SPEAKMAN LAW

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Trusts – Guidelines To What You Should and Should Not Do In Designing and Using a Trust

1. Introduction

This paper sets out dos and don'ts for New Zealand domestic trusts, particularly family trusts that own the family home and/or the family operated business. This checklist is not intended to be exclusive, rather it lists matters to be watchful for, and does not restate the obvious.

2. Checklist

You should:

a) Non-Disclosure to IRD – ensure, where lawfully possible, that the trust is not subject to the disclosure rules in section 59BA of the Tax Administration Act (see section 3 below).

b) Main Home Exemption – ensure the main home exemption from the bright-line test in section CB16A of the Income Tax Act is preserved (see section 4 below).

c) No Settlements – ensure no additional persons inadvertently become settlors of the trust (see section 5 below).

d) No Excessive Reserved Powers – ensure the trust deed cannot be invalidated on account of excessive reserved powers in favour of the settlor (see section 6 below).

e) Disclosure to Beneficiaries – limit the class of beneficiaries and/or establish a class of primary beneficiaries (see section 7 below).

f) Diverting Personal Services Income – refrain from arrangements that seek to use the trust as a means of avoiding tax at the top 39% marginal tax rate (see section 8 below).

g) Mental Incapacity – ensure the trust is not stalemated by dementia or other mental incapacity befalling a trustee (see section 9 below).

h) Power of Variation – ensure the trust deed contains a power to vary the trust deed (see section 10 below).

i) Income and Capital – ensure your trust deed grants trustees the discretion to distinguish between income and capital (see section 11 below).

j) Protected (Heritage) Assets – expressly provide in the trust deed for the retention of the family home and/or family operated business as a permitted investment by the trustees (see section 12 below).

k) Memorandum of Wishes – expressly provide in the trust deed for trustees to factor a MOW given by a settlor in their decision making (see section 13 below).

l) Modifying Default Duties – consider and exclude those default duties that are not appropriate to the trust, including the requirement for unanimity of trustees (see section 14 below).

m) Foreign Source Income – be careful to retain complying trust tax status wherever the trust derives foreign source income (see section 15 below).

3. Non-Disclosure to IRD

The rules requiring disclosure to IRD that came into effect on 1 April 2021 are horrendous. If you can lawfully avoid the need to comply with them, you should. That may be achieved in one of two ways:

a) by ensuring the trust derives no taxable income; or

b) registering the trust as a non-active trust.

Section 59BA of the Tax Administration Act (which prescribes the disclosure rules) only applies to a trustee who is required to file a return for a tax year. No tax return is required for a trust that derives no assessable income. Such a trust therefore falls outside of the disclosure rules.

In the context of a trust that owns the family home there is a trap that must be avoided in this regard. Inevitably the home will be occupied by one or more beneficiaries of the trust and it will be those occupants who meet payments on the home. Where these payments include mortgage interest (or indeed the loan principal repayments), there is a problem. If the beneficiary meets these payments as a condition of his or her occupation of the home (very commonly this is the case, established by trustee resolution), IRD practice is to treat them as trustee income (because they benefit the trust). This will put the trust squarely back into the disclosure rules.

This result can be overcome either by ensuring there are no conditions to a beneficiary's occupation of the home, or by treating the payments either as a gift made by the beneficiary or as a debt owed by the trust to the beneficiary. A loan agreement, or a deed of gift, should be entered into effect to reflect this. The problem could seemingly also be overcome by the trustee allocating the income as beneficiary income of the beneficiary (though this would create the perverse result of the very beneficiary who bears the payments, being taxed on the benefit to the trust arising from them).

As mentioned, there is the alternative of registering as a non-active trust in order to fall outside the section 59BA disclosure rules. This is established by the express exclusion for non-active trusts in section 59BA(3). What is a non-active trust? It is a trust that is non-active throughout the income year, and is a complying trust under section HC10 of the Income Tax Act. In addition, the trustee must have made a declaration that the trust is non-active pursuant to section 43B of the Tax Administration Act.

A trust is non-active for an income year if it has not derived any income in that year nor had any deductions (and has not been party to, or perpetuated, or continued with transactions with assets of the trust or estate, which, during the income year give rise to income in any person's hands or give rise to fringe benefits to an employee or to a former employer). Nominal amounts are ignored for these purposes, as are reasonable fees paid to professional persons to administer the trust and so are rates, insurance and other expenditure incidental to the occupation of a dwelling owned by the trust and incurred by the beneficiaries of the trust.

4. Main Home Exemption

Trust ownership does not deny the benefit of the main home exemption from the bright-line test in section CB16A of the Income Tax Act. Nonetheless, important limitations on the scope of that exemption apply in the context of trust ownership of a main home, as discussed below.

The main home exemption is available to a trustee for a house owned by the trust for:

> "a beneficiary of the trust,…[where]
>
> (i) a principal settlor of the trust does not have a main home; or
>
> (ii) if the principal settlor of the trust does have a main home, it is that main home which [the trustee] is disposing of".

For these purposes a 'principal settlor' means a person whose settlements on the trust are the greatest or greatest equal, by market value.

In other words, if you settle your home on a trust of which you are a beneficiary and you continue to live in it, in most cases the home will remain exempt from the bright-line test.

There are, however, three additional tests that must be satisfied to achieve this result and for a trust owned property to qualify for the main home exemption:

a) the person must not have claimed the main home exemption 2 or more times within the 2 years immediately preceding the bright-line date for the property;

b) the person must not have engaged in a regular pattern of acquiring and disposing of main homes; and

c) only one property may qualify at any given time, see below.

The main home exemption test is intended to apply to a single property only. Feasibly, a person might have a property in his or her own name and another in a trust, for example a bach that is used interchangeably as the main home. The bach will not qualify for exemption in this example. Alternatively, you might establish a trust to hold a property for one or more of your adult children that is used by them as their main home. If you are the principal funder (i.e. you have funded more than 50% of the purchase price), and you already have your own home, the trust will not qualify for the main home exemption on the trust owned property.

5. No Settlements

The trust rules are a settlor-based taxation regime. Consequently, the definition of 'settlor' is important in several respects, in particular it can create a problem in any of the 3 areas outlined below. The relevant definition does not limit a settlor to the person or persons who are named as such in the trust deed. Instead it includes as a settlor any person who transfers value to the trust. As a result of relatively recent tax changes this now includes a beneficiary who is owed more than $25,000 by the trust and who does not charge interest on that amount. This will arise whenever the trust allocates an amount

(whether it be capital or revenue) in favour of a beneficiary, without in fact paying it out, so that the beneficiary has a current account above this $25,000 threshold.

This can be problematic in three respects:

a) Where the beneficiary is a land developer/dealer, there is potential for the trust's land assets to become tainted (or, in reverse, where the trust is a developer/dealer, the beneficiary's land assets may become tainted);

b) The main home exclusion from the bright-line test for land held by the trust (requiring a close connection between the trust and the person who lives in the home) may be lost;

c) If the beneficiary emigrates, you will have a foreign settlor. It then becomes necessary to consider whether taxation of trust rules in the settlor's home jurisdiction may operate (particularly likely if the beneficiary is also a trustee). Further, if there are no other NZ settlors and there remains a New Zealand resident trustee, then any foreign sourced income of the trust will fall under section HC26/CW54 (exempt in the hands of a NZ trustee) and complying trust tax status will be lost, unless a section HC33 election is made.

Two further points as to the scope of the definition of settlor are important. First, the definition extends (see section HC27(2)(b)) to persons to whom a 'Marshall clause' loan has been made. This is where a person has advanced money to the trust that is repayable on demand and where interest is payable only if demanded, and that right is not exercised. If such loans were not treated as a 'settlement' for these purposes, they would represent a straightforward mechanism for a person to avoid settlor status (and thereby escape the trust taxation rules) while still transferring value to a trust.

The second point concerns nominee settlors. A person who makes a settlement on a trust as nominee for another person is excluded from being a settlor. Amongst other things, this ensures that professional advisers or relatives who assist by establishing the trust with a nominal sum, do not suffer the tax consequences befalling a settlor, including a settlor's personal liability to income tax under section HC29.

6. No Excessive Reserved Powers

The success attained by Mrs Clayton in responding to assets settled by her then husband (in the highly publicised Clayton v Clayton case) contrasts with the Financial Markets Authority's failure to access trust assets in the FMA's case against Mark Hotchin. The difference in results of the two cases illustrates the importance of the design of a trust deed.

Mr Clayton had structured his two trusts with excessive reserved powers. Essentially, the bundle of rights conferred on Mr Clayton by terms of the trust deed left it open to him to orchestrate whatever outcome he wished vis-à-vis the trust assets.

He was able to do so because of the control settings in the trust deed, and most notably, the ability to exercise powers in his own favour without any right for others to challenge that. This meant the trust contained no effective self-dealing prohibition, rendering them vulnerable to attack.

In contrast, the terms of Mr Hotchin's trusts contained a self-dealing prohibition that denied him the right to appoint himself as sole trustee, then appoint himself as a discretionary beneficiary and distribute the trust property to himself. Nor was Mr Hotchin able to appoint himself as trustee and use the power of variation in the trust deed to remove the self-dealing prohibition. These actions would not have withstood scrutiny as a proper exercise of power by a trustee.

As a consequence of these two decisions (there are many others, notably Webb v Webb) it is possible to state some guidelines regarding appropriate terms of a trust deed, as a means of minimising the risk of a successful challenge upon the trust's assets:

a) Ensure that the settlor is not empowered with sole trustee appointment rights (usually by the presence and rights of an independent trustee);

b) Ensure that the settlor merely has the right to consent to prescribed actions of trustees, other than to exercise them him or herself;

c) Include an appropriate self-dealing rule, in particular denying a trustee the right to exercise his or her powers as trustee where the trustee's interests might conflict with his or her duties to the trust.

Some further background follows.

The purpose of the self-dealing rule is to preserve the trustee's impartiality towards the interests of the beneficiaries. That impartiality is lost whenever a fiduciary enters into a transaction on both sides of a transaction. It recognises that control over the assets of a trust sits with the trustees and conversely, beneficiaries (for whom the assets are intended) have no control over them.

Scope of the self dealing rule: it applies no matter how fair the transaction – if a trustee sells the trust property to him or herself, the sale is voidable by any beneficiary as of right, however fair the transaction (Fenwick v Naera : NZSC2015). It is not necessary to demonstrate that a beneficiary (or the trust) has been disadvantaged, as enunciated in the Fenwick case.

"It is usually no defence to show that any unauthorised profit was made 'honestly' or in good faith or that the transaction was fair….it is thought that prevention is better than cure in that this provides good protection to beneficiaries and removes temptation from fiduciaries….removing the fruits of temptation is designed to neutralise the temptation by rendering it pointless."

However, the self-dealing rule and the fair-dealing rule do not have application where the trust deed expressly permits trustees to benefit. It is particularly common in the case of family trusts to include this exception. When drafting exceptions to the self-dealing rule, it must be kept in mind that the more the terms of a trust are modified and the more permissive the trust terms are, the more cornerstone duties are compromised.

7. Disclosure to Beneficiaries

The goal of greater transparency of trust information facilitating trustee accountability in favour of beneficiaries has resulted in express disclosure obligations to beneficiaries in the Trusts Act. These are not always welcome and often prompt effort to minimise the need for disclosure.

Two principal means of managing disclosure obligations here evolved in practice. The first is to consider the classes of beneficiaries established by the trust deed and to remove as beneficiaries persons whose interest in the trust is remote. Where it is the trustees who are empowered to take this action, the exercise of their power to do so will be fiduciary in nature. Hence, they must be able to rationalise the removal of beneficiaries, other than merely for reasons of not wishing to disclose trust information to them.

The second development in practice has been to establish a class of primary beneficiaries in the trust deed. For example, it is now common to see definitions of Primary and Secondary Beneficiaries in a modern trust deed. This is then coupled with an express statement of intent in the trust deed on the part of the settlor that the trustees are, unless they see fit to the contrary, to disclose trust information only to the Primary Beneficiaries. This affords the trustees rationale for withholding information from certain beneficiaries as a key factor for trustees in this respect is the expectations of the settlor.

8. Diverting Personal Services Income

The 6% differential between the trustee tax rate and the top personal tax rate offers encouragement, wherever lawfully possible, to divert personal services income through a trust. Historically, that has spawned the incorporation of trust owned companies that contract an individual's services to a supplier, with the income thereby diverted through the company, and by extension, the trust. The individual who provides the services is taxed only on his or her salary, invariably a proportion only of the contract price paid by the supplier.

The personal services income attribution rules and the Supreme Court decision in Penny and Hooper (the two orthopaedic surgeons who transferred their respective surgical practices to a company, resulting in considerable tax savings) offer Inland Revenue ample ammunition to combat these sorts of arrangements. Nonetheless, Inland Revenue has recently released proposals to considerably broaden the scope of the personal services income attribution rules.

As regards arrangements that seek to substitute a trust for personal shareholding in a business operating company with intended tax advantages, firstly beware Revenue Alert RA21/01 which signals Inland Revenue's concern at arrangements by which taxpayers use trusts in this fashion. Expect a challenge whenever the arrangement obtains a tax advantage as a result of the individual service provider and controller of the business receiving less than the full share (or at least a significant share) of the business profits whilst he or she continues to enjoy the benefit of the entirety of those profits (by way of company advances, for example).

The principal factor here is to set the individual's salary at an appropriate level. Widespread practice following the Penny and Hooper decision has been to set the salary at 80% of the total profits of the business. Revenue Alert 21/01, however, suggests this may not be appropriate, and the 80% threshold is not fixed.

Pragmatically, the greater the disparity between the total renumeration paid to the individual service provider as a salary and the profits from the business, the greater will be the amount enjoyed by that individual from the business (i.e. advances paid out to him or her). A significant differential will invite a challenge from Inland Revenue, with potential for tax penalties.

9. Mental Incapacity of a Trustee

There is the obvious point that sound investment of the trust fund will cease to be made (at least with any degree of confidence for the beneficiaries) where the trustee has become mentally incapable. There is also the point that decisions of a trustee are susceptible to challenge by beneficiaries where the trustee's mental capacity is in question.

This begs two questions, namely how is a trustee's mental capacity determined and how might a mentally incapacitated trustee be removed?

There is no definitive test for determining a person's mental capacity. This makes it rather circuitous to simply provide in the trust deed for a trustee's automatic removal when that trustee has lost capacity. Instead, what is preferable is to combine that with a process for determining a trustee's capacity. This can be in addition to the statutory assistance offered by section 96 of the Trusts Act that a person lacks or loses the capacity to perform functions of a trustee if the person is subject to an order appointing a manager under section 31 of the Protection of Personal and Property Rights Act 1988 or has a trustee corporation managing the person's property under section 32 or 33 of that Act.

Moreover, a co-trustee is required by section 104 of the Trusts Act to remove a mentally incapacitated trustee.

An obvious solution might be to ask the affected trustee to retire. This presumes however that he or she has the mental capacity to understand the consequences of that action (namely the relinquishment of control over the trust assets and by extension, transfer of control to another).

Principally, the issue here falls on whomever it is who holds the power of appointment and removal of trustees. The power holder simply exercises that power (confirmed by section 92 of the Trusts Act), perhaps having first obtained advice from a health practitioner. This solution fails where it is the power holder him or herself who's capacity is in question. Often that presumption will fail.

In light of the forgoing discussion, a possible solution is:

a) to provide in the trust deed that where a trustee fails a test of capacity (see below), the power holder shall remove that trustee; and

b) where for any reason, including where the power holder's own capacity is in question, this is not possible, one or more named beneficiaries (and advisedly Primary Beneficiaries or a Special Trust Adviser) shall have the right to require the power holder's capacity to be determined and to appoint as trustee a person who is independent (in the sense that he or she is not a beneficiary of the trust or in any way otherwise involved in it).

Turning to the question as to how a trustee's capacity is to be determined, a suggestion is to set out in the trust deed a capacity test, which might by way of illustration, direct a health practitioner to establish that capacity by reference to questions requiring the trustee to:

a) name any co-trustees;

b) provide an outline of the purpose, nature and extent of the trust and its assets;

c) name the Primary Beneficiaries of the trust;

d) outline decisions customarily made by the trustee in his or her capacity as trustee; and

e) state in whom his or her retirement as trustee would place control of the trust assets.

10. Powers of Variation

Circumstances often arise where it becomes desirable (or necessary) to amend a trust deed. An obvious case in point is the desirability to exclude unwanted or ill-suited default duties under the Trusts Act 2019. This begs three questions, namely is it possible to vary a trust deed, how is it done and what limits are there on the scope of a variation?

Variation of a trust is possible:

a) Where the trust deed specifically confers on trustees the power to do so;

b) To the extent permitted by the Trusts Act;

c) Under the inherent jurisdiction of the High Court

Added to this is the fact that where all beneficiaries are adult (and have their mental faculties), they can direct the trustees to terminate the trust. This is widely believed to permit a trust variation with consent of all beneficiaries.

Reliance on a power of variation in the trust deed is the usual course. Many trust deeds will contain an express power to vary that is wide in its scope and appropriate to rely on. Best practice is to include one in the trust deed and not seek reliance on general trustee powers.

Where the trust deed permits a variation, the procedure to vary is simple, and is effected by a deed of variation by the trustees. No notice is required, nor registration of any sort. If the trust deed does not permit it, unless consent of all beneficiaries is obtained (and all beneficiaries are able to give consent) an application to the court is required. Section 130 of the Trusts Act is the authorising provision (or section 124 in instances where the interests of beneficiaries will be impacted).

There are limits to the use of section 130, however, as a recent case illustrates. That case involved the Central Hawkes Bay Consumer Power Trust. Application was made to vary the provisions in the Deed dealing with the power of appointment of trustees. The Court held that section 130 did not permit this, although the Court accepted the application under its inherent jurisdiction.

How far can you go in varying a trust without triggering a resettlement? The general proposition is that a variation must not vary the substratum (spine, or fundamental provisions) of the trust. This assumes that the substratum can be identified. This will not always possible. Adding and removing beneficiaries inevitably begs the question whether the substratum of the trust is being varied, especially where there are wholesale changes. Hand in hand with this is the obligation on trustees to exercise powers for a proper purpose. These two issues are inextricably linked in that if the fundamental thrust of the trust is being altered, it is unlikely this will illustrate a proper purpose and may be a fraud on a power. As always, careful judgement needs to be applied when varying a trust.

11. Income and Capital

The Trusts Act offers some relief to trustees in distinguishing between income and capital when investing the trust fund. For example, a trust with a share portfolio will invariably derive income in the form of dividends whilst also generating capital growth. This can complicate matters for trustees who reinvest dividends, merging them with the trust capital should the trustee need to distinguish between income and capital in allocating amounts to different classes of beneficiaries (income beneficiaries on the one hand and capital beneficiaries, on the other).

If the trust deed does not distinguish between income and capital beneficiaries, it may be preferable to expressly provide in the trust deed that trustees have a discretion to determine whether an amount is income or capital and appropriate receipts and outgoings against income and capital in a way that is fair and reasonable.

12. Protected Heritage Assets

Often it is the settlor's intention that the trusts retain designated heritage assets, such as the family home, bach or family business. Prudent investment of the trust fund might not warrant retention of these assets.

Section 59 of the Trusts Act assumes relevance in this context. That section lists matters which a trustee may consider in exercising power to invest. One of these, indeed the first matter listed, is the objectives of the trust or the permitted purpose of the trust.

Relying on section 59, where there is a wish to retain a heritage asset in the trust, it will be desirable to insert into the trust deed provision to this effect, and indeed it may be desirable to insert into the trust deed a restriction on the trustee disposing of the asset or a requirement for consent of the settlor.

Where a trust owns shares in an operating company, good practice is to insert into the trust deed an anti-Bartlett clause absolving the trustees from delving deeply into the management of the trust owned company.

Such a clause states that trustees are not bound or required to interfere in the management of conduct of the affairs or business of any company in which the Trust Fund may be invested.

There are differing views on the effectiveness of an anti-Bartlett clause, depending on its scope but nonetheless its inclusion is strongly recommended where the Trust Fund is wholly or partly invested in shares.

13. Memorandum of Wishes

It is a fundamental tenet of trust law that once a settlor has settled assets on trust, control over the assets passes to the trustees who are then tasked with administering the assets strictly as required by the terms of the trust deed.

There is a difficulty here for trustees who on the one hand are compelled to honour the terms contained in the trust deed and who on the other hand, are in possession of a memorandum of wishes expressing the intentions of the settlor, which may be in conflict with the express terms of the trust.

New Zealand case law is generally supportive to trustees taking guidance from a MOW (indeed in the Chambers v SR Hamilton Corporate Trustee Ltd, the Court of Appeal stated that trustees were entitled to take into account a settlor's wishes, and in Clement v Lucas, the trustee's decision was set aside for insufficient attention given to a settlor's MOW, on the other hand in another New Zealand case, McGuire v Earl, trustees were criticised for following a MOW too closely).

A solution to this conundrum is to expressly record in the trust deed provision for the settlor to make a memorandum of wishes from time to time directing the trustees to take note of the wishes. In this way, in the event that trustees regard for a MOW is challenged, they will be able to answer that challenge by pointing to express reference in the trust deed to the need for trustees to consider the MOW. This will not compel trustees to follow a MOW, who continue to have discretion in administering the trust, so long as any decision to act contrary to a MOW is fully considered.

14. Modifying Default Duties

Recalling that the Trusts Act has been drafted to accommodate all types and ranges of trusts, (no matter how big or small) it is inevitable that not all default duties will suit a given trust. Good practice is to exclude those that are ill-suited. Trust advisers are obliged, by section 39 of the Trusts Act, to apprise the settlor of each modification or exclusion of a default duty.

The default duties and suggested responses that perhaps apply most commonly (but not in all cases) are:

a) section 29 – general duty of care. This requires a trustee to exercise the care and skill that is reasonable in the circumstances having regard to any special knowledge or experience of the trustee. **Comment** – it is unusual to modify this and it arguably undermines the trust if exclusion of this duty is made.

b) section 30 – duty to invest prudently. **Comment** – this duty is commonly varied, particularly in a close family setting so as to permit retention of the family home and/or family operating business which might not otherwise constitute a well advised investment of trust resources. Hand in hand with modification of this duty, is often the desirability for an anti-Bartlett clause, discussed in section 12 above.

c) Section 31 – duty not to exercise power for own benefit. **Comment** – again in a family setting, it is almost universally the case that a trustee will also be a beneficiary, with an exception on the part of the settlor that the trustee benefit from the assets of the trust. Many forms of accommodation (with suitable limitations) of self-dealing, are used in practice and this topic is discussed in section 6 above.

d) Section 32 – duty to consider exercise of power. **Comment** – it is most unusual to modify this duty. Circumstances where a trustee is not required to consider actively and regularly whether the trustee should be exercising 1 or more of the trustee's power are rare, perhaps suited to trusts with long term infrastructure assets or family trusts established for the benefit of

grandchildren, with an express or implicit embargo on trustee exercising powers of appointment prior to the grandchildren becoming of age.

e) Section 33 – duty not to bind or commit trustees to future exercise of discretion. **Comment** – this must be considered on a case by case basis. Taking the example above of a multi generational trust under which it is intended that the grandchildren benefit, it may well be appropriate to fetter a trustee's decision making in some respects prior to the grandchildren reaching the threshold age for benefitting.

f) Section 34 – duty to avoid conflict of interest. **Comment** – again, in a family trust setting, it is inevitable that a trustee will also be a beneficiary and for a conflict of interest to arise. Modification to this duty on that score is appropriate.

g) Section 35 – duty of impartiality. **Comment** – creation of different classes of beneficiaries (primary versus secondary beneficiaries) will demand this duty is modified.

h) Section 36 – duty not to profit. **Comment** - in a family trust setting, this will certainly require modification or exclusion, as in the case where for example, a trustee who is also a beneficiary occupies trust owned residential property on a rent free basis.

i) Section 37 – duty to act for no reward. **Comment –** this has particular relevance to a professional trustee who will want to charge for their services (and, in the case of a foreign trust, must do so in order to retain the trust's qualification as a foreign trust, given the breadth of the definition of settlor). Where there is a professional trustee, usual practice is to include a charging clause.

j) Section 38 – duty to act unanimously. **Comment** – best practice is to retain this duty as it avoids the problem of a minority dissenting trustee. On the other hand, where the number of trustees is numerous, it may be best to stipulate a threshold of majority of trustees.

15. Foreign Source Income and Complying Trust Status

A consequence of New Zealand's settlor taxation based trust regime is exposure to adverse tax results where the settlor ceases to be a New Zealand resident. A common scenario entails a New Zealand resident settlor of a trust taking up an employment role overseas. Assume the trust has a share portfolio company both local and international holdings and the shares produce dividend imcome. The settlor leaves the trust in place, with a continuing New Zealand resident trustee, for example the settlor's solicitor or accountant. The trust will, unless steps outlined below are taken, cease to be a complying trust for tax purposes (because it has foreign source income that is exempt in the hands of the trustees under section CW 54) and therefore fails the test for a complying trust in section HC10(1)(a)(i) of the Income Tax Act. This will result in a 45% tax rate on distributions from the trust's accumulated income and capital gains.

Where these circumstances apply, there are two lifelines available to trustees. The first is to ensure that the trustees distribute all foreign sourced income to the beneficiaries in the year the trustees derive that income. Although that will mean the beneficiaries are taxable on that income, the applicable tax rate will be their marginal tax rate, and not the penal 45% tax rate referred to above.

The second thing that can be done (particularly appropriate where it has become too late to distribute the income to the beneficiaries as beneficiary income), is to make an election under section HC33 of the Income Tax Act by which the trustee elects responsibility for the tax liabilities to the trust. Such an election can be made at any time within 4 years of the trust deriving the foreign sourced income.