

INCOME TAX – WHETHER A BENEFICIARY WILL BE TREATED AS A SETTLOR WHERE THERE IS NO LOAN

PUBLIC RULING - BR Pub 14/XX

This is a public ruling made under s 91D of the Tax Administration Act 1994.

Taxation Laws

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This Ruling applies in respect of s HC 27(2)(a) and (b).

The Arrangement to which this Ruling applies

The Arrangement is:

- The trustees of a trust:
 - vest absolutely in interest an amount in a beneficiary of the trust, or
 - pay an amount to a beneficiary of the trust.
- The amount is not transferred into the beneficiary's possession.
- No interest is paid to the beneficiary on the amount.

This Arrangement does not include situations where there is a loan from the beneficiary to the trust of the amount.

For the purposes of this Ruling the word "pay" has the meaning corresponding to para (a) of the definition of "pay" in s YA 1.

For the purposes of this Ruling the word "amount" has the meaning in para (a) of the definition of "amount" in s YA 1.

For the avoidance of doubt the Arrangement does not include arrangements where subpart BG of the Act applies to void the arrangement.

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- The beneficiary will not be a settlor of the trust under s HC 27(2)(a) or (b).

The period or tax year for which this Ruling applies

This Ruling will apply for the period beginning XX [Month] 20XX [date Rulings are finalised] and ending on XX [Month] 20XX [date three years later].

This Ruling is signed by me on XX [Month] 20XX.

Susan Price

Director, Public Rulings

EXPOSURE DRAFT — FOR COMMENT AND DISCUSSION ONLY

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- The trustees of a trust:
 - vest absolutely in interest an amount in a beneficiary of the trust, or
 - pay an amount to a beneficiary of the trust.
- The amount **is not transferred into the beneficiary's possession.**
- The beneficiary loans the amount to the trust.
- Either:
 - no interest is charged on the amount by the beneficiary, or
 - interest is charged on the amount at a below market rate, or
 - interest is payable on the amount on demand and no demand is ever made, or
 - demand for payment of interest or for repayment of the amount (or both) is deferred so long that the loan is uncommercial.

For the purposes of this Ruling the word “pay” has the meaning corresponding to para (a) of the definition of “pay” in s YA 1.

For the purposes of this Ruling the word “amount” has the meaning in para (a) of the definition of “amount” in s YA 1.

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EXPOSURE DRAFT — FOR COMMENT AND DISCUSSION ONLY

This Ruling is signed by me on XX [Month] 20XX.

Susan Price

Director, Public Rulings

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COMMENTARY ON PUBLIC RULING BR PUB 14/XX AND 14/YY

This commentary is not a legally binding statement. The commentary is intended to help readers understand and apply the conclusions reached in Public Rulings BR Pub 14/XX and BR Pub 14/YY (**"the Rulings"**).

Legislative references are to the Income Tax Act 2007 unless otherwise stated. Relevant legislative provisions are reproduced in the Appendix to this commentary.

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Summary

1. These Rulings **give the Commissioner's view on** whether a beneficiary of a trust in the Arrangements considered will become a **"settlor" of the trust** under the extended definition of that term in s HC 27(2)(a) or (b). The Arrangements involve an amount vested in, or paid to, a beneficiary of a trust, but retained in possession by the trustees. The Rulings are about whether the beneficiary will be regarded as a settlor of the trust given that the amount vested or paid remains in the possession of the trustees and, for example, no interest is paid to the beneficiary on the amounts. These Rulings may be relevant to, among other matters, the calculation of a **person's "family scheme income" for social assistance purposes** and to the calculation of **"adjusted net income" for student loan purposes**.
2. BR Pub 14/XX concludes that the beneficiary in the Arrangement ruled on will not be a settlor of the trust. This is because the beneficiary under the arrangement does not receive legal ownership of the amount vested or paid. Without legal ownership the beneficiary is not in a position to

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provide the amount back to the trustees and, in so doing, trigger the **extended definition of “settlor”**.

3. A person will be a **“settlor”** of a trust if, under s HC 27(2)(a), they **“transfer value”** or, under s HC 27(2)(b), they **“provide financial assistance”** to the trust with an obligation to pay on demand and the right to demand is not exercised or is deferred.
4. Essentially, value is transferred from one person to another when one **person provides money or money’s worth to another person and receives in return money or money’s worth that is worth less than what was provided**.
5. The word **“provides”** is used in both the definition of **“transfer of value”** (and **“transfers value”**) and the phrase **“provides financial assistance”**. The word **“provides”** seems to imply a need for conscious, positive action on the part of the person who is providing.
6. It also seems implicit that before a person can **“provide”** an amount, the person must be the legal owner of the amount being provided.
7. When trustees vest an amount in interest in, or pay an amount to, a beneficiary without transferring possession, the trustees continue to be the legal owners of the amount, **subject to the trustees’ equitable obligations** to the beneficiary. The beneficiary receives beneficial rights to the amount, but not legal ownership. This means that an amount of income that is vested in interest in, or paid to, a beneficiary, but not transferred **into the beneficiary’s possession**, could constitute beneficiary income and yet not cause the beneficiary to be a settlor.
8. BR Pub 14/YY differs from BR Pub 14/XX in that the Arrangement ruled on in BR Pub 14/YY involves a loan from the beneficiary to the trust.
9. BR Pub 14/YY assumes that legal ownership of the vested amount can be transferred without transferring possession of the vested amount to the beneficiary (ie, without there being an actual payment of the vested amount to the beneficiary). This could occur under a set-off of, on one hand, the trustees’ obligation to pay the amount to the beneficiary arising from the distribution and, **on the other hand, the beneficiary’s** obligation to pay the loan principal to the trustees under the loan agreement.
10. It is considered that the set-off could be explicitly provided for in an agreement between the trustees and the beneficiary. Alternatively, it is considered that the agreement to set-off amounts could, in the circumstances, be inferred from the loan agreement between the trustees and the beneficiary.
11. In the arrangement ruled on in BR Pub 14/YY, the beneficiary will be a settlor under s HC 27(2)(a) or (b) if:
 - No interest is charged on the amount by the beneficiary.
 - Interest is charged on the amount at a below market rate. What is a market rate will be fact specific.
 - Interest is payable on the amount on demand and no demand is ever made.
 - Demand for payment of interest or for repayment of the amount (or both) is deferred so long that the loan is uncommercial. How long a

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loan must be deferred before it will be uncommercial will be fact specific.

12. A loan does not need to be in writing. However, in the absence of a written agreement, it may be difficult to prove that a loan has or has not been made. Further, the burden of proof is on the taxpayer.

Background

13. Concerns have been raised that beneficiaries with “current accounts” with a trust may be caught by the “settlor” definition in s HC 27(2)(a) or (b).
14. If beneficiaries are treated as settlors under this definition, this would have implications for the calculation of income for social assistance purposes (discussed further below). It is also relevant to other parts of the Act, including the associated person rules in subpart YB. It may also be relevant for the Student Loan Scheme Act 2011. The **definition of “settlor”** in s YA 1 used for the purposes of the trust rules will also be used for **calculating “adjusted net income” for student loan purposes** (see cl 11 of sch 3 of the Student Loan Scheme Act 2011).

Social assistance context

15. The level of social assistance that a person is entitled to is affected by their “family scheme income”.
16. “Family scheme income” is net income for income tax purposes with some adjustments (s MA 8). One of the adjustments is contained in s MB 7. Under this section, if a person is a settlor of a trust, a portion of the trustee income of the trust will be included in the calculation of the **person’s “family scheme income”**. This does not apply to all trusts and the trustee income amount is subject to some adjustments. The portion of the **trustee income that is included in the person’s family scheme income** will be the total trustee income divided by the total number of settlors of the trust. Therefore, the amount of trustee income that is attributed to the person will depend on the number of settlors.
17. Therefore, whether the beneficiary becomes a settlor under the **Arrangements may be relevant to the calculation of the “family scheme income”** of the beneficiary and also of the existing settlors.
18. Section MB 7 is discussed further in *Tax Information Bulletin* Vol 23, No 1 (February 2011) at 59–62. See also Officials’ issues paper “Social assistance integrity: defining family income” (Inland Revenue, Policy Advice Division, August 2010).

Application of the legislation

19. The following analysis will discuss:
 - The definition of settlor.
 - The requirements of s HC 27(2)(a) and (b).
 - **The meaning of “provides”.**
 - The rights of the beneficiaries under the Arrangements. This will involve a discussion of:
 - what it means for an amount to be vested absolutely in interest in, or paid to, a beneficiary,

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- whether a beneficiary has a right to a return on amounts vested, and
- whether a debtor-creditor relationship arises.
- The use of the term “current account”.
- How the law applies where a loan exists.

The definition of “settlor”

20. Generally, a “settlor” is a person who creates or establishes a trust and who “settles” assets on the trust. The settlement involves the creation of equitable obligations on the trustees relating to the assets. The assets are generally held by the trustees for the benefit of the beneficiaries of the trust. The settlor may also be a trustee or beneficiary, although one person cannot be the sole trustee and sole beneficiary. (See *Garrow and Kelly Law of Trusts and Trustees* (7th ed, LexisNexis, Wellington, 2013) at 3 and 51 and *CIR v Dick* (2001) 20 NZTC 17,396 (HC) at 17,402).
21. The Rulings are concerned with the extended definition of “settlor” given in s HC 27(2)(a) and (b) for particular sections and parts of the Act.
22. Section HC 27(1) lists the particular sections and parts of the Act for which the definition applies:

HC 27 Who is a settlor?

When this section applies

- (1) This section applies for the purposes of—
- (a) the trust rules; and
 - (b) the consolidation rules; and
 - (c) section CW 59 (New Zealand companies operating in Niue); and
 - (cb) section MB 7 (Family scheme income of settlor of trust); and
 - (d) section YA 1 (Definitions), the definition of **settlement**; and
 - (e) subpart YB (Associated persons and nominees) as modified by section YB 10 (Who is a settlor?).
23. As well as applying for the purposes of the trust rules, the definition of “settlor” in s HC 27(2)(a) and (b) applies for other specified purposes, including for the calculation of “family scheme income” in s MB 7 and for the associated person rules.

The requirements of s HC 27(2)(a) and (b)

24. A person will be a settlor of a trust under s HC 27(2)(a) or (b) if they “transfer value” to the trust, or “provide financial assistance” to the trust with an obligation to pay on demand and the right to demand is not exercised or is deferred.
25. Section HC 27(2)(a) and (b) state:

Meaning of settlor

- (2) A **settlor** of a trust is a person who, at any time,—
- (a) transfers value—
 - (i) to the trust; or
 - (ii) for the benefit of the trust; or
 - (iii) on terms of the trust:
 - (b) provides financial assistance to the trust or for the benefit of the trust with an obligation to pay on demand, and the right to demand is not exercised or is deferred:

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...

26. The term “transfers value” used in s HC 27(2)(a) is defined in the definition of “transfer of value” in s YA 1:

transfer of value —

- (a) is defined in section CD 5 (What is a transfer of value?):
- (b) means a transfer that occurs when—
 - (i) **person A provides money or money’s worth** to person B; and
 - (ii) **if person B provides any money or money’s worth to person A as part of** the arrangement described in subparagraph (i), the market value of what person A provides is more than the market value of what person B provides; and
- (c) includes the release of an obligation that person B has to pay money to person A, either by agreement or operation of law; and
- (d) **transfers value** has a corresponding meaning

27. Paragraph (a) of this definition states that the term is defined in s CD 5. Section CD 5 gives a definition specific to transfers of value from a company to a person. Paragraphs (b) and (c) of the definition in s YA 1 define “transfer of value” generally. Paragraph (d) states that “transfers value” has a corresponding meaning.

28. The s CD 5 definition of “transfer of value” is:

CD 5 What is a transfer of value?

General test

- (1) A **transfer of value** from a company to a person occurs when—
 - (a) the company provides money or money’s worth to the person; and
 - (b) if the person provides any money or money’s worth to the company under the same arrangement, the market value of what the company provides is more than the market value of what the person provides.

Release of debt

- (2) A company provides money’s worth to a person if the person is released from an obligation to pay money to the company, either by agreement or by operation of law.

When shares are cancelled

- (2B) The market value of any transfer from the shareholder to the company on the cancellation of a share of the shareholder’s rights as a shareholder is zero.

Provision of services for less than market value

- (3) Despite subsection (1), a transfer of value does not occur to the extent to which the money’s worth provided by the company is only the provision of services.

Limit to subsection (3)

- (4) Subsection (3) does not apply to the provision of services by a company that is a close company, if the provision is the benefit of expenditure of the company.

29. Although s CD 5 provides some specific rules for companies, s CD 5(1) and (2) are very similar to the general definition of “transfer of value” in s YA 1.

30. Paragraph (b) of the definition of “transfer of value” in s YA 1 contains a key concept. Essentially, value is transferred from one person to another when the first person provides money **or money’s worth** to the second person and receives in return money **or money’s worth** that is worth less than what was provided. “**Money’s worth**” means something that is

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convertible into money (see *Wilkins (Inspector of Taxes) v Rogerson* [1961] 1 All ER 358 (CA) at 361).

31. An example of a situation that would involve a transfer of value under para (b) of the definition of “transfer of value” is an interest-free loan. The Commissioner’s view is that an interest-free loan will, over time, constitute a transfer of value from the lender to the borrower. Under para (b) of the definition of “transfer of value”, a transfer of value could occur even if the amounts provided by person A and person B are nominally the same. If the amount provided by person B is provided at a later date, the market value of what person B provides may be lower than the market value of what person A provides. This simply reflects the time value of money. This view is supported by a comment in *CIR v Dick* at [34]. *CIR v Dick* concerned the definition of “settlor” in s 61(27) of the Income Tax Act 1976. However, the court also briefly referred to the more extensive definition of “settlor” in s 226(2) of the Income Tax Act 1976, which was the predecessor of s HC 27(2). The High Court noted at [34]:

The question is whether this involvement makes Mr Sloan a settlor of the Foundation. This entails an examination of the relevant definition of settlor. It is common ground that, **if the extended definition of settlor in s 226(2) applies, then Mr Sloan clearly is a settlor (and was from the commencement of the Foundation) given the interest-free loan provided to the Foundation.** It is likely that he would also be a settlor by virtue of the provisions of s 226(3). These definitions, however, only expressly apply in respect of the trust taxation regime and not to s 61(27). [Emphasis added]

32. Under para (c) of the definition of “transfer of value”, person A will transfer value to person B if person B has an obligation to pay person A money and person B is released from that obligation, either by agreement or by operation of law.
33. Section HC 27(2)(b) applies to the provision of financial assistance that carries with it an obligation to pay on demand and the right to demand payment is not exercised or is deferred. “Financial assistance” is defined for s HC 36 (which excludes certain trusts from the minor beneficiary rule), but not for s HC 27.
34. Section HC 27(2)(b) descended from s 226(2)(b) of the Income Tax Act 1976. Although the provision has been rewritten in the Income Tax Act 2007, there has been no intended law change to the provision at any time. Schedule 51 of the Income Tax Act 2007 states: “The definition of **settlor** is clarified so that any transfer to a trust that increases the net assets of the trust is a settlement on **the trust...**”.
35. The purpose of s 226(2)(b) was to overcome a problem with the taxation of trusts that arose from the decision of the Court of Appeal in *Re Marshall (Deceased), CIR v Public Trustee* [1965] NZLR 851. The case concerned whether the failure by a person to claim interest under a mortgage to the trust amounted to a disposition of property. This was a gift duty issue rather than one of the taxation of trusts. The trust deed contained what is now known as a “Marshall clause”, where the lender was able to demand interest on the mortgage every 12 months as long as the demand was made within one month of the end of the period. The court held that refraining from demanding interest was not a forfeiture of interest, hence not a gift. This is explained in the Appendix to *Tax Information Bulletin* Vol 1, No 5 (November 1989) at 41:

6.27 The result in *Re Marshall* was that the failure to demand interest and remuneration did not amount to a disposition of property and, therefore, did not constitute a gift. If this holding were not negated in the context of the new trust

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taxation regime an easy avenue would be available for avoiding settlor status while still transferring value to a trust. Consequently, the provision of on demand loans to trustees where the right to demand interest is not exercised has been specifically dealt with in s 226(2)(b). By that provision, financial assistance is deemed to have been provided at below market value, **thus rendering the person providing such assistance a settlor, if amounts payable in relation to the financial assistance are payable on demand and the right to demand payment is not exercised**. This rule applies whether or not the specified rate of interest payable on demand would otherwise be considered to be a market rate of interest. [Emphasis added]

36. The *Tax Information Bulletin* makes it clear that the purpose of s 226(2)(b) (and now s HC 27(2)(b)) was to deal with Marshall clause situations.
37. Under s HC 27(2)(b), a person will be a settlor if they provide financial assistance (eg, a loan) that involves an obligation to pay on demand (eg, a loan that bears interest if demanded), and the right to demand is not exercised or is deferred. Section HC 27(2)(b) will apply whether or not the financial assistance involves a market rate of interest. For instance, s HC 27(2)(b) will apply to a loan that bears a market rate of interest if demand for payment of that interest is not exercised or is deferred.

The meaning of “provides”

38. The word “provides” is used in both the definition of “transfer of value” (and “transfers value”) and the phrase “provides financial assistance”. Therefore, the word “provides” is central to the question of whether a person is a settlor under s HC 27(2)(a) and (b).
39. The *Concise Oxford English Dictionary* (12th ed, Oxford University Press, New York, 2011) defines “provide” as:

Provide: v. 1, make available for use; supply. (provide someone with) equip or supply someone with.
40. Provide is defined by reference to other verbs such as “make”, “supply”, and “equip”. The use of these words implies a need for conscious, positive action on the part of the person who is providing.
41. The question is whether the beneficiaries in the Arrangements “provide” anything to the trustees when an amount is vested in, or paid to, the beneficiary, but possession of the amount is retained by the trustees.
42. A beneficiary cannot provide what they do not have. Therefore, the rights the beneficiaries receive in the situations described under the Arrangements must be understood to determine what the beneficiaries could “provide” back to the trustees.

The rights of the beneficiaries under the Arrangements

43. The following analysis discusses what rights the beneficiaries receive in the situations described under the Arrangements. As will be discussed further below:
 - The beneficiaries do not have possession of the amounts.
 - In the case of the Arrangement in BR Pub 14/XX, the beneficiary does not have a right to be paid a return on the amount that is vested in, or paid to, them.

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- Despite being described as “absolute” and “indefeasible”, where possession is retained by the trustees, the vesting of an amount transfers only a beneficial interest in the amount, not the full legal ownership. The same is also true in the case of amounts that are “paid”, but retained in possession by the trustees.

What it means for an amount to be vested absolutely in interest in, or paid to, a beneficiary

44. To understand what the beneficiaries receive under the Arrangements, some of the concepts that are used in the description of the Arrangements must be discussed first.
45. The Arrangements in both Rulings apply to amounts that have been vested absolutely in interest in, or paid to, a beneficiary, but have not been transferred into the beneficiary’s possession.
46. **The word “amount” used in the Arrangements has the meaning given to it in para (a) of the definition of “amount” in s YA 1. That is, an amount includes an amount in money’s worth.**
47. The way that the distributions are worded under the Arrangements is deliberately general. The Arrangements will apply to distributions that give rise to beneficiary income under s HC 6(1) and to other distributions whether or not they are taxable distributions.
48. The Arrangements differ in that under the arrangement for BR Pub 14/YY there is a loan back to the trust of the amount.
49. **The meaning of “vests absolutely in interest” and “paid”, as used in the definition of “beneficiary income” in s HC 6, were discussed in Interpretation Statement, IS 12/02, “Income Tax—Whether income deemed to arise under tax law, but not trust law, can give rise to beneficiary income” (published in *Tax Information Bulletin* Vol 24, No 7 (August 2012): 49). That discussion will not be repeated in full here. It is sufficient to note that:**
 - An amount vests absolutely in interest in a beneficiary when the amount derived is indefeasibly vested in the beneficiary so they obtain an immediate right of present or future possession of the income. This means the beneficiary need not receive possession of the amount vested, or even an immediate right to demand possession of the amount, at the time of vesting; but they must have an indefeasible right to that part of the trust property. Although possession of the amount may not be received by the beneficiary until some time in the future, the amount must not be future property or an expectancy. That is, the property must exist at the time of vesting.
 - **An amount will be “paid” if it is actually paid, distributed, credited or dealt with in the beneficiary’s interest. Case law establishes that a declaration or resolution by a trustee allocating income to a beneficiary will be sufficient for an amount to be “paid”.**
50. There may be some overlap between the concept of vesting absolutely in interest, as defined in case law, **and the definition of “pay” in s YA 1.** Neither concept necessarily requires the amount to be transferred into the possession of the beneficiary.

Whether a beneficiary has a right to a return on amounts vested

51. Given the context of this issue, it is relevant to consider whether a beneficiary has a right to a return on amounts that are vested in the beneficiary, but retained in the possession of the trustees. If a right to such a return did exist and no return was received by the beneficiary, it might be argued that the beneficiary transfers value to the trust.
52. However, there is no general rule that requires a trustee to pay a beneficiary interest on the amounts vested in the beneficiary.
53. A trustee does have a duty to invest trust property prudently (*Garrow and Kelly Law of Trusts and Trustees* (7th ed, LexisNexis, Wellington, 2013) at 517). This includes any amounts that are vested in a beneficiary and that remain in the possession of the trustee. However, this does not amount to a duty to pay interest on vested amounts. Whether a trustee has acted prudently or in breach of the trust will depend on the factual circumstances of the particular case (see, for example, *Re Mulligan (Deceased)* [1998] 1 NZLR 481 (HC) at 501 and 502).

Whether a debtor-creditor relationship arises

54. As noted above, there is no general rule that requires a trustee to pay a beneficiary interest on the amounts vested in the beneficiary. This is supported by case law that has held that a debtor-creditor relationship does not arise in circumstances where a trust allocates income to a beneficiary, but does not transfer possession of the income to the beneficiary.
55. In *CIR v Ward* [1970] NZLR 1 (CA) a trustee passed a written resolution, in which she declared that trust income was to be held for the credit of various infant beneficiaries in equal shares. The trust then credited the children in its books, but did not pay the money out until some years later. The court held that the trustee's resolution resulted in the income having been applied for the benefit of the infant beneficiaries. North J stated that this was so because the declaration had the effect of immediately vesting the income in the beneficiaries such that it became their absolute property.
56. McCarthy J, after agreeing with North J, went on to consider an argument raised to the effect that the trustee's resolution should not be regarded as applying income unless it could be shown that the resolution acted as a declaration of trust or created a debtor-creditor relationship between the trustee and the infant beneficiaries. In rejecting this argument, his Honour said at 30:

I believe, too, that it is misleading to speak of debtor-creditor relationship. The rights of the beneficiaries here do not arise out of debt or contract. They arise out of the trusts created by the deed, and the beneficiaries are entitled to invoke the powers of the Court by reason of a new title "consisting of the exercise of the trustees' discretion in the infant's favour".
57. This passage makes it clear that a trust relationship, rather than a debtor-creditor relationship, arises when a trustee allocates an amount to a beneficiary.
58. The proposition that an amount that is vested in a beneficiary, but retained in possession by the trust, is held in trust for the beneficiary is also supported by *CIR v Simpson* [1989] 2 NZLR 704 (CA). In that case, Richardson J stated at 709:

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An appropriation of income by a trustee in favour of an infant beneficiary is only the first step. At that point the trustee holds the moneys appropriated in trust for the infant.

59. Although *Ward* and *Simpson* concerned amounts vested in infant beneficiaries, the Commissioner's view is that the same conclusions would apply for amounts vested in adult beneficiaries where the trustees retain possession of the amounts. Even where an adult beneficiary has a right to demand possession of the amount (where the amount is "vested in possession"), until possession is given the amount is still subject to a trust relationship, not a debtor-creditor relationship. The trustees are holding the amount in trust for the beneficiary.

Beneficial interest only

60. The above analysis suggests that a beneficiary receives only a beneficial interest when an amount is vested absolutely in interest in, or paid to, the beneficiary, but retained in possession by the trustees. Without more (eg, the transfer of possession), the legal ownership of the amount remains with the trustees, **subject to the trustees' equitable obligations to the beneficiary.**
61. To be clear, it is considered that the beneficiary will receive only a beneficial interest—even if they have a right to **present** possession of the amount vested. As noted above, an amount vested in interest may provide the beneficiary with an immediate right of present **or** future possession. Whether the vesting provides for a right of present or future possession, the vesting will not transfer legal ownership.
62. **In the Commissioner's view it is implicit that for a beneficiary to "provide" money or money's worth** to the trustees, the beneficiaries would have to have the legal ownership of the amount being provided. Put another way, **it is considered that a beneficiary cannot "provide" an amount that is still** subject to the ongoing trust relationship and which is still in the possession and control of the trustees.
63. This means that an amount of income that is vested in interest in, or paid to, **a beneficiary, but not transferred into the beneficiary's possession,** could constitute beneficiary income and yet not cause the beneficiary to be a settlor.
64. Under the Arrangement for BR Pub 14/XX, the possession and legal ownership of the amount vested remain with the trustees. The beneficiary has not received the legal ownership of the amount and, therefore, cannot **"provide" the amount to the trustees.**
65. As noted above, to be a settlor under s HC 27(2)(a) or (b) the beneficiary would have to transfer value, or provide financial assistance that has a right to demand payment that is not exercised or is deferred. Both of **these options would require the beneficiary to "provide" money or money's worth** to the trustees. As concluded above, the beneficiary cannot **"provide" the amount to the trustees** under the Arrangement for BR Pub 14/XX. Therefore, the beneficiary will not be a settlor under s HC 27(2)(a) or (b).
66. **In addition, the Commissioner's view** is that if Parliament had intended beneficiaries to become settlors under the Arrangement in BR Pub 14/XX, the legislation would have more clearly expressed this intention.

The use of the term “current account”

67. A “current account” is a company law concept, but it is frequently used by accountants in a trust accounting environment to record amounts that the trust has vested in, or “paid” to, a beneficiary.
68. It may not be wrong to use a “current account” for this purpose. However, it could be misleading to the extent that it implies that the amount recorded is a debt owed by the trust to the beneficiary. As noted above, the vesting of an amount in interest in a beneficiary does not create a debtor-creditor relationship.
69. An example of a case where a current account was used to record a debt between a shareholder and a company is *Case Q6* (1993) 15 NZTC 5,047. In that case Judge Willy made the following observations on the nature of a shareholder’s current account at 5,050:
- [A shareholder’s current account] **represents no more than monies advanced to the company or borrowed from it by that shareholder pursuant to whatever arrangements are in force between them at any given time.** The account may comprise monies which are otherwise payable to the shareholder in the form of undistributed profits that the shareholder chooses not to take out, it may be in the form of wages or directors’ fees or it may be in the form of advances to the company. Howsoever, current accounts arise they result in contractual relations between company and shareholder which relationship will be governed by expressed or implied terms as to payment and repayment. [Emphasis added]
70. The use of a current account to record beneficiary distributions may also be misleading to the extent that it implies that a beneficiary has an on demand right to an amount vested in, or paid to, the beneficiary by the trustees, **but not transferred into the beneficiary’s possession.** The beneficiaries do not necessarily have a right to take possession of the amounts credited to them by the trustees. The amount vested may provide a right to future possession only.

How the law applies where a loan exists

71. BR Pub 14/YY rules on how the law applies where an amount has been vested in a beneficiary, but there has been no transfer of possession of the amount to the beneficiary, and the beneficiary loans the amount back to the trustees.
72. As concluded above, for a beneficiary to “provide” money or money’s worth to the trustees, the beneficiaries would have to have the legal ownership of the amount being provided.
73. Also, as concluded above, a beneficiary receives only a beneficial interest in an amount when the amount is vested absolutely in interest in, or paid to, the beneficiary, but retained in possession by the trustees. Without more, the legal ownership of the amount remains with the trustees, **subject to the trustees’ equitable obligations to the beneficiary.**
74. As suggested above, one way in which legal ownership could be transferred is if the trustees transferred possession of the vested amounts to the beneficiaries. However, it is considered that this is not the only way.
75. BR Pub 14/YY assumes that legal ownership can be transferred without transferring possession of the vested amount to the beneficiary (ie, without there being an actual payment of the vested amount to the beneficiary).

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76. It is considered that a transfer of the legal ownership of an amount could occur, under a set-off, at the same time as the beneficiary loans the amount back to the trustees.
77. Set off allows two people with payment obligations to each other to discharge (at least partially) those obligations without the need for a physical payment of the amounts that are set off. *Laws of New Zealand Contract* (online ed, accessed 25 November 2014) discusses what constitutes a payment that enables a contractual promise to be discharged at [296]:
- ...a settlement of accounts by which items on one side are agreed to be set-off against items on the other side (with any necessary adjustments in cash) amounts to payment of the sums stated on both sides of the account.
78. In *Trans Otway Limited v Shephard* [2005] 3 NZLR 678, the Court of Appeal considered the legal nature of a set-off and whether it constituted a “payment”. The Court of Appeal held that there was “payment” by the relevant company for the purposes of s 292(1)(e) of the Companies Act 1993 where the purchase price payable for property was, by agreement, set off against an existing debt owing by the vendor to the purchaser. Chambers J summarised the legal effect of set off at [24]:
- There can be no doubt as to the effect of cls 2 and 5(e) of the March agreement. Trans Otway was agreeing to pay \$94,996.73 including GST for the client list. The parties agreed that that payment could be set off against the existing debt Newman owed Trans Otway. **This was a classic example of the setting of money cross-claims against each other. The effect of the agreement was that both payments were made.**
- This conclusion is supported by three leading texts in this field. First, Philip Wood, in his classic text *English and International Set-Off* (1989) described the position as follows at (para 1-51):
- Set-off may be regarded as similar to payment. In setting off his cross-claim, the debtor “pays” the creditor’s primary claim pro tanto and obliges the creditor to “pay” the cross-claim. **There is therefore a pro tanto redemption, discharge, satisfaction, extinguishment or reduction of the reciprocal debts. Set-off pays them both. In formal terms, set-off is a form of discharge.** [Emphasis added]
79. Chambers J went on to state at [31] that the payments were made despite there being no physical exchange of money:
- So, while no physical cash was exchanged and while there was not a cheque swap, payments were nonetheless made. As Mr Wood put it, it is the doctrine of set-off which sees both debts paid.
80. In the arrangement ruled on in BR Pub 14/YY, the trustees have a payment obligation to the beneficiary arising from the distributions made, and the beneficiary has an obligation to pay the loan principal to the trustees under the loan agreement. It is considered that these reciprocal payment obligations could be satisfied by way of set off.
81. It is considered that the set-off could be explicitly provided for in an agreement between the trustees and the beneficiary. Alternatively, it is considered that the agreement to set-off amounts could, like any agreement (JF Burrows *Law of Contract in New Zealand* (4th ed, LexisNexis, Wellington, 2012) at 40), be inferred. In this case it could be inferred from the loan agreement between the trustees and the beneficiary. In the arrangement ruled on in BR Pub 14/YY, the amount held in trust and the intended loan amount are clearly identified and linked and there is a clear intention for the legal relationship in respect of that

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amount to be changed from one based on trust to one based on the terms of the loan agreement. Under the loan agreement, the trustees and the beneficiary both intend the amount to be held by the trustees under a loan contract rather than being held in trust and being subject to trust obligations.

82. In the arrangement ruled on in BR Pub 14/YY, the beneficiary will be a settlor under s HC 27(2)(a) or (b) if:
- No interest is charged on the amount by the beneficiary.
 - Interest is charged on the amount at a below market rate. What is a market rate will be fact specific.
 - Interest is payable on the amount on demand and no demand is ever made.
 - Demand for payment of interest or for repayment of the amount (or both) is deferred so long that the loan is uncommercial. How long a loan must be deferred before it will be uncommercial will be fact specific.
83. This result follows from the contractual relationship (ie, the loan) entered into by the beneficiary, as the legal owner of the amount, and the trustees, as borrowers. The amount is no longer subject to the trust relationship.
84. A beneficiary who lends an amount to trustees on commercial terms (ie, where none of the non-commercial elements listed above are present) will not be a settlor under s HC 27(2)(a) or (b).
85. The characterisation of a trustee distribution was recently considered in *Pope v FCT* [2014] AATA 532 (an Australian Administrative Appeals Tribunal (AAT) decision). *Pope* illustrates that if there is a loan created at the time of the distribution, the character of the amount credited to the beneficiary will be different.
86. In *Pope*, the trustees of a trust made distributions to the taxpayer, who was a beneficiary of the trust. The amounts were not actually paid to the **taxpayer, but were credited to an account in the taxpayer's name in the books of account of the trust.**
87. **The distributions were included in the taxpayer's assessable income in the years that the distributions were credited to him.** Later, the taxpayer decided that the trust was not going to be able to pay him the amounts credited to him and, therefore, claimed deductions for bad debts in relation to the amounts. **This was on the basis that the "debt" written off had the character of trust entitlements—the same character as the distributions included in his assessable income.**
88. The Commissioner concluded that the taxpayer was not allowed the bad debt deductions. **The Commissioner disagreed that the "debt" written off had the character of trust entitlements.**
89. The AAT agreed with the Commissioner. The AAT began its analysis by setting out the relevant provisions in the trust deed:

[5] Given one of the arguments of Mr Pope it is necessary to have regard to some of the provisions of the deed establishing the Trust. By virtue of clause 4.1 the trustee was obliged to hold the income available for distribution upon trust,

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... to pay, apply or set aside the income, or any part of the income, to or for the benefit of the beneficiaries...

The trustee had the power to resolve to accumulate the whole or part of the income of a financial year. Where, as happened here, the trustee resolved to distribute, clause 4.4, so far as is presently relevant, provided:

The payment, application or setting aside of income of a financial year may be effectively made as follows:

- (a) for a beneficiary who is not under a legal disability:
 - (i) by paying the income to the beneficiary or to such person on behalf of the beneficiary as the beneficiary may authorise or direct; or
 - (ii) by setting the income aside to a separate account in the books of the Trust in the name of the beneficiary **whereupon such monies will constitute a loan** at call and will not bear interest unless the Trustee and the beneficiary otherwise agree;

...

[6] Finally, reference is necessary to clause 4.6(a) of the deed. It provided:

The payment application or setting aside of income to or for the benefit of a beneficiary may be by a determination or resolution of the Trustee and upon such determination or resolution being made the beneficiary will have an immediate vested indefeasible interest in and to that part of the income so paid, applied or set aside for the financial year to which the determination or resolution relates. [Emphasis added]

90. The AAT stated at [15]:

The starting point must be an analysis of the distribution transaction. That analysis is necessarily informed by the terms of the deed creating the Trust. Each distribution was in discharge of the trustee's obligation to hold the income of the Trust "to pay, apply or set aside the income" of the Trust. The trustee made a resolution in accordance with clause 4.6(a) of the trust deed and, upon that resolution, Mr Pope had "an immediate vested indefeasible interest in or to that part of the income" subject of the resolution. Having resolved to distribute to Mr Pope, a beneficiary not under a legal disability, the trustee could pay the income of the Trust to Mr Pope or could set it aside to a separate account in the books of the Trust in the name of Mr Pope. In the 2005 income year an amount of \$6,566 was paid directly to Mr Pope from a total distribution to him of \$327,921. The difference, \$321,355, is the balance of the account in Mr Pope's name in the accounts of the Trust as at 30 June 2005. As the Commissioner submits, the only rational inference in these circumstances is that the balance of **the distribution to Mr Pope was effected in the manner set out in clause 4.4(a)(ii) of the Trust deed and that the monies distributed in that way constituted a loan at call between Mr Pope and the Trust.** [Emphasis added]

91. The AAT's decision was based on an analysis of the transaction and the terms of the trust deed. The AAT held that the distribution to the taxpayer was effected in the manner set out in cl 4.4(a)(ii) of the trust deed and that the monies distributed in that way constituted a loan at call between the taxpayer and the trust. The AAT reasoned that, because of this character, the debt written off had an entirely different character from the distributions included in **the taxpayer's** assessable income. Therefore, the AAT held that bad debt deductions were not allowed.

92. The decision in *Pope* is consistent with *Ward* (discussed above). As stated in *Ward*, in normal circumstances an amount distributed to a beneficiary, but retained in the possession of the trustees, will not create a debtor-creditor relationship. In *Pope*, a particular provision in the trust deed led to the conclusion that the distribution was a loan. *Pope* illustrates that if

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there is a loan, the character of the amount credited to the beneficiary will be altered.

Factual enquiry

93. Whether a beneficiary has loaned an amount (that was vested in interest in, or paid to, the beneficiary) back to the trust will be a factual enquiry.
94. A loan does not have to be in writing. The existence of a loan may be established from the surrounding circumstances. Taking into account the surrounding circumstances, the Commissioner may consider that a loan does or does not exist. However, the onus of proving that a loan does or does not exist is on the taxpayer and in some cases it might be difficult to satisfy this onus.
95. Situations may exist where a beneficiary is able to demand possession of a vested or paid amount (where the amount is vested in possession), but chooses not to. The fact that the beneficiary chooses not to demand possession of the amount does not, on its own, imply the existence of a loan from the beneficiary to the trustees. The fact that a beneficiary could take possession of the amount vested or paid and derive a return on the amount (eg, by depositing it in an interest bearing bank account) does not change this conclusion.

Examples

96. The following examples are included to assist in explaining the application of the law.

Example 1—Beneficiary not a settlor

97. **Facts.** The trustees of the Baker Family Trust make a resolution allocating \$10,000 to Emma Baker, a beneficiary of the Trust. The \$10,000 is **recorded by the Trust's accountant as a credit** in the "Beneficiary allocation account" for Emma **with the description "Allocation of Trust funds"**. The \$10,000 is **kept in the Trust's bank account with other funds**. Interest derived on amounts in the Trust's bank account is used for Trust purposes generally. The Trust deed does not require that interest on vested amounts be attributed to beneficiaries. Five years later the \$10,000 is transferred to **Emma's personal bank account**. **No interest** is paid to Emma at any time.
98. **Discussion.** Emma immediately received a right to \$10,000. The trustees did not have any obligation to pay Emma any interest on the \$10,000. **Until the \$10,000 was transferred to Emma's personal bank account**, she did not have legal ownership of the money. The **Commissioner's view** is that before a beneficiary can *provide* an amount, the beneficiary must be the legal owner of the amount being provided. Therefore, Emma **did not "provide"** the amount to the Trust during the five years that the Trust had possession of the amount. Therefore, she cannot be said to have transferred value or provided financial assistance to the Trust. Therefore, the arrangement does not cause Emma to be a settlor under s HC 27(2)(a) or (b).
99. **The term "beneficiary allocation account" or similar is preferable to "current account". It is not wrong to use the term "current account", but it is potentially misleading. The term "current account" may suggest that a trust owes a debt to the beneficiary, which is not the case in this example.**

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Example 2—Written loan

100. **Facts.** Mr and Mrs Collins are the trustees and settlors of the Mountain View Farming Trust. The Trust has income of \$70,000 for the income year. Mr and Mrs Collins pass a resolution stating that \$10,000 of the Trust's income is allocated to Peter Collins, their 22 year old son and a beneficiary of the Trust. Peter is single with no children and is working full time in a café in town. This distribution is recorded in the Trust minutes. The distribution is also reflected in the Trust accounts as a credit in the **"Current account" for Peter with the description "Allocation"**.
101. After making this resolution, Mr and Mrs Collins and Peter agree in writing to an interest-free loan of the \$10,000 from Peter back to the Trust. The loan agreement notes that the trustees have an obligation to pay the \$10,000 to Peter on demand arising from the trust distribution and also that Peter wishes to loan an amount of \$10,000 to the trustees. The loan agreement states that the agreement constitutes a set off of these reciprocal payment obligations. The decision to borrow money from Peter is recorded in the Trust minutes. The loan is also reflected in the Trust accounts as a debit in the **"Current account" for Peter and a credit in the "Non-current liability—Peter" account**.
102. Mr and Mrs Collins' accountant argues that Peter has become a settlor of the Trust. The accountant argues that this is because Peter has transferred value to the Trust by providing an interest-free loan. If this is true, Mr and Mrs Collins may be eligible for more social assistance because the trustee income of the Trust will be divided between three settlors, rather than two, when calculating their family scheme income.
103. **Discussion.** Mr and Mrs Collins' accountant is correct. The loan from Peter to the Trust necessarily implies that Peter was given legal ownership of the \$10,000 allocated to him. Having received legal ownership, Peter is able to provide the \$10,000 back to the Trust as a loan. Further, because the loan was interest-free he is treated as having transferred value to the Trust.
104. However, in the future, Peter may regret his decision to loan the \$10,000 back to the Trust if for any reason he needs to apply for social assistance (eg, if he subsequently has children). When calculating his family scheme income, Peter will, as a settlor, be allocated one-third of the trustee income of the Trust. This may reduce the amount of social assistance he is eligible for.

Example 3—No written loan

105. **Facts.** The facts of this example are the same as in Example 2, except no written loan exists. Peter and his parents state that it was agreed that the amount was loaned back to the Trust with no interest. Neither the Trust minutes nor the Trust accounts make any mention of the loan. The accounts simply refer to a credit **with the description "allocation" in the "current account" for Peter**.
106. **Discussion.** Whether a loan exists in any particular situation is a factual enquiry. The fact that the loan is not in writing does not necessarily mean no loan exists. A loan does not need to be in writing. However, the burden of proving that a loan exists is on Mr and Mrs Collins and in this example it may be difficult to satisfy this burden. Mr and Mrs Collins will be relying on **their and Peter's statements that a loan exists and the Commissioner's view of the surrounding circumstances**. The Trust

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accounts do not provide evidence of a loan. The reference to the credit with the description “allocation” in the “current account” for Peter merely records that the Trust vested the amount in Peter; it does not record a loan from Peter to the Trust.

Example 4—Loan with interest

107. **Facts.** The facts of this example are the same as in Example 2 (written loan), except a market rate of interest is paid on the loan and the principal is repaid after 5 years.
108. **Discussion.** As interest has been paid, and the principal repaid, Peter has not transferred value or provided financial assistance to the Trust and, therefore, will not be a settlor under s HC 27(2)(b).

Draft items produced by the Office of the Chief Tax Counsel represent the preliminary, though considered, views of the Commissioner of Inland Revenue.

In draft form these items may not be relied on by taxation officers, taxpayers, and practitioners. Only finalised items represent authoritative statements by Inland Revenue of its stance on the particular issues covered.

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References

Subject references

Beneficiary
Current account
Distribution
Financial assistance
Paid
Settlor
Transfer of value
Trust
Trustee
Vests absolutely in interest

Legislative references

Income Tax Act 2007, subpart BG, ss CD 5, HC 6(1), HC 27(1), HC 27(2)(a) and (b), MA 8, MB 7 and the definitions of “amount”, “pay” and “transfer of value” in YA 1
Income Tax Act 1976, ss 61(27), 226(2)

Case references

Case Q6 (1993) 15 NZTC 5,047
CIR v Dick (2001) 20 NZTC 17,396 (HC)
CIR v Simpson [1989] 2 NZLR 704 (CA)
CIR v Ward [1970] NZLR 1 (CA)
Pope v FCT [2014] AATA 532
Re Marshall (Deceased), *CIR v Public Trustee* [1965] NZLR 851 (CA)

Re Mulligan (Deceased) [1998] 1 NZLR 481 (HC)

Trans Otway Limited v Shephard [2005] 3 NZLR 678

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Other references

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Appendix – Legislation

1. Section CD 5 states:

CD 5 What is a transfer of value?

General test

- (1) A **transfer of value** from a company to a person occurs when—
- (a) the company provides money or money's worth to the person; and
 - (b) if the person provides any money or money's worth to the company under the same arrangement, the market value of what the company provides is more than the market value of what the person provides.

Release of debt

- (2) A company provides money's worth to a person if the person is released from an obligation to pay money to the company, either by agreement or by operation of law.

When shares are cancelled

- (2B) The market value of any transfer from the shareholder to the company on the cancellation of a share of the shareholder's rights as a shareholder is zero.

Provision of services for less than market value

- (3) Despite subsection (1), a transfer of value does not occur to the extent to which the money's worth provided by the company is only the provision of services.

Limit to subsection (3)

- (4) Subsection (3) does not apply to the provision of services by a company that is a close company, if the provision is the benefit of expenditure of the company.

2. Section HC 6(1) states:

HC 6 Beneficiary income

Meaning

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

3. Section HC 27(1) and (2) relevantly state:

HC 27 Who is a settlor?

When this section applies

- (1) This section applies for the purposes of—
- (a) the trust rules; and
 - (b) the consolidation rules; and
 - (c) section CW 59 (New Zealand companies operating in Niue); and
 - (cb) section MB 7 (Family scheme income of settlor of trust); and
 - (d) section YA 1 (Definitions), the definition of **settlement**; and
 - (e) subpart YB (Associated persons and nominees) as modified by section YB 10 (Who is a settlor?).

Meaning of settlor

- (2) A **settlor** of a trust is a person who, at any time,—
- (a) transfers value—
 - (i) to the trust; or
 - (ii) for the benefit of the trust; or

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(iii) on terms of the trust:

- (b) provides financial assistance to the trust or for the benefit of the trust with an obligation to pay on demand, and the right to demand is not exercised or is deferred:

...

4. Section MA 8 relevantly states:

MA 8 Some definitions for family scheme

...

family scheme income means the amount, described in section MB 1 (Adjustments for calculation of family scheme income), based on a **person's net income and adjusted as** provided by subpart MB (Adjustment of net income for family scheme), on which an entitlement and a tax credit under the family scheme is based

...

5. Section MB 7 states:

MB 7 Family scheme income of settlor of trust

When this section applies

- (1) This section applies for the purpose of determining the amount that represents the family scheme income of a person for an income year when the person is the settlor of a trust (the **person's trust**) at a time in the income year, other than solely as a result of providing personal services for less than market value in the administration of the trust or the maintenance of trust property.

Exception for some trusts

- (2) This section does not apply if—
- (a) the trustee of the person's trust is registered as a charitable entity under the Charities Act 2005;
 - (b) the person's trust is solely for the benefit of a local authority;
 - (c) interest and dividends derived by the trustee of the person's trust would be exempt income of the trustee under section CW 45 (Funeral trusts);
 - (d) the person's trust is a superannuation fund;
 - (e) the person and the members of the person's family are not permitted to benefit from the person's trust except under an order of a court.

First formula: family scheme income

- (3) The person's family scheme income for the income year includes the amount calculated using the formula—

(trustee income + companies income) / settlor number.

Definition of items in formula in subsection (3)

- (4) In the formula in subsection (3),—
- (a) **trustee income** is the net income of the trustee of the person's trust for the income year reduced, to not less than zero, by the amount of the trustee's income that vests or is paid by the trustee as beneficiary income for the income year;
 - (b) **companies income** is the greater of zero and the amount given by totalling the amounts calculated by applying the formula in subsection (5) to each company in which the trustee of the person's trust and associated persons hold, on the last day of the income year, voting interests of 50% or more;
 - (c) **settlor number** is the number of settlors of the person's trust who are alive at any time in the income year, including the person, for which this section applies.

Second formula: companies income

- (5) For the purposes of the item **companies income** in subsection (4)(b), an amount to be totalled is, for each relevant company, calculated using the formula—

trustee's interest x (income – dividends).

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Definition of items in formula in subsection (5)

- (6) In the formula in subsection (5),—
 - (a) **trustee's interest** is the percentage voting interests for the relevant company held, on the last day of the company's year, by the trustee:
 - (b) **income** is the net income of the relevant company for the company's income year:
 - (c) **dividends** is the total dividends paid by the relevant company for the company's income year.

6. Section YA 1 provides the following relevant definitions:

amount—

- (a) includes an amount in money's worth:

...

pay,—

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

...

transfer of value—

- (a) is defined in section CD 5 (What is a transfer of value?):
- (b) means a transfer that occurs when—
 - (i) person A provides money or money's worth to person B; and
 - (ii) if person B provides any money or money's worth to person A as part of the arrangement described in subparagraph (i), the market value of what person A provides is more than the market value of what person B provides; and
- (c) includes the release of an obligation that person B has to pay money to person A, either by agreement or operation of law; and
- (d) **transfers value** has a corresponding meaning