



# White Paper - N°10

## NZ Foreign Trusts (2019)

Covisory

### Key Points

- 1. New Zealand Foreign Trusts are caught as a reverse hybrid entity under NZ Income Tax Legislation.**
- 2. There is no tax impact yet as the relevant provisions for the Income Tax Act have not been passed, but it is coming in the next year or so.**

### 1 Background

- 1.1 Trusts established in New Zealand (NZ) with a non-resident settlor or settlors are known as Foreign Trusts. NZ's income tax legislation taxes the trust's income based on the resident of the settlor. As Foreign Trusts have non-resident settlors, their non-NZ sourced income of the Trust was not generally taxable in NZ.
- 1.2 The potential tax mismatches with NZ Foreign Trusts were noted by the NZ Government when considering the OECD's Base Erosion and Profit Shifting (BEPS) Action Plan.
- 1.3 As part of Action 2 of the Plan, the OECD recommended changes to a country's domestic law to eliminate or counter-act these cross border arrangements that utilise differences in tax treatments between countries to eliminate, defer or reduce income tax.
- 1.4 Both the Inland Revenue and the Treasury recommended to the NZ Government that NZ Foreign Trusts should be incorporated into changes to NZ domestic law to eliminate these potential mismatches. Subpart FH of the Income Tax Act 2007 was introduced to adopt most of the OECD's recommendations in their action plan.
- 1.5 The majority of the legislation applies from the income years beginning on or after 1 July 2019.
- 1.6 This paper outlines how this legislation applies to a NZ Foreign Trust.

### 2 Reverse Hybrid Entities

- 2.1 A hybrid entity is defined in section FH15 of the Income Tax Act 2007 (Act).
- 2.2 It means a person or other entity that is recognised as a person who is subject to tax in a country that treats it as a tax resident and is not recognised as a person that is subject to tax in another country.
- 2.3 "Hybrid Entity", for two countries or territories, means a person or other entity that is:
  - a recognised in one of the countries (the resident jurisdiction) as being a resident of the resident jurisdiction and subject to taxation under the taxation law of the resident jurisdiction;

- b not recognised in the other country or territory (the overseas jurisdiction) as being a person, or other entity, subject to taxation under the taxation law of the overseas jurisdiction in relation to income with a source in the overseas jurisdiction.
- 2.4 A NZ Foreign Trust will fall within the definition of a hybrid entity as it is resident in New Zealand and subject to the tax laws of New Zealand. However the foreign sourced income earned by the NZ trustee of a Foreign Trust was not taxed in NZ on the basis that it was more appropriately treated as earned by a foreign settlor, who is not subject to New Zealand tax on non-source New Zealand source income.
- 2.5 A NZ Foreign Trust is therefore a reverse hybrid entity for the purposes of the legislation. Both NZ Treasury and Inland Revenue recommended that reverse hybrid entities should be taxable on their non- NZ sourced income if this income was not taxable in the overseas jurisdiction i.e. the country of residence of the non-resident settlor.
- 2.6 Section FH 7 of the Act deals with payments made to a reverse hybrid. However, this section denies deductions rather than including income.
- 2.7 Sections FH 4 and FH 6 treat receipts as assessable income. However, sections FH 4 and FH 6 apply to payments received by the NZ entity that are deductible in the other jurisdiction but not treated as taxable in NZ.
- 2.8 Accordingly, there is no specific provision under subpart FH which would tax the trustee income of a NZ Foreign Trust on income derived outside New Zealand. For example, income from foreign investments of the trust which may be taxable under NZs CFC or FIF legislation.
- 2.9 We have discussed this issue with a senior Inland Revenue policy official who has confirmed the above analysis. It is still their policy intention that the non-NZ sourced income of a NZ Foreign Trust should be taxed in NZ, particularly, if it is not taxed in the other jurisdiction of the reverse hybrid entity. However, they were unable to devote adequate resources to prepare the provisions (and amendments elsewhere in the Act) for it to be introduced within the Government's timeframe.
- 2.10 This issue remains on the Inland Revenue's Policy Work Programme. The question now is when will sufficient resources be devoted to preparing legislation and have the support of the Government of the day for it to be enacted.
- 2.11 We consider that NZ Foreign Trusts do not have a long-life expectancy, but for now they remain effective.

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## *About Covisory*

The Covisory Group specialise in International and Domestic Tax Services, Trust Management, Succession Planning, Strategic and Business Planning, Accounting Services and Business Valuations.

Established in 2007, The Covisory Group has grown from one business to four with a diversity of clients. Covisory clients are owners of family businesses, operating both in New Zealand and globally. Our team of specialists work either one-on-one or alongside our clients' team of professional advisers to develop appropriate short- and long-term solutions.

We build strong relationships with our clients based around trust, accessibility, and responsiveness. There is no 'one size fits all' about our services. Our solutions are bespoke to each client, drawing on our up-to-date specialist knowledge and our years of experience. providing one-on-one expert advice.

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