TAX

Pieter Holl, Pieter Holl & Associates

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Lindsay: I'm pleased to introduce Pieter Holl of Auckland accounting firm Pieter Holl & Associates Limited. Pieter has a particular focus on providing tax and accounting services to medium sized businesses, their owners and high net worth individuals. He's a contributor to the Tax Chapter in the CCH New Zealand Master Trust Guide and having used Pieter's services in the past, I know he is well placed to give an overview of managing tax and GST obligations as a trustee.

Pieter, what are some of the problems that you're seeing trustees getting into with their tax?

Pieter Holl: The main problems I'm seeing really relate to a lack of understanding by trustees of what a trust is and what obligations they have as trustees.

Of course, those are issues which apply in a more general sense under trust law, but the same issues are also particularly relevant for tax. It really is important that trustees do understand what a trust is and what their obligations are under both trust law and tax law.

Trustees also need to understand what their record keeping and administration responsibilities are. In particular, the need to prepare financial statements for the trust, the need to establish a separate bank account for the trust and the need to have regular trustee meetings at least annually. It would also include the need for trustees to prepare and sign appropriately worded resolutions for distributions made and major transactions of the trust.

More specifically in relation to tax, the trustees must ensure that any required tax returns are prepared and all of the other tax obligations of the trust are met (e.g. tax is paid by due date).

One issue I often come across in the tax area is the lack of understanding as to how trusts are taxed. The income of a trust is taxed either in the hands of the beneficiaries (as beneficiary income) or in the hands of the trustees (as trustee income). Many trustees don't have a good understanding of the steps they need to take to achieve the tax result they want.

Another issue I see is around a lack of understanding of how Goods & Services Tax (or GST) applies to trusts. While most trusts don't carry on activities that are subject to GST, those that do need to register for GST and are subject to all of the GST obligations that any GST registered person has to meet.

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So, it's important for trustees to be aware of the type of activities that are subject to GST. Property development and subdivision activities and renting out a holiday home are examples of activities that can give rise to GST obligations.

Lindsay: Thanks Pieter. You've mentioned the two options for taxing trusts and that trustees don't always understand the steps to achieve the tax result they want. Can you expand on that a bit more?

Pieter: Sure. If the trustees decide that the income of the trust should be taxed in the hands of the beneficiaries (as beneficiary income), that income must be distributed to the beneficiaries either within the year in which it is derived or within the timeframe specified in the tax legislation (which can be up to twelve months after the end of the year).

However, many trust deeds have a clause saying that trustees have only six months after the end of the tax year to make their decision. Trustees need to check what their trust deeds say and take legal advice on whether they can or should vary their trust deed to extend the six month period to twelve months.

To achieve this result (i.e. to have income taxed in the hands of the beneficiaries), the trustees then need to pass an appropriately worded resolution within the specified timeframe. This resolution needs to be carefully worded and it must be irrevocable, so care is required.

Where a decision is made for the income of a New Zealand family trust to be taxed in the hands of the trustees (as trustee income), any subsequent distribution of that income to the beneficiaries should generally be tax-free in their hands.

Different rates of tax will apply depending on whether trustees choose to have the trust income taxed as either beneficiary income or trustee income.

Lindsay: Thanks Pieter. You touched on record keeping problems that trustees can get into. What sort of problems are you identifying?

Pieter: Yes. I think it's very important for trustees to ensure the trust's tax record keeping and other obligations are being met (for example, that tax returns are being filed and any tax is being paid by due date). Any trustee who doesn't understand these requirements, or know whether they are being met, should raise this issue with their fellow trustees and/or the trust's accountant or lawyer.

An issue to watch out for is whether the trust has its own bank account and whether it is being used solely for trust related transactions. Some trustees (who are also often the settlors) don't

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understand that intermingling personal and trust transactions can create all sorts of problems, both as to the validity of the trust and the associated tax issues.

Another problem area I see is where financial statements are not being prepared for a trust. I'm of the view that all trusts should prepare financial statements. I know that financial statements are often not prepared for trusts that only own family homes, but personally I do not think that is a good approach. I would recommend that financial statements be prepared for even very simple trusts.

It's also important for trustees to know that any trust that derives income must apply for an Inland Revenue Department number and file income tax returns. This requirement applies even if the trust only derives a very small amount of income, such as interest on a bank account. I'm sure this requirement is often overlooked by trustees.

Lindsay: So Pieter, good tax management is about trustees properly understanding their trust and tax obligations and good record keeping…

Pieter: The key point to note here is that trustees are personally liable for the debts and obligations of the trust and this includes the trust's tax debts and obligations.

There have been situations where independent trustees have been held personally liable for paying the tax or GST payable by a trust. This isn't limited to non-professional trustees. Some professional trustees, such as accountants and lawyers, have also been caught out by this requirement to pay the trust tax personally.

It's important to remember that the activities of a trust and the use of trust assets can change over time. An asset could start outside of the tax base (i.e. it's used by the beneficiaries) and quite easily become an asset that is within the tax base.

For example, a family home that was previously occupied by the beneficiaries could be rented out, or a lifestyle property that was previously used by the beneficiaries could be subdivided and sold.

These changes can have tax and GST consequences. In these situations, the trustees can be held to be personally liable for any unpaid tax and GST and that includes trustees who may be friends, family members or professional trustees.

Lindsay: This has really reinforced to me the importance of trustees keeping tax and GST top of mind when they are managing their trusts, especially if there is a change in the use of assets in a trust. What about the winding-up of a trust, what needs to be considered then?

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Pieter: There are no specific tax rules that apply when a trust is being wound up. However, the various steps taken to wind up a trust will often give rise to tax issues. For example, any sale or distribution of the income-earning assets of a trust will often give rise to tax liabilities. Any tax depreciation previously claimed on those assets may be recovered and, in some cases, the gains on sale may also be taxable.

The trustees will also need to ensure that the trust's final income tax return is filed. If the trust is registered for GST, PAYE or similar taxes, it will need to be deregistered from those taxes when any final tax owing has been paid. I would recommend trustees obtain tax advice as soon as they are thinking about winding up a trust so the tax position can be carefully considered.

Lindsay: Pieter, what would you then suggest are good practices for trustees to manage their tax?

Pieter: I think firstly that all trustees need to ensure they have a good understanding of their obligations under both trust law and tax law. That includes understanding what a trust is. A lot of people mistakenly think a trust is an entity, like a company. A trust is not an entity, it's essentially a relationship between the various parties and it's really important to understand that. It's also important for trustees to understand their trust deed.

Specifically from a tax perspective, I would suggest that all trustees should ensure they have at least a general understanding of how trusts are taxed. We touched on the distinction between beneficiary income and trustee income. There are obviously a lot of other issues arising under tax law for trustees and I think it's important for trustees to have a general understanding of those issues.

There are a number of good publications trustees can refer to. You've touched on the CCH Master Trust Guide. The Inland Revenue Department has also produced a "Trusts and Estates Income Tax Rules" guide that is available for download from its website (search for IR288). Various other excellent books have also been written for non-professional trustees.

If all trustees have at least a general understanding of the tax rules applying to trusts, they will have a much better idea as to when the trust might not be meeting its tax obligations. It will also flag to trustees when they need to get advice from a tax advisor or an accountant before any major transactions are entered into that may have significant tax consequences.

Finally, it's particularly important for trustees to establish clear responsibilities and procedures for complying with the trust's tax obligations. All trustees should ensure they know who is responsible

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for preparing the trust's tax and GST returns and paying the taxes due. They should also ensure that those obligations are being met on an on-going basis.

It's in situations where no one has taken responsibility for the tax obligations of the trust that issues have arisen for the trustees and the tax requirements have fallen through the cracks.

Lindsay: I'd add that it's important when you're changing trustees in a trust (for example, when a trustee retires or resigns), to notify the Inland Revenue Department in writing that a person is no longer a trustee, otherwise that trustee's obligations for tax and GST to a trust will continue.

Pieter: Yes, and particularly in the GST area where the GST legislation clearly provides that trustees will continue to be liable for the GST payable by the trust until the Inland Revenue is advised that they have ceased to be a trustee.

Lindsay: Pieter Holl, thank you very much for the insights that you've given and the suggestions you have made to help trustees better manage their tax and GST obligations. If people wish to contact you they can do so by email at pieter@phaal.co.nz. Thanks again Pieter.

Pieter: Thanks Lindsay.