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When a beneficiary can become a settlor

The Inland Revenue have issued a policy document to clarify the position of undrawn beneficiary accounts in trusts. From 1 April 2020 a beneficiary of a trust whose current account balance at the end of the income year is not greater than $25,000 do not become settlors.

How does this impact your trust? If a beneficiary has a balance of more than $25,000 they may become a settlor of the trust which might have unforeseen consequences.

This change comes as the Government recognises that when an amount of income is allocated by a trust to a beneficiary but retained in the trust, and no interest is paid by the trust to the beneficiary, such a beneficiary may become a settlor. This is because they meet the definition of "settlor" in section HC 27 of Income Tax Act 2007 by transferring value to the trust.

As a quick recap, a settlor of the trust is a person who transfers value to the trust, for the benefit of the trust or on the terms of the trust.

The law around whether a beneficiary who leaves distributions in a trust is regarded as a settlor has been unclear with the Inland Revenue previously stating a beneficiary in this position would not be a settlor, they have now changed their minds and clarified the positon to be:

- leaving funds on call in a current account (without market interest being paid) would result in a beneficiary becoming a settlor, and

- if funds were loaned to a trust at less than market interest rates the beneficiary would also become a settlor.

This amendment comes into force on 1 April 2020, and does not have retrospective effect. To provide greater certainty and to minimise compliance costs, Inland Revenue will continue to allow taxpayers to rely on the existing public position up to and including 31 March 2020.

Being a settlor of a trust can impact social security, student loans and possibly some associated person tests. The settlor of a trust also determines tax residence of the trust. A trust needs at least one New Zealand resident settlor to remain a complying trust otherwise it can become a non-complying trust which can have unintended tax consequences.

We personally believe the IRD are incorrect with this position but until it is challenged in court it is their current policy.

If you would like to know more or require assistance please contact Kirit or Alannah.

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