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1. There should always be a good understanding of the potential tax effects when entering into transactions and agreements. In fact, where it is possible to do so, there is a case for clearly specifying the tax outcome(s) intended by the parties to an agreement in order to avoid unintended tax consequences. Two draft Interpretation Statements issued by Inland Revenue serve to exemplify the importance of this:
   - Draft Interpretation Statement - *Income Tax: Whether income that is deemed to arise under tax law, but not trust law, can give rise to beneficiary income* (which was issued on 5 December 2011 and closed for comments on 17 February); and
   - Draft Interpretation Statement - *Income Tax: Timing of share transfers for the purposes of the continuity provisions* (which was issued earlier this year and closed for comments on 11 April).

Income under tax law vs trust law

2. The draft IS lists the following tax provisions, which give rise to taxable income without any corresponding income under trust law:
   (a) Section CP 1 (which deems an investor in a multi-rate portfolio investment entity ("PIE") to have income including an attributed amount from that PIE);
   (b) Sections CQ 1 and CQ 4 (which provide that attributed CFC income and FIF income, respectively, of a person is income); and
   (c) Other tax provisions that create a mismatch between trust income and income under tax law, because the cash flow arises in a different income year, such as:
      (i) The financial arrangements rules; and
      (ii) The rules in sections CB 6 to CB 15 that tax amounts from land transactions as income, whereas a trust may characterise those amounts as being on capital account.

3. Under trust law, the income of a trust is determined with reference to the terms of the trust deed and general principles of trust law. Trust law distinguishes between capital and income to the extent that a trust deed requires this: for example, when assets are held on trust to pay the income to an income beneficiary (for example, a life interest), and the capital to a capital beneficiary (for example, a remainder interest).

4. The trust deed may define what is to be treated as income and what is capital. Otherwise, the courts must apply trust law principles distinguishing capital and income. Trustees cannot simply rely on tax law, generally accepted accounting principles or international financial reporting standards to make the distinction between income and capital.

(However, it is noted that most modern family trusts are more flexible discretionary trusts with income and capital payable at the trustee's discretion.)

5. For these reasons, the draft IS concludes that the income of a trust under trust law will not necessarily be the same as the income of the trust under tax law. If tax law income is greater than income under trust law, the draft IS addresses the question of whether the excess tax law income can be vested in, or paid to, beneficiaries.

6. (The draft IS does not address the question of gross income versus net income. For tax purposes in New Zealand, trustee income is a reference to gross income derived by the trustee. Beneficiary income under NZ tax law is also gross income: the amount of the gross income derived by the trustee that is treated as beneficiary income under the tax rules. In fact, a beneficiary is not allowed any tax deductions – all the trust's tax deductions are allocated to the determination of trustee income that is taxable to the trustee [section DV 9]. By contrast, in Australia, it is net income that is allocated between the beneficiaries and the trustee – see for example *FCT v Bamford* [2010] HCA 10.)

When deemed income of a trustee can be treated as beneficiary income

7. The draft IS concludes that it is possible for deemed income of a trustee to be beneficiary income on the basis that:

   (a) The deeming takes effect for a trustee in all relevant contexts.

   (b) There is no clear policy implication that would lead to a conclusion that beneficiary income is limited to a sub-set of a trustee income.

   (c) Trustee income that is not derived under ordinary concepts is treated, under section HC 5(2), as derived in the income year for purposes including the purpose of the definition of "beneficiary income" in section HC 6. This indicates that deemed income can be beneficiary income.

8. The thrust of the draft IS, however, is that it will not be possible to treat deemed trustee income as beneficiary income unless both trust law requirements and tax law requirements are met. The trust law requirements referred to are:

   (a) The trust deed must define trust income to include amounts of deemed income that arise under tax law, or provide the trustee with the discretion as to: how to characterise receipts (as income or capital) and/or how to make distributions (from income and capital); and

   (b) The trust deed must allow for such amounts to be distributed to beneficiaries (either automatically or through the actions of the trustee).

9. In addition, the draft IS states that the trust must have an actual (non-deemed) amount (that corresponds to the deemed income amounts) to allow the deemed income to be vested in, or paid to, a beneficiary. The distribution must "reflect" the amount of deemed income – i.e. there must be an explicit link between the amount of deemed income for tax purposes and the additional payment to beneficiaries: e.g. the resolution allocating the additional payment may state that the trustee is allocating the sum to a beneficiary because tax income exceeds trust income. If there is no such link, then the payment may be capital or corpus. The source of the funds – i.e. the trust assets(s) used to make the distribution of deemed income is not critical as long as the link is clear.

10. (The Law Society has submitted that the trust need not have any cash or amount to hand. What it requires is a source in its accounts from which to make the distribution of the deemed income: *Allchin v Coulthard* [1942] 2 KB 228. The Law Society has also submitted that the only source that is relevant is the accounting entry in the trust's accounts – and not any asset - recording the distribution.)

11. The important point is that a trust may be denied the ability to treat all of the trust's income as beneficiary income, as may well have been anticipated by the settlor(s) and trustee(s). The preferable course of action will be to consider, and incorporate as necessary into the trust deed, the trust law requirements referred to above, so as to ensure that all of the trust's income is in fact treated as beneficiary income for tax purposes, if that was what was intended.

12. There could be potentially adverse implications for LTCs if all trustee income is not able to be distributed as beneficiary income. Clause 88(16) in The Annual Rates Tax Bill contains an amendment that will mean a trustee of a family trust is not treated as a relative. Consequently, a trustee of a family trust will be a separate look-through counted owner if, for example, the LTC derives FIF income that cannot be treated as beneficiary income. If this is unintended, the "5 or fewer look-through counted owners" requirement could be breached.

Who "holds" shares for shareholding continuity purposes

13. The second draft IS addresses the question of when a share in a company changes hands for the purposes of the shareholding continuity requirements to carry forward tax losses, imputation credits and excess tax credits.

14. The company law and tax law share ownership rules are first considered to determine who it is that "holds" a share at any time. The conclusion reached is that a "share" as defined for tax purposes is the same as a "share" referred to in section 51 of the Companies Act 1993 ("the CA"). Therefore. The "holder" of a share for tax purposes is the person whose name is entered on the share register of the company: the person who owns the share and has the legal title to the share. The case *BHL v CIR* (2011) 25 NZTC is cited in support of this proposition.

15. It is noted that there are specified tax law exceptions to this rule:

    (a) A person with the legal title to a share who holds the share as a nominee for another person, or as a bare trustee, is not treated as the "holder": the other person or beneficiary is treated as the holder (section YB 21).

    (b) Shares are deemed to be held by specified persons other than the legal owner when the requirements of sections YC 8 to YC 19 and FB 10 are met.

16. These ownership rules are then applied to share transfers as follows:

    (a) *When a share transfer agreement has been completed – i.e. the agreement has become unconditional and settlement has occurred* (but the purchaser is yet to become the registered holder of the shares) - a bare trust will exist and the vendor will be treated as the nominee of the purchaser. The authorities cited for this proposition are *Musselwhite v CH Musselwhite & Son Ltd* [1962] Ch 964 and *Avon Downs Pty Ltd v FCT* (1949) 78 CLR 353, where it was said at p. 365:

"… a transferor of a share who has been paid the consideration for the transfer, holds simply as a passive trustee until the registration of the transfer and entry of the transferee's name on the register."

(b) *Where an unconditional agreement for the sale and purchase of shares is entered into, but settlement has not occurred*, the shares would still be "held by the vendor" for tax purposes. This is because, although the shares will (before settlement) be held by the vendor on trust for the purchaser, the trust is not a bare trust. The purchaser merely had an equitable interest in those shares. The vendor will retain the prima facie right to vote in relation to those shares.

17. The stated authority for the view that an unpaid vendor is a trustee for the purchaser, but not a bare trustee is *Musselwhite*. The draft IS also notes the comments of the UK Court of Appeal in *Michaels v Harley House (Marylebone) Ltd* [1999] 1 All ER 356, at p. 367:

    "A registered shareholder who is a vendor under an uncompleted contract is in an intermediate position, a fiduciary but not a nominee."

18. Reference is also made to the judgment of Deane and Dawson JJ in *Stern v McArthur* (1988) 165 CLR 489, at p. 552:

    "It has been said in a variety of ways that a vendor under a valid contract for the sale of land holds the land as trustee for the purchaser. He is, however, a trustee only in a qualified sense and the qualifications are such as to rob the proposition of much of its significance or, for some purposes, its validity … the vendor retains a substantial interest in the property until the whole of the purchase money is paid. … Any right to equitable ownership on the part of the purchaser is contingent only…"

19. (The Law Society made a submission that an unpaid vendor is not a trustee for the purchaser at all, based on the above quote from *Stern and McArthur* and on the comments of Deane J in *Kern Corp Ltd v Walter Reid Trading Pty Ltd* (1987) 163 CLR 164, at pp. 191-192:

    "… However, and with due respect to some past statements of high authority to the contrary, it is wrong to characterise the position of such a vendor as that of a trustee. … it is both inaccurate and misleading to speak of the unpaid vendor under an uncompleted contract as a trustee for the purchaser…")

20. Whatever the case, it should be possible to contract out of any trustee type relationship if that is the genuine intention of the parties to the agreement. The draft IS notes that a nominee relationship can be created by agreement. By implication, it should be possible to agree that no fiduciary relationship will arise under a share transfer agreement. The courts will not disregard documents that correctly record the parties' intentions. In *Mills v Dowdall* [1983] NZLR 154 (CA) Richardson J referred at page 159 to:

    "… the principle that the legal consequences of a transaction turn on the terms of the legal arrangements actually entered into and carried out…".

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