHOMMIE, *supra* note 11, ¶8.09 (note that this discussion relates to domestic trusts and the throwback rules for domestic trusts were repealed in 1997).

D. Dealing With Deferral

Conceptual Purity or Administrative Simplicity

The United States adopts a conceptually pure approach to taxation of accumulated income. By attempting to tax any trust income in the hands, and at the applicable marginal tax rate, of the ultimate beneficiary of those funds, plus applying a penalty to compensate for the late payment of that correct level of taxation, the United States is striving to discourage or at least eliminate any benefit from, the deferral of taxation by use of a trust as an intermediary vehicle. By contrast, New Zealand draws a distinction between those funds that properly belong and are taxed in New Zealand, those funds that are not within the New Zealand tax net until actually derived by the beneficial owner and those that can't be properly characterised and are to be subjected to a punitive rate of tax. This latter approach, while much less precise, is administratively much easier than adopting complicated mechanisms such as the throwback rules. The case of the foreign trust provides fertile grounds for a deeper consideration about whether conceptual purity is to be preferred over administrative simplicity in tax law.

One example of a move away from the conceptual purity of pass-through taxation of trusts is the repeal of the throwback rules in the context of U.S. domestic trusts. What the throwback rules are designed to achieve is to ensure that any tax paid by a trustee on accumulated income is effectively a withholding tax on account of the beneficiary's final tax liability. In the case of accumulated income, the recipient of a particular amount of income is not known so the trustee is required to pay tax as a proxy for the ultimate beneficiary. When the income is finally distributed and the beneficiary is known, the tax is recalculated accurately as if that income had been received by the beneficiary in the income year in which it was earned, with a credit for tax paid by the trustee on behalf of the beneficiary. In his comprehensive review and proposal for reform and simplification of Subchapter J, Dodge reflects that the throwback rule, in the context of U.S. domestic trusts "was too complex and involved excessive recordkeeping for its ultimate payoff, which was to foreclose assignment of income to a lower bracket separate entity."[269] He identifies that this system became redundant, given the enactment of the compressed rate schedule, which applies so that a trust can only earn a very low level of income before becoming subject to the top marginal tax rate, and the rules allowing the I.R.S. to consolidate multiple trusts and treat them as a single entity.[270]

The flat rate taxation of qualifying trusts adopted by New Zealand avoids the complexities of identifying the tax payable by any particular beneficiary. Several commentators hold the view that pass-through treatment is the ideal method of taxing trusts.[271] If pass-through treatment is desired, the simplest way to improve on the New Zealand taxation of qualifying trusts would be to ensure that, firstly, accumulated income taxed in the trustee's hands is taxed at 39 percent, being the current highest marginal tax rate applying to individuals, and secondly, upon distribution, that accumulated income is not exempt from tax in the hands of the beneficiary but subject to tax at their ordinary income tax rate but with a credit for tax paid by the trustee and a refund of the tax paid in excess of such liability. Anti-avoidance measures would need to be implemented to avoid the benefit that could be obtained by accumulating income while the beneficiary was a high income earner and distributing in a year when that beneficiary could obtain a refund in respect of excess tax paid. The solution to such a problem lies in something akin to the throwback rules, which would attribute distributions received by the beneficiary back to the income year in which they were earned by the trustee.

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[269] JOSEPH DODGE, *Simplifying Models for the Income Taxation of Trusts and Estates*, 14 Am. J. Tax Pol'y 127, 230 (1997).

[270] 26 U.S.C. § 643(f).

[271] See SHERWIN KAMIN, *A Proposal for the Income Taxation of Trusts and Estates, Their Grantors and Their Beneficiaries*, 13 Am. J. Tax Pol'y 215 (1996); DODGE *supra* at note 260; and, PETER FRAWLEY, *Abuse of the Trust Device – Proposals for Reform*, 1 N.Z. Jnl. Tax Law & Pol. 200 (1995) (in the context of New Zealand's tax laws, Frawley proposes that pass-through treatment, akin to the grantor trust rules, should apply so that a person who "controls and enjoys an asset should be treated as owning that asset absolutely").

If such an approach were adopted, difficulties would arise in respect to the treatment of refunds and the charging of any interest thereon. There may also be cases where a particular beneficiary had not been born in the year the income was accumulated and there would still be considerable scope for avoidance in a discretionary trust where trustees could tailor distributions of accumulated income to ensure that the distributions are received by a beneficiary who was subject to only low levels of income tax in the year of accumulation. As noted by Lord Reid in the case of *Gartside v IRC*[272] "the objects of a discretionary trust do not have interests extending to the whole or any part of the income of the trust fund."[273] The fact that a discretionary right to be considered as potential recipient of funds under a trust may crystallise in an actual distribution in a later income year makes it difficult to say that that person actually derived, or should be taxed as if they derived, that amount in the year in which it was earned and not in the year in which that amount is distributed. Revenue authorities generally do not like to carry an unquantifiable liability to refund taxes indefinitely, or at all. The fact that the U.S. throwback rules did not (in the context of domestic trusts) and do not (in the context of foreign trusts) permit refunds of excess tax paid by the trustee, or that the tax paid by the trustee is not linked to the particular distribution made to a beneficiary so that the beneficiary may not carry the economic burden of such tax in the sense of an ordinary withholding tax,[274] show a weakness in the argument that such a method is in fact conceptually pure.

This paper has touched on some of the tax rules applying to trusts in the United States generally but is in no way an exhaustive explanation of all such rules. Compared to New Zealand's regime the rules are highly complicated. Dodge argues that the present system of taxing trusts under Subchapter J:

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[272] (1968) A.C. 553.

[273] *Id.* at 607.

[274] *See* DODGE *supra* at note 260 (for discussion on the failure of the throwback rules to act as a withholding tax and the shortcomings of the throwback rules generally).

> has too many (and unnecessary) distinctions and categories, such as: (a) rules based on accommodation to (nontax) trust accounting rules, (b) different rules for estates, simple trusts, and complex trusts, including the distinction between "first tier" and "second tier" distributions, and (c) rules treating specified distributions of specific property and fixed dollar amounts (payable in no more than three instalments) as non-distributions.[275]

In addition, the application of the grantor trust rules, in the context of domestic trusts, relies on the particular terms of the trust, making the assessment of tax for each trust a very difficult process. These distinctions and difficulties are avoided under the New Zealand regime, which draws no distinction between complex and simple trusts and, while turning on the residence of the settlor, does not look through a trust, except in the case of sham.

Trust income is taxed at 33 percent in New Zealand. This represents the middle income tax band and the rate which applies to the average income earner in New Zealand. If income is taxed at this rate and then exempt upon distribution to a beneficiary, this is arguably no less sound than taxing trust income at a higher rate and refusing a refund when distributed to a lower income tax earner. The hybrid system of taxation allows a trustee to distribute current income to beneficiaries who pay less than 33 percent tax on their income in order to take advantage of that lower rate. In this sense, the approach taken is warranted, given the complexities involved in devising a system which would tax accumulated distributions from domestic trusts with precision.

The focus of this paper, however, has been the taxation of foreign trusts and, in terms of ensuring that no deferral of income recognition is permitted, New Zealand's regime falls woefully short.

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[275] *Id.* at 231.

CHAPTER 5

CONCLUSION

Many similarities exist between the New Zealand and the United States methods of taxing trust income. A hybrid approach to taxation of trusts is applied in both cases. Income distributed currently is taxed directly to the beneficiary in a pass-through manner whereas accumulated income is taxed at the entity level. Under both regimes, the ultimate owner of accumulated income is effectively ignored in the case of distributions from domestic (in the case of the United States) or qualifying (in the case of New Zealand) trusts. The residence of the grantor or settlor is of paramount importance for the purposes of determining how any particular trust will be taxed.

The United States is significantly more advanced in terms of creating an even playing field between taxpayers and ensuring that U.S. taxpayers cannot defer taxation by accumulating foreign sourced income in offshore trusts. No such measures have been implemented in New Zealand. Measures such as the throwback rules and additional interest charge on accumulation distributions from foreign trusts have the effect of dissuading U.S. taxpayers from utilising foreign trusts altogether, despite the relative ease with which a trust established by a U.S. person may be regarded as “foreign” if either the court or control tests of trust residence is failed.

Despite discouraging the use of foreign trusts, the completeness and complexity of the U.S. trust taxation regime and, in particular, the calculation of throwback tax, can be regarded in many ways as much more robust and conceptually pure than the New Zealand broad brush approach, which clearly allows for the deferral of tax in the case of foreign trusts and merely sweeps across any non-complying trust with a flat penalty rate of tax on distributions.

In this modern world where frequent changes of residence are not uncommon, the consequences of such far reaching tax rules applying to trusts are that persons new to the United States may find themselves being taxed as the owner of a trust, and subject to a migration penalty comprising tax on the UNI of such trust, which until that time they had regarded as a completely separate entity. U.S. persons who leave the United States but seek to provide for beneficiaries they have left behind may well find that the impact of the throwback rules and the compounding interest charge will, over time, be so significant as to completely deplete the value of accumulation distributions made to those U.S. beneficiaries. That is provided the non-resident grantor and their U.S. beneficiaries even know to apply the complex rules, which, in the case of many Americans who have moved to New Zealand and have been lured into thinking that a New Zealand trust is a good way to hold assets, is often the first hurdle to overcome.

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