THE USE OF DISCRETIONARY TRUSTS IN TAX PLANNING

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Socrates: The Tyrant hopes, does he not, that the taxes his subjects have to pay will impoverish them, so that they will be compelled to give their minds to earning their daily bread, and not to conspiring against him.
Glaucon: Why, obviously.
Plato, *Republic,* VIII, 567

> "Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it would otherwise be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he can not be compelled to pay an increased tax."[1]

The discretionary trust has proved to be a simple, flexible and extremely effective means by which a taxpayer may order his affairs so that the tax he pays is less than it would otherwise be. This paper examines why this has been so and considers the implications of current New Zealand tax reforms for the use of discretionary trusts in tax planning.

I INTRODUCTION

1. *What is a Discretionary Trust?*

The term 'trust' defies precise definition. In imprecise terms it is an arrangement whereby property is settled on a person or persons (which may be or include the settlor) in such a manner that that person is or those persons are obliged to deal with that property not for themselves but for the benefit of another person or persons (which may include but not be only themselves). The persons with the obligation are called trustees and those to whom the obligation is owed are called beneficiaries. Fundamental to the arrangement is the obligation which is enforceable at the suit of the beneficiaries.

The traditional trust was non-discretionary or fixed. Under such a trust, property is settled on a trust for named beneficiaries in defined shares. The exact shares of income and capital which beneficiaries are to take are defined in the trust instrument. This is not so with the modern discretionary trust which is a far more flexible and loose arrangement. Property is still settled on trustees for the benefit of specified beneficiaries or objects but often this will be a wide class of persons some of whom may never actually benefit under the trust. In the widest form of discretionary trust the trustees are obliged to deal with the settled property for the benefit of one or more (or all) of the members of the specified class of beneficiaries in such manner as the trustees in their absolute discretion think fit. In other words beneficiaries are not entitled to defined shares of income or capital, indeed they are not entitled to anything until an exercise of trustee discretion in their favour.[1] The trustees

[1] Per Lord Tomlin in *IRC v Duke of Westminster* [1936] AC 1, 19.
Until that time beneficial rights "float ghostlike in the sky" — Grbich Munn Reicher Modern Trusts and Taxation 10.

have a discretion to select those persons who will benefit from among the specified class of beneficiaries.

The amount of discretion vested in the trustees can vary. Sometimes they may have no discretion about whether to allocate the annual income but only a discretion as to how to distribute that income. This is known as an exhaustive discretionary trust[2] in recognition of the fact that the fund subject to the discretion (i.e. the income) must be exhausted before a defined date. If the trustees have a discretion as to whether and to what extent a distribution will be made as well as how it will be made the trust is said to be non-exhaustive[3] because the trustees are not obliged to exhaust the discretionary fund before a defined date. It is the non-exhaustive discretionary trust that is most attractive to the tax planner as its flexibility offers the greatest scope for tax minimisation. This kind of trust is particularly suitable for family arrangements and it is non-exhaustive discretionary family trusts that make up the bulk of discretionary trusts.

In summary then the usual type of discretionary trust used for tax planning purposes provides that, during the life of the trust, the trustees have an unfettered discretion, which they need never exercise (although invariably they will), to dispose of income and capital among such one or more of the members of the class of beneficiaries in such proportions as the trustees from time to time decide. At the end of the stated maximum life of the trust[4] any funds then remaining will be distributed as directed by the trust instrument, e.g. in stated shares to an easily identified class of beneficiaries such as the children of the settlor then living.

2. *The Framework of a Discretionary Family Trust*

It is in the family arena that discretionary trusts play their greatest role. A brief examination of the basic framework of such a trust will help in understanding how these trusts operate.

The trust is constituted by the settlor and trustees entering into a trust deed setting out the terms of the trust and recording the settlement of property on the trustees. The initial property settlement is sometimes of a small amount with a view to later adding to the trust property. The object is usually to put income into the hands of the trust so that either income producing assets are transferred to the trust or income from property[4] is assigned to the trust.[5]

The settlor is the person seeking to order his affairs so as to pay less tax than he otherwise would.[6] The trustees usually include the settlor so that he can still have some control over the trust property. However a settlor in his capacity as a trustee has fiduciary obligations and can not deal with the trust property contrary to the terms of the trust deed. The practical point is however that those terms usually vest a wide discretion in the trustees and the settlor/ trustee can influence if not control the exercise of that discretion. It is important to have one trustee who is not a relative of the settlor so as to avoid the possible loss of tax advantages of the trust.[7]

[2] E.g. *Re Gourju's Will Trusts* [1943] Ch 24.

[3] E.g. *Gartside v IRC* [1968] AC 553.

[4] The duration of a trust is limited by the rule against remoteness of vesting.

[4] But not from personal exertion (i.e. salary or wages).

[5] See infra Funding Of Trusts for methods of getting property into a trust.

[6] The practice of having someone other than the real creator as settlor is no longer followed in N.Z. as there are no tax reasons for doing so.

[7] See infra S 96 Income Tax Act 1976.

A wide range of beneficiaries is usually specified such as the settlor's spouse or any future spouse, the settlor's children, grandchildren and other descendants, usually the spouses of any of those beneficiaries and possibly other relatives (e.g. parents) as well. Sometimes the trustees will be empowered to add beneficiaries and/or make payments to charity. Normally the settlor is not a beneficiary to avoid losing estate duty advantages of the trust but if the trust is confined to income tax planning the settlor may be a beneficiary.[8]

The trustees will usually have an unfettered discretion as to:

(a) income and capital distributions including the application of income for or towards the personal support, maintenance, comfort, education and advancement in life of any infant beneficiaries[9] or payment of infant beneficiary allocations to parents or guardians;
(b) termination of the trust before the expiration of its maximum specified life;
(c) resettlement of trust funds on other trusts for the benefit of any of the beneficiaries.

Needless to say such discretions make the trust extremely flexible and allow trust funds to be allocated with a view to tax minimisation as well as responding to the needs and changing circumstances of the various beneficiaries.

A discretionary family trust, like all private trusts, can not last indefinitely. Its maximum life must be limited by reference either to a stated period of time not exceeding eighty years[10] or to a period of twenty-one years after the death of a person alive at the creation of the trust.[11] Most inter vivos trust deeds are now expressed so that the trust's effective life is a maximum period of eighty years with a discretion vested in the trustees to terminate at any earlier time. The trust instrument will also provide for what is to happen to any funds remaining at the expiration of the maximum period.[12]

Although the framework sketched here is common it should be appreciated that the discretionary trust can vary widely in its construction. This is because trust arrangements are custom built to meet the wishes of the individual settlor and to best accommodate his particular family and financial circumstances.[13]

3. *The Function of a Discretionary Trust*

The principal function of a discretionary trust is tax avoidance in the sense condoned by Lord Tomlin.[14] The great beauty of the discretionary trust is that it allows the taxpayer to order his affairs so that he pays less income tax and less estate duty whilst at the same time ensuring that the objects of his bounty are benefited wisely and in accordance with their needs so that both he and they are better off. Before examining some of the ways in which these wonderful ends can be reached it is necessary to examine the taxation

[8] See infra S 12 Estate and Gift Duties Act 1968; Congreave, Tax Planning, 1986 N.Z. Master Tax Guide para 2144.

[9] See infra Beneficiaries' And Trustees' Income for the significance of this.

[10] S 6 Perpetuities Act 1964.

[11] Common law rule against remoteness of vesting (the rule against Perpetuities).

[12] Supra text at note 4.

[13] See Taxation In N.Z., Report Of The Taxation Review Committee, Oct 1967 (hereinafter referred to as the Ross Report) para 668.

[14] Supra text at note 1.

of trusts because the manner in which they are taxed is a vital element in their success as a tax planning instrument.

II The Taxation Of Trusts

1. *Introduction*

The essential feature about income associated with a trust is that it is taxed once only. Such income is classified either as trustees' income or as beneficiaries' income. The former is subject to rates of tax applicable to trustees and the latter to the rate of tax applicable to each individual beneficiary. Income on which trustees have paid tax is not subject to further tax when that income is distributed to beneficiaries.[15] Under the progressive tax system in place in New Zealand until October 1, 1988, discretionary trust income can be channelled to the various beneficiaries and/or retained by the trustees in such a manner as to minimise the total tax paid on that income. Such tax minimisation is achieved by paying income to respective beneficiaries until their total taxable income is such that their tax rate will exceed the rate applicable to the trustees. When this point is reached for all the beneficiaries the trustees will retain the balance of the income, pay tax on it and at their discretion possibly distribute it six months after the end of the income year in which it was received. Any earlier distribution would render the income "beneficiaries' income" and thus defeat the tax minimisation objective.[16] Such an objective does of course ignore all other considerations such as the personal circumstances and needs of the particular beneficiaries and it may well be that total tax minimisation may in some instances take a "back seat" to other considerations. Even when this happens tax savings are only reduced, not eliminated. The mere fact that income has been diverted from the settlor to the trust will invariably result in tax savings irrespective of the manner in which the trustees exercise their discretion.

The taxation of trusts is governed by *ss. 226-232 Income Tax Act* and attention is now turned to the important provisions of these sections.

2. *Specified Trusts and Other Trusts*

For tax purposes trusts are classified into two categories: specified trusts and other or non-specified trusts. This distinction had its genesis in the Ross Report.[17] The Committee responsible for that report was "disturbed about the inequities in tax burdens that result from the use of family trusts to fragment income".[18] The Committee was particularly concerned about horizontal equity,[19] viz. similar treatment of individuals in similar circumstances. It was of the opinion that horizontal equity was not being achieved because the trust as a tax planning device, while available to taxpayers with business, property and investment income was denied to the wage and salary earner. Accordingly, in an effort to curb the tax avoidance problem associated with trusts the Committee recommended[20] that a flat tax rate of 35% should be imposed on trustees income subject to safeguarding provisions that if the tax assessed

[15] *C of T v Luttrell* [1949] NZLR 823.
[16] S 227(3).
[17] Op. cit. para 686 and recommendation 4 page 280.
[18] Ibid para 681.
[19] Although this term was not used in the Report.
[20] Ibid para 686.

at the basic rates applicable to an individual is higher than that assessed at the flat rate, the higher tax should be payable. The Government of the day acted upon this suggestion but rather than applying it to all trusts decided (in deference to the evils of retrospective legislation) that the new taxing provisions would apply only to new private inter vivos trusts. The exclusion of testamentary trusts was presumably a reflection of the fact that such trusts are less likely than inter vivos trusts to be blatant tax avoidance devices and may very likely be genuine attempts by testators to provide for their dependents and other family members after their death. The exclusion of public or charitable trusts was consistent with the favourable tax treatment traditionally accorded such trusts.[21] Accordingly the term "specified trust" was introduced on Budget night 1968[22] to distinguish those trusts which would be subject to the new taxing provisions from those that would not be affected by the new provisions. Essentially a specified trust is a private intervivos trust created on or after 19 July 1968.[23]

3. *Taxation of 'Specified' and 'Other Trusts*

From an income tax point of view the important distinction between the two types of trusts lies in the treatment of trustees' income. Such income in a specified trust is currently[24] taxed either at a flat rate of 35% or if an individual would pay a higher rate on the same amount of income, at the rate applicable to an individual with an income of that amount.[25] In other words the Revenue has it both ways; a flat rate regardless of how small the income might be but a higher rate once the income exceeds a certain figure. For the income year ended 31 March 1986[26] that figure was $33,673. Trustees' income of other trusts is taxed at the rate applicable to individuals deriving the same amount of income[27] and the trustees are entitled to a special exemption of $100 in computing taxable income.[28] There is no similar exemption for specified trusts.[29] This means that up to a threshold figure trustees' income is taxed at a higher rate in a "specified" trust than in an "other" trust. The threshold was considerably increased by the new income tax scale for individuals introduced on 1 October 1986. This scale reduced marginal income tax rates which in turn reduced average income tax rates. Thus the threshold of $33,673 for the income tax year ended 31 March 1986 increased to $52,500 for the year ended 31 March 1988. The threshold will change again with the introduction of further personal income tax rate changes on 1 October 1988 and a possible consequential change to the rate appplicable to trustees' income. If the latter rate is not altered trustees of a specified trust are likely to take steps to ensure that all income is taxed as beneficiaries; income rather than as trustees' income. This is because the top rate applicable to beneficiaries' income (33%) will be less than the rate applicable to trustees' income (35%).

[21] Some other less common trusts were also excluded. These are listed in S 266(1)(a).

[22] 19 July 1968.

[23] For a full definition see S 226(1).

[24] Changes are likely with effect from 1 October 1988 as a consequence of changes to personal income tax rates effective from that date; see Government Economic Statement, 17 December 1987 p.9.

[25] The rates are stated in the First Schedule, Income Tax Act 1976.

[26] The last full year before the introduction of reduced tax rates from October 1, 1986.

[27] Supra n. 11.

[28] S 230(1)(c).

[29] S 228(1).

The extra tax currently suffered by a specified trust is best illustrated by example. The following calculations are based on the rates applicable for the year ending 31 march 1988 and ignore the $100 special exemption for "other" trusts:

Trustees' Income	$30,000.00	
Tax payable if specified trust		$10,500.00
Tax payable if other trust		$ 7,575.00
	Difference	$ 2,925.00

Although at the time of its introduction in 1968 the 35% minimum rate was punitive it never really succeeded in curbing tax avoidance through the use of discretionary trusts. The following figures are illustrative:[30]

At 31 March 1968 there were 20,000 trusts

At 31 March 1976 there were 56,500 trusts

As more and more individual taxpayers became subject to higher marginal tax rates which rose to a maximum of 66%, the 35% minimum rate lost some of its sting. A minimum rate on trustees' income was not on its own an effective curb on the trust as a tax avoidance device. Indeed a trust that could arrange its affairs so that there was no trustees' income was totally unaffected by such a provision. The Ross Committee did not propound the minimum rate as the sole panacea. Rather it propounded a package of recommendations to counter tax avoidance via trusts.[31] The Government did not however adopt the complete package. Had it done so the attack on trusts may have been far more successful.

As regards beneficiaries' income there is no distinction between the two types of trusts. Such income is taxed at the rate applicable to each beneficiary having regard to his or her total taxable income. For collection purposes the trustee is deemed to be the agent of the beneficiary and liable for the tax payable by the beneficiary.[32] The trustee is required to file a return[33] which shows trustees' and beneficiaries' income and the division of the latter amongst the beneficiaries.[34] Tax is then calculated and paid by the trustees in respect of each beneficiary's share of the income as if each beneficiary's share was the only income derived by that beneficiary.[35] Each beneficiary must include in his own return of income his gross share of beneficiaries' income but can claim a credit for tax paid by the trustee in respect of that income. By these mechanics the effective tax rate on beneficiaries' income is adjusted to equal each beneficiary's marginal tax rate. This system and the end result is very similar to the full imputation system introduced from 1 April 1988 for taxing company income distributed to shareholders.[36]

[30] From: Harley, Structural Inequities And Concepts of Tax Avoidance (1983) 13 VUWLR 38,46.

[31] Including aggregation of a child beneficiary's income with that of its parent — see para 687 of the Committee's Report.

[32] S 227(1).

[33] Ss 10,228(2) and 230(2).

[34] Form IR 6.

[35] N.Z. Income Tax Law And Practice, para 28-120.

[36] See Hon. R O Douglas, Statement On Taxation And Benefit Reform 1985, p. 52 et seq and Government Economic Statement, 17 December 1987, p. 8 and Annex 1.

4. *Beneficiaries' and Trustees' Income*

The division of income into "beneficiaries" or "trustees" income is clearly important because of the different rates of tax that apply to each class of income. The starting point to determine what income is beneficiaries' income and what income is trustees' income is S.227(l). In terms of that subsection trust income is beneficiaries; income if a beneficiary is "entitled in possession to the receipt thereof" in the same year that the income is received. All other trust income is trustee's income.[37] So when is a beneficiary "entitled in possession to the receipt" of income? Subsections (3) and (4) of S 227 are of assistance in answering that question. Those subsections deem a beneficiary to be entitled in possession to the receipt of income in certain circumstances.

5. *Discretionary Trusts — The 'Paid or Applied' Test*

Subsection (3) applies to discretionary trusts only and allows such trusts to be most useful tax saving aids because where income is dealt with according to its requirements a beneficiary is deemed to be entitled in possession to the receipt thereof and thus the income is beneficiaries' income and taxed as such. What then are the requirements of S 227(3)? The first requirement is that of a discretionary trust. The second is for the trustee by the exercise of his discretion to pay or apply income to or for the benefit of a beneficiary during, or within six months after the end of the trustee accounting year. The payment or application must also be a bona fide transaction which places the income beyond the possession and control of the trustee in his capacity as trustee of that trust. This second requirement is sometimes referred to as the 'paid or applied' test.[38] Just what is required to satisfy the test is not altogether clear. The leading authority is *CIR v Ward*.[39] In this case a majority of the Court of Appeal held that a valid payment or application could be effected merely by a resolution of the trustee which rendered the beneficiaries absolutely entitled. So long as the income was irrevocably allocated to, or for the benefit of, the beneficiaries, it was irrelevant that the moneys were not actually paid to them or separately invested. In so holding the majority followed *Re Vestey's Settlement*[40] in which the majority of the English Court of Appeal held that income had been applied when the trustees passed resolutions allocating specified sums for beneficiaries. However following the decision in *Ward* S 227(3) was amended. This amendment in 1968 added for the first time the requirement that the payment or application be by a "bona fide transaction" placing the income "beyond the possession and control of the trustee in his capacity as trustee of that trust". Relying on this amendment the Commissioner, who is of course keen to restrict the operation of S 227(3), adopted the view that "a resolution purporting to vest income of a trust, without a severance of funds into a properly constituted secondary trust, will not be effective to say that the income has been 'paid or applied'".[41] This is still the view of the Commissioner.[42] He requires the actual severance of the income from the funds of the original trust and, if appropriate, clear

[37] Ss 228(1) and 230(1).
[38] See for e.g. N.Z. Tax Planning Report No. 4-83 at page 30.
[39] [1970] NZLR 1.
[40] [1950] 2 All ER 891.
[41] Consolidation of Public Information Bulletins 1-51, 202.
[42] See for e.g. N.Z. Tax Planning Report No. 4-83 at page 31.

evidence indicating that the income is held on a separate trust for beneficiaries.[43] It is however arguable[44] that a resolution which irrevocably allocates income to beneficiaries is all that is required because that does place the income beyond the possession and control of the trustee in his capacity as trustee of that trust. Support for this view is found in the judgment of Tompkins, J at first instance in *Ward*.[45] He said:[46]

> "In the present case the determination of the trustee that the income be distributed to the infants *takes those amounts out of the control of the trustee under the terms of the deed.* It is no longer income under the trust. It belongs to the infants *freed from the terms of the trust.*" (Emphasis added).

It does not matter that the trustee remains in possession and control of the income so long as he does not do so in his capacity as trustee of the original trust. Formal resettlement on a second or subtrust would appear not to be necessary. Tompkins J in *Ward* was of the view that the action of the trustee in resolving to allocate income constituted her a trustee to hold that income on behalf of the beneficiaries until payment to them.[47] Molloy is also opposed to the Commissioner's view. He submits[48] that S 227 (3) is satisfied "by a resolution of the trustee, sufficient to transform the expectant or contingent interest of the beneficiary into an absolute interest, notwithstanding that there is not payment into a new and physically separate trust fund."

The difficulty with the view opposing that of the Commissioner is that if it is correct the 1968 amendment would appear to have achieved nothing. The 'paid or applied' test would seem to be no different to what it was prior to the amendment. About all that can be said with certainty is that any trustee relying on the Commissioner's view being wrong should ensure that his resolution applying income is irrevocable and is carefully recorded in writing for evidential purposes.

6. *Trust Losses*

The 'paid or applied' test has some interesting connotations for net losses incurred by a trust. One view[49] is that losses cannot be transferred to beneficiaries because it is impossible for such a transfer to be a payment or application of income to or for the benefit of a beneficiary. However, there are grounds for an argument to the contrary. A transfer of a loss to a beneficiary can certainly be of benefit to the beneficiary if he has income from other sources against which the loss can be set to gain a tax relief. There are dicta in *Re Super Luggage Stores Ltd*[50] and in *CIR v Challenge Corporation Limited*[51]

[43] 986 N.Z. Master Tax Guide, para 525.
[44] See references at footnotes 28 and 29 supra.
[45] [1969] NZLR 12.
[46] Ibid at 19.
[47] Ibid.
[48] Molloy A P, *Molloy on Income Tax*, Wellington, Butterworths, 1976, para [1606].
[49] See for e.g. McLay N.Z. Tax Planning Report No. 1-85 page 3.
[50] (1982) 1 NZCLC 95-069 per Savage J at p.98, 562.
[51] (1985) 9 TRNZ 81 per Richardson J at p. 97. This dictum was not disturbed by the Privy Council reversal of the Court of Appeal decision reported at (1986) 8 NZTC 5,219.

to the effect that tax losses can in some circumstances be regarded as an asset. The contrary argument then is that transfer of a loss to a beneficiary can certainly be an application to or for the benefit of the beneficiary. The stumbling block with this argument is however the word "income". S 227(3) requires a payment or application of "income" so that even if a transfer of a loss is an application for the benefit of the beneficiary it might be difficult to prove that this is an application of "income". If the correct view is that losses cannot be transferred this represents an important tax distinction between trusts and partnerships. Partnership losses are transferred to the individual partners who may offset their share of the loss against income from other sources although this is no longer the case with Special partnerships formed after 31 July 1986.[52] If a trading operation with losses is envisaged an ordinary partnership may be a more appropriate business vehicle than a trust.

Although it may not be possible to disperse a trust loss amongst the beneficiaries it is possible for such a loss to be carried forward and deducted from trust profit in a later income year. The general rule is that a loss suffered in one income year may be carried forward and deducted from the profits of a subsequent income year where there is an express direction or a sufficient indication of the settlor's intention that losses should be charged to capital.[53]

7. *The Timing of the Payment or Application*

The remaining requirement of S 227(3) is that the payment or application must be made during, or within six months from the end of, the year in which the trustee derives the income in question. There is in effect a period of six months grace after the end of the income year for the trustees to ascertain the trust income and then to pay or apply it. This grace period was introduced after the Ross Committee[54] recommended a four month period to overcome the difficulties of ascertaining trust income within the income year. Prior to the amendment the payment or application had to take place "during the income year" in question. The practical difficulties could be overcome by an allocation to the beneficiaries of fractional or percentage shares in the income before the end of the year[55] and such an approach could still be adopted now in the unlikely event that income is still unknown within six months of the end of the income year.[56]

8. *Infant Beneficiaries*

Trust income can only be beneficiaries' income if a beneficiary is "entitled in possession to the receipt thereof" during the same income year.[57] This requirement poses difficulties for infant beneficiaries because an infant cannot demand immediate payment, nor give a valid receipt, even in respect of income absolutely vested in him by a trust. The matter was neatly put by Smith J in *Doody v C of T*:[58]

[52] See S 211B Income Tax Act 1976 as inserted by S 35 Income Tax Amendment Act (No. 4) 1986.
[53] *Rutherford v CIR* [1965] NZLR 445.
[54] Report paras 675-676 and recommendation 1 page 280.
[55] Richardson, Taxation of Trusts (1968) 5 VUWLR 26, 32.
[56] Molloy op. cit. para [1607].
[57] S 227(1).
[58] [1941] NZLR 452, 458.

"An infant, who cannot demand the receipt of his income or sue for it, ... cannot be said to be entitled in his possession to the receipt of that income under the trust during the income year".

This rule cannot be overcome by inserting provisions in the trust instrument to the effect that the infant is entitled to be paid, that he can sue the trustees and that the trustees are not required or entitled to demand a receipt.[59] The point is that even in the face of such provisions a trustee has an inherent discretion to withhold payment from an infant[60] so that the infant is not entitled in possession to the receipt of the income.

The question arises then, can trust income associated with infant beneficiaries ever be classified as beneficiaries' income? The answer to the question is yes — in certain circumstances trust income associated with infant beneficiaries is beneficiaries' income.

S 227(3) is helpful in determining when income derived by an infant beneficiary is beneficiaries' income. Everything mentioned in relation to that subsection so far is applicable equally to infant and to adult beneficiaries. Thus if:

(a) a trust is a discretionary trust and
(b) income is paid or applied to or for the benefit of an infant beneficiary and
(c) this is done during or within six months after the end of the accounting year that income is deemed to be within the words of S 227(1) and thus beneficiaries' income. However there is a proviso to S 227(3) which applies to infant beneficiaries under a specified trust only. The effect of this is that in the case of a specified discretionary trust income of an infant beneficiary will be "deemed not to have been paid or applied for the benefit of that beneficiary" if at any time while the beneficiary remains an infant the income returns to the possession or control of the trustee in his capacity as trustee of that trust or it is used in any business carried on by the trustee in his capacity as trustee of that trust. The result will be that the income is taxed as trustees' income.

The proviso represents further discrimination against specified trusts. The combined effect of the main part of S 227(3) and the proviso is that income of an infant beneficiary having passed the 'paid or applied' test, but then returned to the possession or control of the trustee or used by the trustee in any trust business is trustees' income under a "specified" trust but remains beneficiaries' income under an "other" trust. In practical terms this means that income of an infant beneficiary not required for its maintenance and advancement cannot be ploughed back into a trust business without adverse tax consequences in the case of a "specified" trust whereas in the case of an "other" trust there are no adverse tax consequences.

9. *Summary Re Discretionary Trusts*

To summarise the position of beneficiaries' versus trustees' income of a discretionary trust. Income is beneficiaries' income if it is paid or applied to or for the benefit of a beneficiary during or within six months after the

[59] *Blathwayt v CIR* [1974] 2 NZLR 196.
[60] Ibid.

end of the income year. Even if this is done, if the beneficiary is an infant and the trust is a "specified" trust, if the income is used for any business carried on by the trust or otherwise comes within the possession or control of the trustee in his capacity as trustee of the trust, the income will be trustee's income. All income that is not beneficiaries' income is trustees' income.

9. *Non-Discretionary or Fixed Trusts*

The classification of income of a non-discretionary trust into trustees' and beneficiaries' income might be considered irrelevant to a paper on discretionary trusts. However the position vis-a-vis non-discretionary trusts is useful by way of comparison and for the sake of completeness.

The starting point is once again S 227(1) which applies to all trusts. Thus income is beneficiaries' income if it is "derived by a beneficiary entitled in possession to the receipt thereof" during the same income year as it is derived by the trustee. As regards adult beneficiaries there are no further provisions in the Act. Accordingly, if by the terms of the trust instrument, income is absolutely vested in adult beneficiary he is "entitled in possession to the receipt thereof" because he is entitled to have the income paid to him. There is nothing to stop a sui juris beneficiary converting income which is vested in interest into income which is vested in possession. No deeming provisions are needed as they are for discretionary trusts because the beneficiary of a fixed trust does not have to rely on any discretionary act of the trustee in his favour to obtain a vested interest in income. In contrast the beneficiary of a discretionary trust has no interest of any kind in the trust income unless and until the trustee exercises his discretion in the beneficiary's favour.[61] Thus it is far more difficult for a discretionary beneficiary to claim to be "entitled in possession" to the receipt of income. This is why he is given some legislative assistance by being deemed to be "entitled in possession" in certain circumstances.

As regards the infant beneficiary even if he has an indefeasibly vested interest in income he is still not "entitled in possession" to that income because of the inherent discretion of a trustee to withhold payment from an infant.[62] Unlike his adult counterpart, an infant cannot convert income vested in interest into income vested in possession. Once again however the legislature has seen fit to provide assistance, this time in the form of S 227(4). This subsection provides that infant beneficiaries deriving trust income under a non-discretionary trust will in certain circumstances be deemed to be "entitled in possession to the receipt of that income". The circumstances are that the trust is not a specified trust and that the income is indefeasibly vested.[63] It follows that income indefeasibly vested in an infant beneficiary under a non-discretionary "other" trust will be taxed as beneficiaries' income. Conversely income indefeasibly vested in an infant beneficiary under a non-discretionary specified trust will be taxed as trustees' income. This is once again discrimination against the specified trust.

To summarise the position of beneficiaries' versus trustees' income of a fixed trust. Income that is indefeasibly vested in the income year in an adult

[61] Supra text at note 1a page 2.

[62] *Doody v C of T* [1941] NZLR 452; *Blathwayt v CIR* [1974] 2 NZLR 196.

[63] If it is only defeasibly vested it is not within S 227(4) — *C of T v Johnson and Maeder* [1946] NZLR 446.

or, in the case of a non-specified trust in an infant, is beneficiaries' income. All other income, including income indefeasibly vested in the income year in an infant beneficiary of a specified trust, is trustees' income.

10. *Multiple Trusts*

Under a progressive tax system the advantages of trusts as income splitting devices can in certain circumstances be increased by using multiple trusts for essentially the same beneficiaries. The scope for multiple "other" trusts exists because of the separate trustees' exemption of $100.00[64] for each trust and the application of the progressive rate structure to trustee's income under each trust. The scope for multiple specified trusts is less because of the current minimum 35% rate[65] on trustees' income and the absence of any exemption. However, there is scope for multiple specified trusts in the situation where, if there were only one trust, the trustees' income would be such that the tax rate on it exceeded 35%.

III How Discretionary Trusts Avoid Tax

1. *Introduction*

> "The trust, that brilliant invention of the law which sits in relation to modern tax planning in much the same place as the invention of the wheel sits in relation to modern transport, ...".[66]

If this reflection on the utility of the trust is correct it is indeed an extremely useful tax planning device. Although the tax saving abilities of the discretionary trust will already be apparent to some extent from the preceding sections of this paper just how the discretionary trust operates to avoid tax warrants further discussion. The discretionary trust can be employed to avoid income tax and estate duty. Sometimes a settlor will be fortunate enough to save on both of these taxes. At other times the income tax objectives may conflict with estate duty aims and the settlor may have to be content with a saving in one direction only. Originally the main functions of trusts in the tax planning arena was in relation to estate duty savings but over the last twenty-five years or so they have come to be used more and more to avoid income tax.[67] This is no doubt a reflection of the fact that during these years, prior to the introduction of lower tax rates on 1 October 1986, marginal tax rates tended to increase for many taxpayers.

2. *Income Tax Avoidance*

In its role as an income tax saver the discretionary trust is dependent on a progressive tax system, the key to its success being diversion of income from higher marginal rate taxpayers to lower marginal rate taxpayers. The proposal to introduce a single personal income tax rate[68] threatened the demise

[64] S 230(1)(c).

[65] This rate is likely to change with effect from 1 October 1988 as a consequence of reduced personal income tax rates from that date; see Government Economic Statement, 17 December 1987, p. 9.

[66] Hutchins, Lecture at the Law Institute of Victoria, June 1980.

[67] Taxation in New Zealand, Report of the Taxation Review Committee, Wellington, Februarv 1967 (Ross Report) para 666.

[68] As announced in the Government Economic Statement, 17 December 1987.

of the discretionary trust as an income tax avoidance device. However the abolition of that proposal in favour of retaining a progressive tax structure, albeit a considerably flattened one,[69] means that opportunities remain to avoid income tax via a discretionary trust.

Under a progressive tax system if it is possible to split one taxpayer's total income into smaller segments and to have each segment taxed separately, each segment will be taxed at lower rates and the overall tax on the total income is less. The trust provides a means of splitting income in this manner. If income of a taxpayer can be diverted to a discretionary trust the 'paid or applied' test[70] can then be utilised to ensure that discretionary beneficiaries become "entitled in possession to the receipt" of income. This ensures that the income is split amongst as many of the discretionary beneficiaries as is considered advantageous with the consequence that each beneficiary's entitlement is taxed at his or her low rate of income tax. Such arrangements are of course usually restricted to family groups so that the total income is kept within the family. Infant children and unwaged spouses are ideal "target beneficiaries" because they are likely to enjoy the lowest rate of income tax.

But what of the income lost to the settlor? In practice this tends not to be a problem and there is often little or no change in the overall financial position of the settlor.[71] This is because beneficiaries' income does not have to be actually handed over to the beneficiaries, all that is required is that it be paid or applied to or for the benefit of the beneficiaries.[72] In the absence of an express provision along these lines the trustees can rely on S 40 Trustee Act 1956 to do the same thing. Thus beneficiaries' income can be used to pay school fees, clothing, travel expenses and the like simultaneously relieving the settlor from these expenses which he would otherwise have been expected to meet out of his previously more severely taxed income. Indeed the Ross Committee went so far as to say "[t]he taxpayer is not moreover deprived completely of the benefit of the income as the trustee may apply each beneficiary's share of the trust income by paying the net income after tax to the taxpayer to be spent in the beneficiary's interest, ..."[73] and the McCaw Committee referred to cases "in which trust income while purporting to have been applied on the beneficiary's behalf, is in reality simply being used to meet day to day family needs".[74]

The proposed a rebate that willl rates will then be 9% compared to the current 33%. However taxpayers with income of less than $9,500.00 a year may qualify for a rebate that will give them an effective tax rate of 15%[75] instead of the new bottom rate of 24%. With respect to such taxpayers the differential is effectively 18%. However the Government has yet to announce just who will be eligible for the rebate and it may be that income received as a beneficiary will not qualify for the rebate.

The advantages of income splitting via a discretionary trust are best illustrated by way of a simple example. Let us assume that a taxpayer has a salary

[69] As announced by the Government on 10 February 1988.
[70] Supra page 11.
[71] Ross Report, op. cit. para 667.
[72] Supra page 4.
[73] Ross Report, op. cit. para 679.
[74] Report of The Task Force On Tax Reform, April 1982 (hereinafter cited as the McCaw Report) para 3.24.
[75] Government announcement, 10 February 1988.

of $30,000.00 per annum plus investment income of $21,000.00 per annum. By establishing a discretionary trust for the benefit of his unwaged spouse and two infant children and transferring the investments to the trustees[76] significant tax savings can be achieved. The following figures are based on the tax rates applicable from 1 October 1988, ignore any deductions, exemptions or rebates and assume a discretionary application of trust income of $9,500.00 to the spouse and $5,750.00 to each child:

Before trust settlement			
Settlor's income	$51,000.00		
Tax on this		$14,051.25	
Total tax before trust			$14,051.25
After trust settlement			
Settlor's income	30,000.00		
Tax on this		7,200.00	
Spouse's income	9,500.00		
Tax on this		2,280.00	
First child's income	5,750.00		
Tax on this		1,380.00	
Second child's income	5,750.00		
Tax on this		1,380.00	
Total tax after trust			12,240.00
	Tax Saving		$ 1,811.25

This annual tax saving is achieved because most of the investment income of $21,000.00 is taxed at 33% in the settlor's hands but at only 24% in the beneficiaries' hands. If the spouse and two children qualify for the rebate the total tax after the trust settlement will decrease to $10,350.00 resulting in a tax saving of $3,701.25.

3. *Trading Trusts*

In the last twelve or so years there has been a proliferation of trading or business trusts in Australia.[77] These are trusts that conduct a business that might otherwise have been conducted by a company. Company profit has of course traditionally been taxed twice,[78] once in the hands of the company and then again in the hands of the shareholders at the marginal tax rate applicable to the individual shareholder. By using a trust instead of a company double taxation of business profit was eliminated. In addition the single rate levied was in some circumstances lower than either of the rates levied on company profit. On the rates in force before 1 April 1988 a distribution to a shareholder on the top marginal rate would be taxed at 48% after having been previously subjected to 48% company tax. The same profit received by trustees could be accumulated by them at a rate of 35% (up to a maximum of $52,500.00) and was not subject to any further tax when distributed to the beneficiary.

[76] By a method that will avoid the operation of S 96 and gift duty, see infra Pitfalls To Be Avoided.

[77] See for e.g. Grbich, Transcript of Lecture held at the Law Institute of Victoria, June 1980, page 25; Hutchins, op. cit. 47; Grbich Munn Reicher, op. cit. 263 et seq.

[78] This ceased on 1 April 1988 on the introduction of an imputation system.

Some of the Australian arrangements involving trusts for business purposes are complex in order to maximise tax avoidance. Pyramids of trusts have been used in which the beneficiaries of the head trust are further discretionary trusts and even "trust stripping"[79] operations have been indulged in. Discretionary trusts have also been used in tandem with a company and/or a partnership. Furthermore the use of trusts has not been restricted to family or private businesses. For larger operations involving public subscription resort has been had to the unit trust. These were originally a medium for collective investment and not trading concerns but as noted by Gower[80] they "offer to the public an investment practically indistinguishable from shares in a limited company". In substance they are very similar to a public company but quite different in form and this difference in form has been exploited for tax advantages.

Not surprisingly there has been a series of legislative amendments in Australia in recent years designed to counter the widespread use of trading trusts as tax avoidance devices.[81] The legislative attacks are continuing.[82]

The explosion of trading trusts in Australia has not been mirrored in New Zealand where they have tended to be used for farming businesses only. This is a little surprising given the generally more favourable tax treatment of family trusts in New Zealand than in Australia. There is an explanation in respect of unit trusts because in New Zealand these are treated as companies for tax purposes.[83] The explanation in respect of other trusts is not so apparent although one possibility is that professional tax planners in New Zealand have stayed away from the trading trust in favour of a company for reasons of limited liability enjoyed by the latter. This is hinted at by McLay[84] and support for this explanation can also be gained from the following statement by Paterson:[85]

> "A trust is often not the most suitable entity to carry on business as most trustees are not prepared to assume personal liability for trading debts. For this reason a trust is ideal to own an income-producing asset such as realty or shares in a company but not to carry on business in its own name."

When a statement such as this from a leading tax planner is disseminated via a New Zealand Law Society travelling seminar it is perhaps not surprising that the trading trust has not taken hold in New Zealand. McLay[86] suggests that:

> "[i]t may be an interesting indictment of professional advisers that trading trusts are used extensively in farming businesses in New Zealand but virtually in no other industries".

[79] Analogous to dividend stripping, see Hutchins op. cit. 57.
[80] Gower L.C.B., Principles of Modern Company Law 4th ed. with supplement, London, Stevens and Sons (1979) 266.
[81] E.g. the introduction of Division 6B (1981) and Division 6AA (1980) into Income Tax Assessment Act 1936 (Cth).
[82] See Statement by the Australian Treasurer, The Hon. P. Keating, September 1985.
[83] S 211.
[84] Alternative Business Structures, N.Z. Tax Planning Report No. 1-85, page 3.
[85] N.Z. Law Society Estate Planning Seminar, May 1984, page 22.
[86] Op. cit. page 3.

The point is that the Australian professional tax adviser has not forsaken limited liability by resort to the trust concept. He has combined the best of both worlds by the device of the corporate trustee — not the traditional Trustee Company but the now famous two dollar nominee trustee company. A company with a nominal capital is appointed trustee of a discretionary trust and carries on business for and on behalf of the trust. Because the trust is not a separate legal entity people conduct business with the trustee not the trust. Should things go wrong it is to the trustee that creditors of the business must look to but of course if the trustee is a company it enjoys the protection of limited liability. The promoters of the business who are the beneficiaries of the trust are effectively shielded from personal liability. Thus limited liability is achieved in combination with the tax advantages of a trust. The income derived by the company is received by it in its capacity of a trustee. The relevant taxing provisions are thus those relating to trusts and not those relating to companies.

It is now almost certainly too late for widespread use of the trading trust in New Zealand. The introduction on 1 April 1988 of an imputation system for the taxation of companies and shareholders[87] ended double taxation of company dividends. The incentive to trade via a trust rather than a company was also reduced by the reduction in the company tax rate to 28% on 1 April 1988. This rate is lower than both the top marginal personal income tax rate and the rate applicable to trustees' income in a specified trust.

4. *Service Trusts*

Income tax can also be reduced by exploiting the fact that the Income Tax Act allows a deduction for any expenditure incurred in gaining assessable income or necessarily incurred in carrying on a business for the purpose of gaining assessable income. It follows that if deductions can be created or increased assessable income is reduced and so is the amount of tax payable. The fact that these deductions will reduce the net income by more than the tax they are calculated to avoid would have done is not a disadvantage if the deductions are paid to a discretionary family trust. The end result is a form of income splitting. Essentially a slice of the profits of the business is syphoned through the trust to family members where, under a progressive tax system, it is likely to be taxed less severely than if it had been left in the business.

Trusts used in this context are generally referred to as service trusts because the trust provides services such as the provision of office accommodation, office equipment, staff, library and research facilities, administrative, managerial, financial services and anything else necessary to the derivation of income by the principal taxpayer. The principal taxpayer pays a commercially realistic price for these services enabling the service trust to make a profit for distribution to the beneficiaries. The fact that the services cost the principal taxpayer more than if they were obtained directly without the interposition of a trust is all part of the tax avoidance exercise. The extra 'cost' is the mark-up or gross profit of the trust.

Service trusts are usually associated with professional partnerships[89] but

[87] See Government Economic Statement 17 December 1987, p. 8 and Annex 1; see also Statement on Taxation and Benefit Reform 1985, op. cit. 5 et seq.

[88] S 104.

[89] E.g. accounting, law, medicine, architecture, etc.

the principles are equally applicable to most business undertakings. The point is that deductions, the key to the success of a service trust, are not the exclusive prerogative of the professions. Why they have emerged more frequently in the professions is because other tax schemes have often not been available because of statutory or ethical regulations prohibiting professional practice via a corporate vehicle or an unqualified person.[90]

The service trust has grown rapidly in Australia since it was sanctioned by the Federal Court in *Phillips v FCT*.[91] The facts of that case are illustrative of the nature and operation of a service trust. Phillips was a partner in an accounting firm which, in addition to accounting services, also provided other services including the maintenance of company share registers, personnel selection, typing, printing, and copying. With the stated purpose of reducing income tax and the assets of the partnership, a unit trust[92] was formed the units of which were held by the families of the partners. The unit trust, through its management company, then purchased from the partnership all the furniture, office machines and other equipment, and re-employed all of the non-professional staff hitherto employed by the partnership. The unit trust then entered into lease and service agreements whereby the partnership acquired the use of the furniture and office equipment, and the provision of clerical and secretarial services at commercial rates.

However service arrangements have not always fared so well in New Zealand[93] and it may be that in this country the situation in *Phillips* would be found to be an arrangement for tax avoidance under Section 99[94] and thus fail in its object. This seems a likely possibility in view of the recently reported decision in *P v CIR*.[95] The service vehicle in this instance was a partnership of family trusts the beneficiaries of which were the families of the partners in a professional engineering partnership. The service firm purchased from the engineering firm all of the latter's equipment and furniture, took an assignment of the lease of the premises used by the engineering firm and employed the staff previously employed by the engineering firm. The staff superannuation scheme was also taken over by the service firm. A contract was entered into between the two firms whereby the service firm agreed to supply the engineering firm with offices, office equipment, clerical services and also to undertake design and other engineering work for the engineering firm. In return, the engineering firm agreed to pay 75% of its fees to the service firm. This figure was calculated so as to give a targeted 20% markup on the estimated cost of providing the services which became the service firm's responsibility. In the words of Hardie Boys J "the arrangement was bound to produce tax savings for two reasons. First, the overheads of the [engineering] firm [were] increased by the 20% profit margin built into the 75% commission rate. Secondly, what would have been solely the objector's [a partner in the engineering firm] income [was] spread between him, his trust and its

[90] This is now changing for some professions, e.g. service companies of accounting and legal firms for superannuation purposes.

[91] (1978) 78 ATC 4361.

[92] In N.Z. an ordinary trust would be required to avoid S 211, supra text at note 18 p. 23.

[93] See for e.g. *Wisheart v CIR* [1972] NZLR 319 a service company was in issue here but the aim of the exercise was the same as when a service trust us used. Contra *Grierson v CIR* (1971) 3 ATR 3 and *Loader v CIR* (1974) 74 ATC 6014.

[94] See infra Pitfalls To Be Avoided.

[95] (1987) 9 NZTC 6, 155 affirmed on appeal at (1987) 9 NZTC 6, 167.

beneficiaries".[96] The old Section 108 (in its 1966 form[97]) was used by the Commissioner to include in the objector's assessable income the income of the family trust and this was upheld by both the High Court and the Court of Appeal.

It was accepted that a major purpose of the arrangement was increased efficiency and profitability but the application of Section 108 was justified because one of the main effects of the arrangement was tax avoidance and this could not be regarded as merely incidental to the legitimate business purpose. That purpose could have been achieved without the introduction of the family trusts, the real purpose of which was to divert income to persons who did not contribute anything, "other than the ownership of assets which they had rather artificially acquired,"[98] to earning that income.

Quite apart from the possible application of S 99 to an arrangement involving a service trust the income tax saved by these trusts will be reduced on the introduction of the two ter personal income tax scale on October 1, 1988. The differential between company tax and the lowest personal rate will then be only 4% compared to 33% prior to 1 April 1988. The new differential will however stretch to 13% for those with income under $9,500.00 who qualify for the 9% rebate.[99] Apart from income tax avoidance the service trust has a role as an estate planning tool in appropriate circumstances.[100]

5. *Estate Duty Avoidance*

The need for estate planning has disappeared in many estates with the progressive increase in the amount of the duty free estate to the present figure of $450,000.00.[101] However should the final balance[102] of an estate exceed that figure the excess is subject to a flat rate of tax of 40%.[103] Estate planning thus remains important for the well to do and for these people the discretionary trust is as useful a tool as ever for reducing the final balance of an estate and thereby reducing estate duty. As with income tax plans, estate plans are many and varied, however most estate planning schemes are based on certain fundamental principles and the role of the trust is best examined in relation to those principles.

6. *Stabilisation of an Estate*

As estate duty is levied on the final balance of an estate the first step with most schemes is to stabilise or peg the estate at its present value. This is usually achieved by transferring to another person or entity assets which have a high value and are likely to appreciate in value. Alternatively new assets may be acquired in the name of another entity rather than in the name of the person with the estate duty problem. This alternative is particularly appropriate if a person with an existing sizeable estate is about to embark

[96] (1987) 9 NZTC 6, 155 at 6, 160.

[97] Although this case was determined by the High Court in 1985 the assessment in dispute was for the year ended 31 March 1966.

[98] Per Hardie Boys J at 6, 162.

[99] Supra p. 21.

[100] See infra pp. 27-31.

[101] Estate and Gift Duties Act 1968 S 4 and First Schedule.

[102] Defined as the dutiable estate less the allowable debts and the matrimonial home allowance — S 5 Estate and Gift Duties Act 1968.

[103] Estate and Gift Duties Act 1968 S 4 and First Schedule.

upon a new venture which it is anticipated will prove financially rewarding.[104] Assets commonly transferred are land, life insurance policies, company securities, plant and equipment. The immediate result of this exercise is that henceforth any increase in the value of the assets concerned accrues to the other entity rather than to the estate with the duty problem.

Usually the discretionary trust is the most suitable entity to receive the assets. It may not, for example, be appropriate at this stage to vest the property in the ultimate beneficiaries — it may be needed for business purposes or reasons such as age, instability or indefinite plans of beneficiaries might militate against immediate vesting. The discretionary trust overcomes all of these problems — the vesting date of the trust property can be postponed to a date at the discretion of the trustees[105] and in the meantime the settlor, by a judicious choice of trustees and other means,[106] can retain de facto control over the property. Indeed the settlor may be a trustee himself. Retention of some control over the property is often very important to the person forsaking legal ownership even if it is only because he does not want the ultimate beneficiary to obtain immediate control. In addition the trust allows the settlor to provide for persons not in existence at the time of settlement, e.g. grand-children, and provides tremendous flexibility in the destination and distribution of both capital and income. Furthermore the beneficiaries of a discretionary trust have no interest in the trust estate which can be included in their estate on their death. This is because they are only entitled to benefit from the trust if the trustees exercise their discretion in their favour.[107] The discretionary trust is thus sometimes dubbed a "generation-skipping" device as it is a means of leapfrogging estate duty liability which accrues (subject to estate values) on the dropping of lives once in each generation.[108]

Provided sufficient discretion is vested in the trustees, account can be taken of changing circumstances not only of the beneficiaries but also by reason of changes in legislation relating to tax and duty. To this end it is quite common to reserve to trustees not only the discretion to terminate the trust before the ultimate vesting day but also an extensive power to vary the terms of the trust or to revoke the trust and substitute a new trust.[109] It is important that such powers are not reserved to the settlor but only to the trustees.[110] Of course the discretion need not be as wide as this if that is the preference of the settlor.

Quite apart from the flexibility offered the estate planner by the discretionary trust there have, under our progressive tax system, been income tax advantages[111] associated with the trust. Under such a system the discretionary trust can be an estate planning tool and income splitting device at one and the same time. Take for example the businessman or professional person who owns the premises from which he operates. If he transferred the premises

[104] Wickham, Trusts — their Use and Operation in Estate Planning, page 5.
[105] Subject to the rule against remoteness of vesting, supra page 5.
[106] N.Z. Estate and Gift Duty Reporter, para 9-005.
[107] Supra p. 2.
[108] See for d.g. Grbich Munn Reicher op. cit. 2 and N.Z. Estate and Gift Duty Report, para 9-005.
[109] Kelly N.C., Kelly's Law of Trusts and Trustees 5th ed., Wellington, Butterworths, 1982, p. 99.
[110] To avoid S 12 Estate and Gift Duties Act 1968 — infra Pitfalls To Be Avoided.
[111] Supra p. 19.

to a discretionary family trust he could then rent the premises from the trust. Whether he operates in his own name or via a company is immaterial, the rent is a deductible expense providing funds to split amongst the family.[112] At the same time the settlor would have pegged the value of his estate in so far as that building was concerned.[113]

The trust is usually a preferable estate planning tool to the private company which can involve problems with control and minority interests finding themselves "locked in".[114] Double taxation of company dividends is however no longer a problem since the introduction of a dividend imputation system on April 1, 1988.

7. *Establishing a Platform and Reduction of the Estate*

A transfer of a valuable asset will not in itself reduce the final balance of an estate if the transfer is by way of sale rather than gift, as will usually be the case in order to avoid gift duty. One asset (e.g. land) has been exchanged for another asset, namely a debt or outstanding purchase price.[115] But the trust, in addition to stabilising the value of the estate, also provides a platform from which that value can be steadily reduced by a gifting programme. Further additions may also be made to the trust.

At present one may make gifts totalling $27,000.00 in any twelve month period without incurring gift duty.[116] Thus it is possible over a period of years to reduce the amount owed by the trust to the settlor's estate which in turn reduces the value of the estate which ultimately reduces estate duty. If the estate is large and time is short it may be advisable to gift more than $27,000.00 annually as gift duty is considerably lower than estate duty.[117] There is a progressive scale of gift duty with a maximum rate of 25% payable once dutiable gifts exceed $72,000.00 in a twelve month period compared to estate duty at a flat rate of 40%.

The traditional method of reducing an estate by forgiveness of debt was briefly challenged by the accrual rules introduced by the Income Tax Amendment Act 1987. This Act inserted inter alia S 64F into the Income Tax Act 1976 the effect of which was to make the amount forgiven taxable as income in the hands of the donee with effect from 1 April 1985. The Income Tax Amendment Act (No. 2) 1987 added subs (7) to S 64F the effect of which was to exclude the operation of the new rules to forgiveness of debt before 1 October 1987, provided the forgiveness was in consideration of natural love and affection. This subsection was also effective from 1 April 1985 so that there existed a moratorium for family arrangements until 1 October 1987.

On 11 December 1987 the Income Tax Amendment Act (No. 3) 1987 received the Royal Assent. This Act inserted, inter alia, a new subs (7B) into S 64F. That subsection states that "where an amount owing under a debt . . . . is forgiven on or after the 1st day of October 1987 by a natural person in consideration of natural love and affection, the amount forgiven shall, for

[112] i.e. A very simple service trust.
[113] Cf. Wickham op. cit. at p. 9.
[114] See for e.g. *Thomas v H W Thomas Ltd* (1984) 2 NZCLC 99, 148.
[115] There is a distinction between the two — infra Pitfalls To Be Avoided.
[116] Section 62 and Third Schedule Estate and Gift Duties Act 1968.
[117] N.Z. Society of Accountants CE Paper, New Tax Legislatin and Practice, June 1985, S 1, p. 29.

the purposes of sections 64B to 64M of this Act, be deemed to have been paid when the amount is forgiven." This amendment ensures that a gift by way of forgiveness of debt in consideration of natural love and affection for the beneficiaries of the trust appears to be clearly covered. Accordingly the traditional gifting programme in the context of family estate planning is now unaffected by the accrual rules. The permanent exclusion of the accrual rules to forgiveness of debt out of natural love and affection was made after recognition by the Hon. T A de Cleene, Minister of Revenue, that "the accrual tax accounting regime was aimed at arm's length tax motivated dealings rather than family dealings"[118] and followed submissions by the New Zealand Law Society[119] and others to the effect that debt foregiveness in the context of estate planning and family arrangements should not be caught by the accrual rules.

8. *Provision of Funds to Pay Estate Duty*

The trust is also a useful means of providing funds for the payment of any estate duty which may be payable. This is normally achieved by way of life insurance. The proceeds of any life policy are included in a testator's estate if owned by him at the date of his death which only adds to the duty problem. It is therefore advantageous if a life policy is owned by a trust. The proceeds of the policy are not then included in the settlor's estate but can still be used to meet estate duty liability if the trustees lend the proceeds to the estate for that purpose.

9. *Estate Duty Summary*

The discretionary trust is an extremely useful device for the implementation of an estate plan because it can assist with all of the basic steps upon which most plans are based viz. stabilisation, establishing a platform, reduction and provision of funds for duty. It is not the only entity that can be used for these purposes but because of its advantages over the alternatives it is the most common and is likely to continue to assist those estates sizable enough to warrant an estate plan.

10. *How Do Discretionary Trusts Avoid Tax?*

Hopefully the answer to that question is clear from the foregoing discussion. It is left to the reader to judge the validity of Hutchins' analogy with the wheel.[120] From the income tax and estate planner's perspective the trust has been a brilliant invention possibly as vital to his art as the wheel is to transportation. Those concerned with an equitable taxation system are however far less complementary towards the trust. Harley, for example, has described the discretionary family trust as "one of the sources of the greatest tax inequalities in our system".[121] The point is that the tax benefits of the trust are not available to all taxpayers but essentially only to those with business investment or property income. The wage or salary earner cannot settle his

[118] Hon. T A de Cleene, Press Statement, December 10, 1987, reproduced verbatim in The Dominion, December 11, 1987, p. 17.

[119] See Law Talk 273, 1 (November 11, 1987); see also the Press statement referred to in n. 53 supra.

[120] Supra text at note 1 page 19.

[121] Structural Inequities And Concepts Of Tax Avoidance, (1983) 13 VUWLR 38, 46. See also Ross Report op. cit. para 681.

pay packet on trust and is thus denied the benefits available to taxpayers with income from other sources. Whereas the wheel is available to all taxpayers, even those who can only afford a bicycle or have to bus to work because they cannot afford a car, the tax avoiding trust tends to be the exclusive prerogative of those at the upper end of the income scale.[122] There is perhaps some irony in the fact that the trust was a creation of equity.

IV. Pitfalls To Be Avoided

1. *Introduction*

The road to income tax and estate duty avoidance via the discretionary trust is not without its potholes which need to be swerved if the end of the road is to be reached without serious damage to the plan. There is a "battery of statutory provisions designed to safeguard government revenue, seemingly at every turn" to which the driver must be alert "lest unwittingly the tax-saving effect intended for a particular move turns out to be frustrated because the asset or income is still caught in the tax-gatherer's net".[123]

Essentially the statutory provisions are designed to stop the taxpayer "having his cake and eating it too". In other words if the taxpayer is to pay less income tax this should only be because he has been prepared to take a drop in income and if he is to pay less estate duty this should only be because of a genuine reduction in the size of his estate. If for example an asset is no longer part of a taxpayer's estate it should follow that he no longer has the rights of ownership over that asset. Things can not remain exactly as they were before so that there is no outward justification for the beneficial tax consequences. A number of the provisions are aimed at ensuring that the taxpayer gives up control of assets or income but the cynic might argue that all these do is have the taxpayer cloak his arrangements with an air of respectability because in practice retention of some degree of control does not seem to be too difficult to achieve.[124]

It is not proposed to review the entire battery of provisions designed to protect the Revenue but some comment is needed on those of special importance.

2. *Section 96 Income Tax Act 1976*

Sometimes a taxpayer may attempt to achieve short term tax savings by only temporarily transferring income producing property to a trust with the property to revert to him in a fairly short time. Such an arrangement could result in substantial tax savings with only limited loss of control over the property settled. Section 96(3) is designed to combat short term trusts where the settlor retains control over the disposition of the corpus. Its broad aim is to tax a settlor on the income from short term trusts where he retains the corpus or, either directly or through his family, will recover it or be able to control its disposition.[125] Where the settlor does retain such control over

[122] Those whom the Hon. T A de Cleene, when Finance Under-Secretary, called "the sophisticated rich and not the ordinary PAYE earner" — see The Christchurch Star, July 17, 1986, p. 16.

[123] Arthur C.M., Estate Planning A Handbook for Accountants, Wellington, Sweet & Maxwell, 1977, 14.

[124] Supra reference and text at note 43 page 29; Paterson, N.Z. Law Society Estate Planning Seminar 22.

[125] See Richardson (1968) 5 VUWLR 26, 37.

the corpus the operation of Section 96(3) will be avoided if the trust is for a minimum period of seven years or, if children of the settlor are beneficiaries, a period of seven years or until the youngest child reaches its twentieth birthday whichever is the longer.[126] If a trust is to last for less than these prescribed minimum periods the corpus must not revert to the settlor or his family pursuant to the settlement nor must he or his family have any control over the disposition of the corpus. If the subsection operates the income of the trust is deemed to be income derived by the settlor and by no other person as if the settlement had not been made. This means of course that the trust is ineffective to save tax.

There is a danger under Section 96(3) if trustees have the power to accelerate vesting of the corpus so that the trust may not last the minimum time period. It has been suggested[127] that the subsection applies to the typical trust under which the trustees have a discretion as to which beneficiaries are to take the corpus and also have a power of advancement from capital, if the settlor or a relative is sole trustee or if the settlor and/or relatives of the settlor are the trustees. A suggested[128] answer to this problem is to provide in the trust deed that the trustees cannot exercise their discretionary power to accelerate the vesting of the corpus if the settlor or a relative is either sole trustee or the trustees do not include a non-relative of the settlor.

Section 96(1) is designed to catch short term assignments of income in the same manner and in much the same circumstances as subs (3) catches settlements of income producing property. This is of relevance to trusts because sometimes a settlor will establish a trust with a gift of a nominal amount (sometimes as little as $10.00) and then assign to the trust the right to receive certain income, e.g. from a rented property. Any plan of this nature must have regard to sub (1) if the income is to be successfully assigned for tax purposes.

3. *Funding of Trusts*

Section 96 catches many transactions which would not normally be thought of as assignments or settlements. This is principally due to the very wide definition of "settlement" which includes any disposition, trust, covenant, agreement, arrangement, or transfer of assets.[129] This wide definition means that Section 96 has implications for the funding of trusts. The usual way in which a trust acquires an asset is by transfer of the asset for full consideration with the purchase price remaining as a debt owing by the trust to the vendor. The debt is usually interest-free repayable on demand to overcome the decision in *Rosster v CIR*[130] to the effect that an interest-free loan for a fixed period constitutes a gift of interest at the time of the loan. At the time an on demand loan is made it can not be said that there is necessarily a gift of interest because the lender is entitled to call up the loan immediately and this effectively overcomes any liability to gift duty.

However, although an interest-free on demand loan will overcome gift duty it may trigger the operation of Section 96(3) and income flowing to the trust

[126] S 96(1) — prescribed period.
[127] Richardson op. cit. at 37.
[128] Paterson op. cit. at 12; see also Patterson op. cit. at 78.
[129] S 96(1).
[130] [1977] 1 NZLR 195.

as a result of the loan will be assessable to the lender. This is because (a) a loan is within the definition of settlement, (b) it is for less than the prescribed time (i.e. on demand) and (c) the settled property or corpus (i.e. the sum lent) reverts to the settlor (i.e. repayment of the loan). Before Section 96(3) could operate there would need to be identifiable income[131] arising from the settled property for it is only "income from the settled property or from any property substituted therefor"[132] that can be assessed back to the lender. Thus if the sum lent is invested by the trust in such a way (e.g. by way of loan or purchase of shares) as to produce identifiable income (e.g. interest or dividends) Section 96(3) will operate. This is what happened to the detriment of a lender in *James v CIR*.[133] The taxpayer lent his family trust a sum of money interest-free repayable on demand. The trust then on-lent the money at interest for a fixed term. The interest on the on-loan was assessed to the taxpayer.

The *James* decision sent shivers down the spine of many tax advisers because the interest-free on demand loan is such a common feature of family arrangements. But Section 96(3) has not proved to be as onerous in practice as was first feared after this decision.[134] In particular it seems that Section 96(3) applies to loans but not to outstanding consideration for the transfer of an asset.[135] Where property is transferred and the consideration left outstanding, Section 96(3) cannot apply to income identifiable with that asset if the asset is transferred for longer than the minimum prescribed period. It does not matter that the outstanding consideration is payable on demand. It can even be secured by a mortgage provided the documentation refers to security for the "outstanding consideration" rather than for a "loan" or "advance" and that "vendor" or "purchaser" are referred to but not "borrower" or "lender". If, on the other hand, the full purchase price is met by means of a collateral interest-free loan from the transferor then Section 96(3) might catch that loan transaction as it caught the loan in *James*. "Although the substance of both transactions is the same, the difference in form may well enable the Commissioner to apply Section 96 in one situation but not the other."[136] So by careful attention to the legal form of their transactions taxpayers may outflank Section 96(3).

The law's adherence to form rather than substance in this situation is a specific example of the general rule that legal form is paramount when it comes to the imposition of tax. A substance approach to tax matters was firmly rejected in *IRC v Duke of Westminster*[137] when the House of Lords made clear its preference for "the golden and streight metwand of the law" to "the incertain and crooked cord of discretion" which a suggested doctrine of substance was likened to.[138] The lead of the House of Lords has been followed in the New Zealand courts[139] and it is well established here that

[131] Richardson, A Review of Tax Legislation And Judicial Decisions 1973-75, N.Z. Society of Accountants CE Paper p. 3.
[132] S 96(3).
[133] [1973] 2 NZLR 119.
[134] Paterson op. cit. at p. 10.
[135] N.Z. Tax Planning Report No. 1-80 p. 6; Richardson, supra note 9 at 4.
[136] N.Z. Tax Planning Report No. 1-80 p. 6.
[137] [1936] AC 1.
[138] Ibid Lord Tomlin at p. 19 and Lord Russell at p. 22.
[139] See for e.g. both *Europa* cases [1971] NZLR 641 and [1976] 1 All ER 503; *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61, 271.

in tax matters it is the legal character of a transaction which is decisive and not the substance of the transaction. The traditional adherence to form is currently being threatened in England by the recent emergence of the fiscal nullity doctrine.[140] Under this doctrine any part of a transaction a taxpayer has entered into is ignored for tax purposes if that step has no business or commercial purpose other than the avoidance of tax. The potential application of this doctrine in New Zealand remains to be tested.[141] In the meantime the traditional adherence to form must remain a basic tenet of tax law in this country.

4. *Section 11 Estate and Gift Duties Act 1968*

"The object of Section 11 is to exact estate duty on gifts inter vivos over which the donor retains strings during the three-year period before his death. Accordingly, if the donor possesses or enjoys some part of that which is given or if he gains some indirect benefit related to that which he has given that gift is caught by Section 11 unless those strings are released at least three years before death."[142] It is a corollary of Section 10 which catches for estate duty purposes all gifts made within three years of death. In view of Section 10 it would be anomalous if gifts outside of the three year period escaped recapture even though, to use the language of Adams and Richardson, the gift had strings attached which could be pulled by the donor within the three year period.

This section means that if property is given to a trust the donor must be entirely excluded from the possession, use or enjoyment of that property not less than three years before his death. If he is not the property will be included in his dutiable estate. Take for example[143] the owner of a week-end cottage who gives it to a family trust with the reservation that he is to have until his death the exclusive use of the cottage every week-end in December and January of every year. Under Section 11 the value of the cottage would be included in the donor's estate. It is submitted however that if the reservation was unrecorded the Commissioner would be none the wiser and such an arrangement might in fact succeed.

There is an important exception to the rule discussed above.[144] It does not apply if retention or resumption by the donor of actual occupation or enjoyment of land or actual possession of chattels is for full consideration. Thus property can be gifted to a trust and leased back to the donor for full consideration. In other words if a donor is prepared to pay for the possession use or enjoyment of something he has given away that is acceptable.

The possible pitfalls of Section 11 in relation to trusts are usually avoided by a sale of property to the trust. The section only applies to gifts and not to sales. Any desired gift is then effected by forgiving all or part of the purchase price.[145]

[140] See *W T Ramsay Ltd v IRC* [1981] 1 All ER 865; *IRC v Burmah Oil Co Ltd* [1982] BTC 56; *Furniss v Dawson* [1984] AC 474; *Reed v Nova Securities Ltd* [1985] 1 All ER 686.

[141] The Commissioner expressly disclaimed reliance on it in the Court of Appeal in *CIR v Challenge Corporation Ltd* (1985) 9 TRNZ 81, 94.

[142] Richardson I.L.M. & Congreave R.L., Adams and Richardson's Law of Estate and Gift Duties 5th ed., Wellington, Butterworths, 1978, 87.

[143] This example is slightly adapted from an example given in N.Z. Duties and Sales Tax Guide para 550.

[144] S 11(2) provides the exception to the main rule in S 11(1).

[145] Paterson op. cit. 7.

5. *Section 12 Estate and Gift Duties Act 1968*

This is another section designed to complement Section 10. Essentially its aim is to stop a person removing property from his estate during his lifetime and replacing it with what amounts to a life interest in that property with the result that neither the property transferred nor the life interest in lieu thereof forms part of his estate on his death. Thus Section 12 recaptures for estate duty purposes any property comprised in any trust made by the deceased where (a) an interest in the property (or the proceeds of sale thereof) was reserved to the deceased for his life or the life of some other person, or (b) a benefit to the deceased for his life or the life of any other person accompanied the settlement, or (c) a right to restore or reclaim the property was reserved to the deceased, unless the interest, benefit or right wholly ceased to exist more than three years before death.

Section 12 is not restricted to gifts, it applies to any disposition of property. However Section 12 is subject to Section 34 which in most cases provides for a credit for any consideration paid to the deceased. This prevents the Commissioner having it both ways: he can not have included in the dutiable estate the property disposed of as well as consideration received for that property.

Because of Section 12 it is important that a settlor can not revoke a trust if it is to be successful from an estate duty angle.

It is usually claimed that both Sections 11 & 12 dictate that the settlor should not be a beneficiary of a discretionary trust.[146] In so far as such a claim rests on the basis that the beneficiary of a discretionary trust has an interest in the trust property it is open to doubt because of conflicting authorities. There is authority[147] to the effect that a beneficiary of a discretionary trust does have such an interest but it is submitted that these authorities must now be regarded with caution because of more recent cases[148] in which it has been held that beneficiaries of a discretionary trust have no interest at all in the trust property. Although the latter cases were not concerned with provisions corresponding to Sections 11 or 12 as the earlier were, and the earlier cases were merely distinguished, the "very cogency of the reasoning"[149] in the later cases may cast doubt on the earlier cases. In any event "an interest" in the property concerned is not the only trigger for Sections 11 & 12. "Any benefit" will suffice and this is wider than an interest and extends to possibilities or advantages insufficient to constitute an interest.[150] It would appear then that the settlor who is also a discretionary beneficiary could be caught under the "benefit" limbs of Sections 11 & 12.

It is certainly conventional practice to exclude the settlor as an actual or potential beneficiary if the principal object of the trust is effective estate planning. The matter is otherwise however if the trust is for income tax planning purposes. In such a case it may be advantageous to include the settlor as a discretionary beneficiary where it is anticipated that at some time in the future his income

[146] See for e.g. Arthur op. cit. 162; Paterson op. cit. 22, 23; N.Z. Estate and Gift Duty Reporter para 9-040; Adams and Richardson op. cit. para [11/40]; Patterson op. cit. 78.

[147] *A.G. v Heywood* (1887) 19 QBD 326 and *A.G. v Farrell* [1931] 1KB 81.

[148] *Gartside v IRC* [1968] AC 553; *Sainsbury v IRC* [1968] 3 All ER 919.

[149] Adams and Richardson op. cit. para [12/21]; Grbich Munn Reicher op. cit. 10-30 (in strong support of the later cases).

[150] Adams and Richardson op. cit. para [12/22].

will diminish to the extent that it may need to be supplemented by income from the previously diverted source.[151]

If the discretionary trust is to be an effective estate planning device it is vital that the operation of Sections 11 & 12 be avoided so that property transferred to the trust is not included in the settlor's dutiable estate. It is submitted that a settlor will not be troubled by these sections if he is prepared to heed the words of Black J in the American case of *CIR v Estate of Church:*[152]

> " . . . . an estate tax cannot be avoided by any trust transfer except by a bona fide transfer in which the settlor, absolutely, unequivocally, irrevocably and without possible reservations, parts with all his title and all of his possession and all of his enjoyment of the transferred property."

6. *Section 99 Income Tax Act 1976*

Unfortunately, from the tax planners viewpoint, the discretionary trust is not immune from Section 99. This is the infamous general provision of the income tax legislation aimed at tax avoidance schemes. It nullifies against the Commissioner for income tax purposes any arrangement to the extent that it has a purpose or effect of tax avoidance, unless that purpose or effect is merely incidental.[153] The terms "arrangement" and "tax avoidance" are defined very widely.[154] It is not proposed to undertake a detailed examination of this section but merely to make some brief general observations on it in relation to trusts so that the reader is alerted to the possible danger of this section when discretionary trusts are used in a tax planning scheme.

One's first reaction might be that as nearly all inter vivos discretionary trusts have as one of their purposes or effects (which is not merely incidental) the avoidance of tax they must be caught by the wide language of Section 99. However this has never been so because as stated by McCarthy P. in *CIR v Gerard:*[155]

> "It [S 99] cannot be given a literal application, for that would, the Commissioner has always agreed, result in the avoidance of transactions which were obviously not aimed at by the section. So the Courts have had to place glosses on the statutory language in order that the bounds might be held reasonably fairly between the Inland Revenue authorities and taxpayers."

The result is that tax saving trusts can and do survive Section 99.

This was confirmed by an obiter dictum of Richardson J in the Court of Appeal in *CIR v Challenge Corporation Ltd*[156]. After noting that the Act makes special provision for the treatment of trusts the learned judge stated:

> "Thus the special provisions of the Act for taxing trustees' income and beneficiaries' income . . . . allow considerable scope for tax saving in family property planning involving the use of trusts. Those provisions leave

[151] Congreve, Tax Planning, 1986 N.Z. Master Tax Guide para 2144.
[152] 335 U.S. 632, 645 (1948).
[153] S 99(2).
[154] S 99(1).
[155] [1974] 2 NZLR 279, 280.
[156] (1985) 9 TRNZ 81.

> unspecified the role of Section 99 in controlling the shifting of income through the use of trusts, which in New Zealand practice in the vast majority of cases is substantially influenced by tax considerations, should be automatically voided under its provisions."[157]

It is submitted that this dictum is not in conflict with the majority judgment of the Privy Council which allowed an appeal in this case and that the Privy Council decision in *Challenge*[158] leaves room for the continued use of discretionary trusts as tax planning devices despite Section 99.

The majority judgment delivered by Lord Templeman drew an important distinction between tax avoidance and tax mitigation with only the former falling foul of Section 99[159]. Tax mitigation was explained as reducing one's tax liability by accepting a reduction of income or actually incurring expenditure i.e. a real or actual change in one's financial position as contrasted with an "arrangement" whereby one seeks to obtain a reduction in tax liability without suffering a reduction in income or incurring loss of expenditure. An arrangement of this nature is the hallmark of tax avoidance.[160]

Thus provided a trust falls under the mitigation rather than avoidance head it escapes the operation of Section 99. It is submitted that a trust must be regarded as a mitigating device if it results in a real change to the financial position of the settlor such as a reduction in his income because of the transfer of an income producing asset to the trust. This is made clear by Lord Templeman when he states:

> "When a taxpayer makes a settlement, he deprives himself of the capital which is a source of income and thereby reduces his income. If the settlement is irrevocable and satisfies certain other conditions the reduction in income reduces the assessable income of the taxpayer. The tax advantage results from the reduction of income."[161]

On the other hand a trust which is part of any arrangement to reduce tax with an apparent but not a real change to a settlor's financial position can be regarded as an avoidance exercise and subject to the application of Section 99. If the reality of the situation is that the settlor's financial position is unaffected, the Commissioner is entitled to invoke Section 99.

Orthodox estate planning arrangements have generally fared quite well in relation to Section 99.[162] Unorthodox estate plans may however fall foul of Section 99 as happened in *Tayles v CIR*[163] where income shifting was such an essential feature of the transactions that tax avoidance had to be regarded as one of the purposes or effects of the plan.

Income tax planning trusts are possibly more susceptible to Section 99 than the estate planning variety but once again if the arrangement is orthodox simple and genuine problems should not arise. For example, it is accepted

[157] Ibid. at 101.
[158] (1986) 8 NZTC 5, 219.
[159] Ibid. at p. 5, 225.
[160] Ibid. at p. 5, 226.
[161] Ibid. at p. 5.
[162] See *Poulgrain, Randall & Rennie v Stirling* (1980) 5 NZTC 61, 331; *Tayles v CIR* (1982) 5 NZTC 61, 311.
[163] (1982) 5 NZTC 61, 311.

that a permanent divestment of a source of income to a trust would not normally be challenged.[164] However, where the arrangements are not so simple, such as the divestment of assets and their lease back to the settlor by the trustees, the position becomes less clear.[165] About all that can be said with certainty is that the more artificial contrived and tortuous the arrangement the more chance there is of a finding that at least one of its purposes or effects is tax avoidance.

It is sufficient to caution that complex and elaborate tax plans, whether or not involving the use of a discretionary trust or trusts,[166] should only be implemented after careful consideration of the possible applications of S 99.

V. CONCLUSIONS AND THE FUTURE OF THE DISCRETIONARY TRUST

There can be little doubt that the discretionary trust has been an enormously successful tax planning device. In 1964-65 the annual loss of revenue caused by the use of family trusts was estimated by the Commissioner to be about $4.5 million.[167] Since then rising marginal tax rates until the introduction of GST on 1 October 1986, combined with a widespread feeling that the tax system was unfair led to more and more people looking for ways to reduce their tax liability.[168] Many turned to the discretionary trust as a means to that end so that the 6,500 trusts in existence in 1965 had mushroomed to 56,000 by 1976 and there is nothing to suggest that the growth has stopped since then.[169]

Despite a suggestion to the contrary in the 1982 McCaw Report[170] the introduction of the specified trust in 1968 did not stem the tide but imposed "only the mildest of disincentives".[171] This is evidenced by an increase of 36,500 trusts between 1968 and 1976.[172] It is submitted that the discretionary trust has flourished mainly for the following reasons:

(a) as an income splitting device because of the Act's treatment of trusts combined with recognition of the individual as the basic tax unit, a progressive tax scale applicable to that unit, and increasingly more of those units higher up that scale;
(b) as an estate planning device because the trust is the most useful entity to take a transfer of assets from an estate or to acquire new assets;
(c) as a vehicle for carrying on a business because there is no double taxation of trust profit as there has been of company profit.

If our traditional tax system remained unchanged there would be every likelihood that the popularity of the discretionary trust would continue unabated, barring specific anti-avoidance measures directed at its use. However

[164] *CIR v Challenge* P.C. (1986) 8 NZTC 5, 219 at 5, 255.
[165] Cf. for e.g. Case El (1981) 5 NZTC 59, 001 (car purchased with funds lent by settlor leased to settlor — void) with *Loader v CIR* 74 ATC 6014 (Sale and leaseback to settlor — valid).
[166] It is an arrangement as a whole that will or will not activate S 99 and not merely the use of trusts.
[167] Ross Report op. cit. para 667.
[168] Douglas, Statement on Taxation and Benefit Reform 5.
[169] Harley op. cit. at 46.
[170] Op. cit. para 3.22.
[171] Arthur op. cit. 14.
[172] Harley op. cit. at 46.

our traditional tax system is in a state of metamorphosis. The present Government is intent on far reaching tax reform as evidenced by, inter alia, the introduction of GST from October 1, 1986, a full dividend imputation scheme from April 1, 1988 and a two tier personal income tax scale from October 1, 1988. These reforms have important consequences for the discretionary trust as a tax planning device.

The new personal income tax rates effective from 1 October 1988 will reduce the gains to be had from income splitting because of the reduction in the differential between the highest and lowest marginal personal income tax rates. Nevertheless a differential of 9%, or possibly 18% depending on rebate eligibility,[173] should still provide sufficient incentive to manipulate income via a trust.

The full imputation system for taxes on companies and shareholders has implications for the discretionary trust as a vehicle for conducting business. Such a system removes the principal incentive for trading via a trust rather than via a company, viz. double taxation of distributed company profits. This combined with a substantial reduction in company tax from 1 April 1988 will almost certainly ensure that the discretionary trust is seldom employed as a vehicle for conducting a business in New Zealand.

The need for the use of estate planning trusts has declined with the duty threshold increased to $450,000. However for those estates where planning is still desirable the discretionary trust is likely to continue to play a most valuable role.

The current New Zealand tax reforms have made some inroads into the effectiveness of the discretionary trust as a tax avoidance device. However opportunities remain for significant tax avoidance via the discretionary trust. "Nothing in tax planning is ever permanent except the probability of more change."[174] In the meantime the discretionary trust still has a useful role to play in tax planning.

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[173] Supra p. 21.

[174] Hutchins, The Impact of Recent Tax and Death Duty Changes on the Use of Trusts, Lecture at the Law Institute of Victoria June 1980, transcript p. 52.

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