The Treasury

Budget 2023 Tax Initiatives Information Release

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POLICY AND REGULATORY STEWARDSHIP

TE TAI ŌHANGA
THE TREASURY

Tax policy report: Taxation of trustee income

Date:	10 November 2022	**Priority:**	High
Security level:		**Report number:**	IR2022/484 T2022/2469

Action sought

	Action sought	Deadline
Minister of Finance	**Indicate** whether further work should be undertaken	21 November 2022
Minister of Revenue	**Indicate** whether further work should be undertaken	21 November 2022

Contact for telephone discussion (if required)

Name	Position	Telephone
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Stephen Bond	Manager, Tax Strategy The Treasury	

10 November 2022

Minister of Finance
Minister of Revenue

Taxation of trustee income

Executive summary

Purpose

1. You have asked for advice on options to raise revenue for Budget 2023 and also to address longer-term rate misalignment issues with the tax system. This report seeks your direction on potential policy responses to address issues with the misalignment of the trustee tax rate and the top personal tax rate.

2. This report is part of a suite of three reports. The other two reports are:

   2.1. IR2022/483, T2022/2474: *Broader context for considering decisions on the trustee* [33] *tax rates* ("broader context report").

   2.2. [33]

Rate misalignment constrains the ability to raise revenue from personal taxes

3. Currently, the ability to raise more revenue from the personal tax base is significantly constrained because of misalignment between the 39% top personal tax rate and the 33% trustee tax rate. This misalignment allows the top personal rate to be circumvented and reduces the progressivity of the income tax system. These issues are discussed further in the broader context report.

Trustee rate and top personal rate misalignment is unusual

4. Australia, Canada, the UK, and the US all have broadly similar tax regimes and trust laws to New Zealand. In those countries, most trustee income is subject to tax at the top personal rate. New Zealand's current misaligned tax treatment of trustee income is an outlier. When the trust tax regime was introduced in 1989, the trustee rate was chosen to align with the top personal rate.

Aligning the trustee rate with the top personal rate would address under-taxation…

5. We have explored a range of options and consider that aligning the trustee tax rate with the top personal tax rate at 39% would be the most effective way of addressing the under-taxation of trustee income within the existing regime for trusts. This would strengthen the sense of fairness in the tax system by ensuring that trusts cannot be used to shelter income from the top personal tax rate. It is notable that most trustee income (86%) is concentrated in a relatively small number of trusts (8%).

6. This approach would raise revenue for Budget 2023 and be relatively simple to design and implement, although it would not be able to be implemented until 1 April 2024 at the earliest. This option is expected to raise $350m per annum, however this is highly uncertain and largely dependent on the extent of the behavioural response.

7. [33]

We expect there would be some restructuring behaviour in response to an increase in the trustee rate and we consider that, even if there is substantial restructuring behaviour, the options in this report would raise revenue in a relatively low-cost way, while promoting the Government's distributional objectives.

… and concerns about over-taxation can be mitigated

8. Aligning the trustee rate with the top personal rate may result in distributions to lower-rate beneficiaries being taxed above the beneficiaries' marginal rates. This may be appropriate, for instance in the case of a discretionary trust where the beneficiary is a minor and a relative of the settlor. In cases where it is not appropriate, there are options to mitigate this. An existing rule allows income earned by a trust to be taxed at a beneficiary's personal tax rate if the income is allocated to the beneficiary before the trust files its tax return. This is the method that comparable jurisdictions mostly rely on to mitigate over-taxation.

9. There may be situations where this existing rule would not effectively prevent over-taxation. Other jurisdictions have rules to address specific situations. Should you wish to proceed with raising the trustee rate, we will report back on potential modifications to mitigate any over-taxation of lower-rate beneficiaries.

Well-being and economic considerations

10. On balance, aligning the trustee rate with the top personal tax rate is likely to strengthen New Zealanders' sense of fairness in the tax system (social cohesion) through improving horizontal and vertical equity.

11. While increasing the trustee rate would increase the effective tax rate on some taxpayers and therefore some investments, the impacts on aggregate capital investment (and therefore productivity and wages) are unlikely to be large. This is because an increase in the trustee rate would generally not impact on the return to foreign investors, which is important to determining the capital stock.

12. Further, there are likely to be some offsetting positive impacts on the capital stock because more consistent tax treatment of income – no matter the legal form it is earned through – would promote efficient organisation of income-earning activities. The net impact is likely to be small and depends on how the revenue is spent, or which other taxes do not need to be levied, as a result.

13. Any assessment of how Māori would be impacted by the options in this report requires engagement with relevant Māori groups. However, we are aware that trusts, like companies, are a convenient vehicle for Māori to transact with the Crown. A number of these commercial structures are subject to specific regulations and statutory constraints. The tax system recognises these constraints and provides a specific set of rules (the Māori authority tax rules) for entities that manage and own Māori communal assets. As such, it is our initial assessment that an increase in the trustee rate is unlikely to impact Māori development outcomes or present a barrier to sustainable prosperity and resilience for whānau Māori and future generations.

14. Given these considerations, we consider increasing the trustee rate will give rise to a net benefit in terms of well-being.

Other options

15. We also considered two other options involving more fundamental reform to the taxation of trustee income: taxing trustee income at the principal settlor's personal rate, or introducing an imputation-style system (which would ultimately tax beneficiaries on distributions of trustee income at their personal rates). An imputation system in particular could improve the long-term robustness and sustainability of the tax system. However, both options would be significantly more complex to design, implement, and administer than option 1, and the earliest they could be implemented is 1 April 2025. For these reasons, officials would not recommend these other options.

Next steps

16. If you wish to progress policy work on one of the options in this report, we can discuss timeframes and preferred focus areas. We recommend undertaking targeted confidential engagement with external tax advisors and overseas revenue authorities. If you agree to proceed, we will report back to you in February 2023 on detailed design features in time for Budget 2023.

Recommended action

We recommend that you:

1. **Note** that we consider the proposals in this report would be a worthwhile step forward in addressing misalignment, [33]

   Noted Noted

2. **Indicate** your preferred option that officials should undertake further work on:

   i. **Option 1** – Increasing the trustee rate to 39%, with modifications for certain trusts with lower-rate settlors and beneficiaries if necessary ***(officials' preferred option)***; **OR**

   Agreed/Not agreed Agreed/Not agreed

   ii. **Option 2** – Taxing trustee income at the principal settlor's personal tax rate; **OR**

   Agreed/Not agreed Agreed/Not agreed

   iii. **Option 3** – Introducing an imputation-style system for the taxation of trustee income.

   Agreed/Not agreed Agreed/Not agreed

3. **Note** that the fiscal impact of option 1 is highly uncertain. Increasing the trustee rate to 39% with no modifications is estimated to raise $350m per annum from the 2024–25 year, although this is largely dependent on the extent of the behavioural response.

   Noted Noted

4. **Note** that while an announcement regarding the trustee rate could be made as part of Budget 2023, the earliest option 1 could be implemented is 1 April 2024. The earliest options 2 or 3 could be implemented is 1 April 2025 due to their complexity.

   Noted Noted

5. **Agree** that officials undertake targeted confidential engagement with external tax advisors and overseas revenue authorities to assist policy development of the option chosen in recommendation 2.

Agreed/Not agreed Agreed/Not agreed

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The Treasury

Peter Frawley
Policy Lead
Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2022

Hon David Parker
Minister of Revenue
/ /2022

Background

Current tax law

1. The annual income of a trust is taxed as it is derived, either to the trustees or to the beneficiaries of the trust. Trustees of a trust are treated as a single taxable unit, and their trustee income is calculated separately from their personal income.

2. **Beneficiary income** is all income earned by a trust in an income year which is allocated to the beneficiaries before the trust has filed its tax return. Income does not need to be paid to a beneficiary to be beneficiary income; the income can be allocated to a beneficiary and credited by the trust to that beneficiary's current account. Income in a beneficiary's current account is available to be called upon at any time by that beneficiary, although in practice it is usually paid to a beneficiary only when the trustee or settlor thinks it is appropriate.

3. Beneficiary income is taxed at the beneficiary's personal tax rate unless it is subject to the minor beneficiary rule. This rule applies to beneficiary income derived by a minor (under 16 years old) from property settled on a trust by a relative or legal guardian, or an associated person of the relative or legal guardian. The minor beneficiary rule taxes beneficiary income of a minor at 33% to prevent parents, other relatives, or guardians from splitting their income with children.

4. **Trustee income** is all taxable income derived by a trust in an income year that has not been allocated as beneficiary income. It is taxed at a flat rate of 33%. Once income has been taxed as trustee income, distribution of that income to the beneficiaries is tax-free. That is, trustee income is subject to a final tax imposed in the year the income is derived by a trust.[1]

5. Corpus means property settled on a trust. Corpus is used by trustees to derive income and capital gains. Distributions of any amounts other than beneficiary income, including corpus, capital gains or trustee income from prior years, are exempt from tax to the receiving beneficiary.

Trustee rate and top personal rate misalignment is unusual internationally

6. Australia, Canada, the UK, and the US all have broadly comparable tax regimes and trust laws to New Zealand. We are currently an international outlier in taxing trustee income below the top personal rate.

Table 1: International comparison of the taxation of trustee income

	NZ	Australia	Canada	UK	US
Top personal tax rate	**39%**	45%[2]	33%	45%	37%
Top personal income threshold	$180,000	$180,000	$216,511	£150,000	$539,901
Tax rate on trustee income	**33%**	45%	33%	45%	37%[3]

Tax planning using a trust

7. Trusts are often used to split income within a family unit so that tax is paid at low rates under a progressive tax scale. Trustees can allocate beneficiary income as

[1] This is the treatment of the large majority of domestic trusts ("complying trusts"), which are the focus of this report. This report does not consider the treatment of two other relatively small classes of trusts: foreign trusts and non-complying trusts.
[2] Excludes a Medicare levy of 2%, which applies to both personal income and trustee income.
[3] The 37% rate applies to trustee income over $13,450 derived by non-grantor trusts. Trustee income derived by grantor trusts, which are trusts effectively controlled by the settlor, is taxed at the personal tax rate of the settlor.

they choose to beneficiaries on lower personal tax rates. The minor beneficiary rule partially limits the ability to split income in this way.

8. Trusts can also be used to shelter income from high personal tax rates. If a trust has a 39% rate settlor, income may be accumulated in the trust and taxed at the 33% trustee rate; there is no further tax when the income is later distributed to the settlor in their capacity as a beneficiary. This sheltering from the top personal rate can also be achieved for the other beneficiaries of the trust.

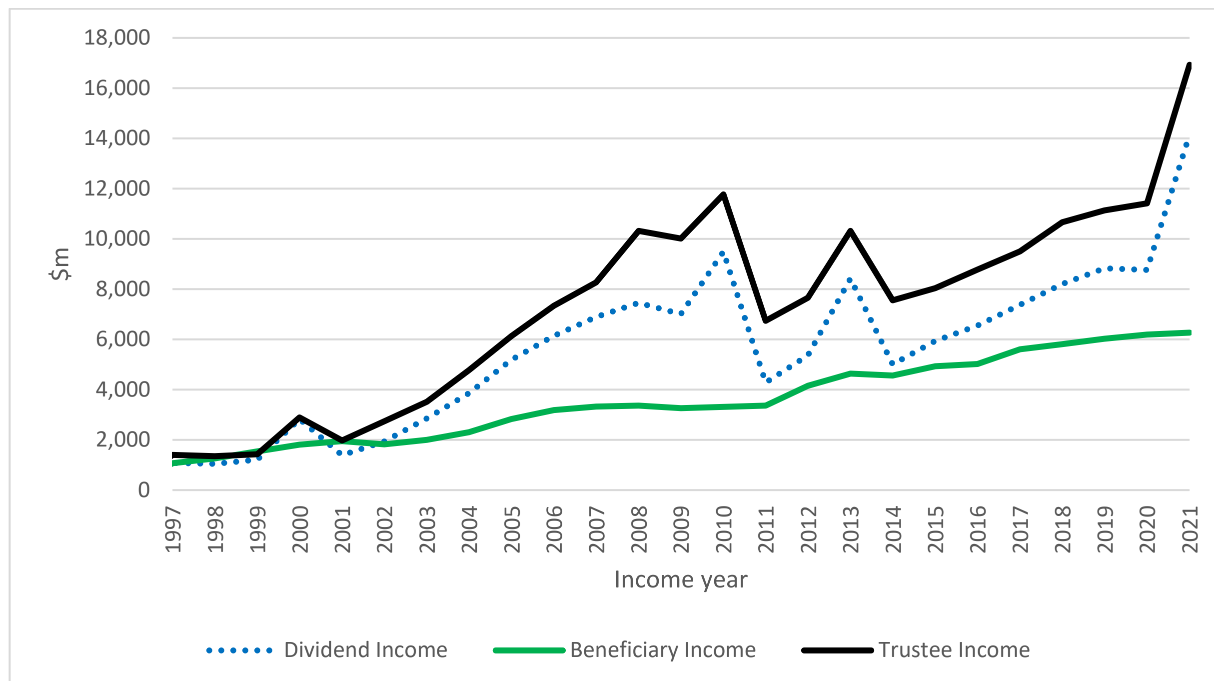
9. These tax benefits mostly relate to income from capital rather than from labour. Capital income can be shifted to a trust without constraint, simply by shifting ownership of the assets. However, it can be more difficult to shift labour income to a trust. Labour income is normally taxable to the person providing the labour.

10. Trusts also offer non-tax advantages. Settlors can use trusts for family succession planning, to protect assets from creditors and relationship property claims, and circumvent rules that aim to target government assistance to low-income people in certain situations. A settlor can retain effective control of trust property by also being a trustee or having powers to appoint new trustees. A settlor can also retain enjoyment of trust property by being a beneficiary or having close family members who are beneficiaries. Trusts, therefore, may allow settlors to retain the benefits of ownership of property transferred to a trust while avoiding the burdens and risks of ownership.

Misalignment in the 2000s

11. Since the introduction of the current tax regime for trusts in 1989, the trustee tax rate has been 33%. This rate was chosen intentionally to achieve alignment with the top personal rate, and it has only fallen out of alignment during the two periods since 2000 when the top personal rate was 39%.[4]

Figure 1: Income reported on trust tax returns 1997 – 2021



12. Figure 1 shows how significant amounts of income were diverted into trusts and taxed as trustee income when the personal tax rate was raised to 39% in 2000 and the trustee rate remained at 33%. Much of the growth of trustee income was in the

[4] A 39% rate on income over $60,000 was introduced in 2000; this threshold was increased to $70,000 in 2008. The top personal rate was lowered to 38% in 2009 and then back to 33% in 2010.

form of dividends.[5] Many small-to-medium enterprises reorganised as companies owned by family trusts in the early 2000s to take advantage of the misalignment.

13. After the top personal rate was reduced to 33% in 2010, there was no longer misalignment between the trustee rate and the top personal rate. This meant that there was no longer a tax advantage in passing dividends through trusts, although existing structures often remained in place. From 2021–22, the top personal tax rate has again been higher than the trustee tax rate. In advance of this taking effect, there were larger than usual dividend flows in the 2020–21 income year, resulting in a spike in trustee income.

Data limitations relating to trusts

14. Increased disclosure requirements were introduced for the 2021–22 and later income years to help evaluate the effectiveness of the 39% rate and gain insight into the use of structures and entities by trustees. We are yet to receive a full year of data from these new requirements, as most trusts can file their first returns under these rules as late as 31 March 2023. We expect that the larger, more complex trusts will file close to this deadline. Therefore, there are significant limitations with using interim data from the trust disclosure rules at this point in time as it may not be representative of the entire domestic trust population.

15. The Trusts Act 2019 came into force in January 2021 and introduced greater transparency and compliance requirements for trusts. Between the trust disclosure rules and the Trusts Act both coming into force in 2021, Inland Revenue's most recent full year of data (the 2020–21 income year) will largely precede the current regulatory environment for trusts.

Current landscape

16. Over 400,000 trusts are registered on Inland Revenue's systems, with approximately 180,000 filing returns reporting positive income. In the 2021 financial year, total income derived by domestic trusts (including estates) was $23,300m. This was split between $6,300m beneficiary income (27%) and $17,100m trustee income (73%).

Table 2: Proportion of beneficiary and trustee income

	FY2020	**FY2021**
Number of trusts *(excl. trusts with nil income)*	182,000[6]	177,000[7]
Beneficiary income	$6,200m (35%)	$6,300m (27%)
Trustee income	$11,400m (65%)	$17,100m (73%)
Total income	$17,600m	$23,300m

17. Most trustee income is concentrated in a relatively small number of trusts. In the 2021 financial year, 86% of trustee income ($14,600m out of $17,100m) was reported by 8% of trusts with positive income (14,000 out of 177,000). These trusts all reported trustee income above $180,000.

[5] The 2013 spike was due to the expiration of a transitional rule which allowed dividends to be imputed at a higher rate. The spike is from dividends that were distributed to trusts by companies.
[6] Including approximately 19,000 estates and 400 foreign trusts.
[7] Including approximately 17,000 estates and 300 foreign trusts.

Table 3: Trustee income is concentrated in a relatively small number of trusts

	FY2020		FY2021	
Trustee income per trust	*Number of trusts*	*Aggregate amount of trustee income*	*Number of trusts*	*Aggregate amount of trustee income*
Up to $180,000	170,500 (94%)	$2,500m (22%)	163,000 (92%)	$2,500m (14%)
Over $180,000	11,500 (**6%**)	$8,900m (**78%**)	14,000 (**8%**)	$14,600m (**86%**)
Total	182,000	$11,400m	177,000	$17,100m

Problem definition

18. As discussed in the broader context report, the integrity pressures which currently arise from misalignment between the trustee, PIE, company, and top personal tax rates make it very difficult for the Government to raise significant additional revenue in a way that is progressive and economically efficient. A key factor to consider for options to address misalignment between the trustee rate and the top personal rate is whether an option moves in the direction of a robust and sustainable tax system. To help achieve this, any reform should:

    18.1. ensure trusts cannot be used to circumvent the 39% rate, and

    18.2. minimise the over-taxation of lower-rate individuals where possible, particularly for trusts with only lower-rate settlors and beneficiaries.

19. [33]

20. We expect there would be some restructuring behaviour to companies and PIEs if one of the options in this report is adopted. However, companies are an imperfect substitute for trusts due to the non-tax benefits that trusts offer. Even if there is substantial restructuring behaviour, the options in this report would raise revenue in a relatively low-cost way, while better meeting the Government's distributional objectives.

21. One difficulty with addressing rate misalignment between the trustee rate and top personal rate is that it is not always clear who the ultimate recipient of trustee income will be. This means different perspectives can be taken regarding to whom trustee income should be attributed when determining the appropriate rate (that is, the settlor, the trustee, or a beneficiary). A key problem, therefore, is how to determine the appropriate tax settings for income derived by a trust and not allocated to a particular beneficiary at that time.

Analysis

22. There are two competing considerations – the over-taxation of some lower-rate individuals and the under-taxation of trustee income.

Existing settings, or alignment of the trustee rate with the top personal rate, may over-tax some lower-rate individuals…

23. A beneficiary with personal income of less than $70,000 has a marginal tax rate of <33%. If income is retained in a trust as trustee income and later distributed to a <33% rate beneficiary, that income would be taxed at a higher rate than their

personal income. This is an existing risk in the tax system that would be exacerbated if the trustee rate is raised. As noted in paragraph 3, there are cases where it is appropriate to tax a beneficiary at a rate higher than their personal income if the beneficiary is a minor and a relative of the settlor.

24. Table 3 shows that in FY2021, 92% of trusts (163,000 trusts) reported less than $180,000 of trustee income each ($2,500m in aggregate, or 14% of trustee income). The majority of trusts therefore have relatively small amounts of trustee income. This illustrates that while increasing the trustee rate would likely be progressive, some trusts with lower-rate beneficiaries could be over-taxed.

… however, this can be mitigated under current law

25. This over-taxation risk can be mitigated under current law by trustees allocating income to a lower-rate beneficiary as beneficiary income, instead of treating it as trustee income. This allows the income to be taxed at the beneficiary's lower personal rate, rather than the higher trustee rate. However, this may result in compliance costs for trusts.

26. Since a settlor can also be a beneficiary of a trust, this approach can be used in situations where the settlor has a personal rate lower than the trustee rate. Income of the trust can be allocated to a lower-rate settlor (as beneficiary income) and taxed at the settlor's lower rate. If the settlor does not want to retain the income, the settlor can settle that income back on the trust as corpus. Distributions of corpus to beneficiaries are not subject to tax. This approach effectively allows income to be taxed at a settlor's lower rate but retained in the trust for later distribution to beneficiaries.

27. However, as discussed at paragraph 44, there may be situations where it is not desirable or possible for income to be allocated to lower-rate beneficiaries. As a result, some level of over-taxation may not be preventable under existing settings.

Retaining income as trustee income results in under-taxation…

28. Income allocated to trustees as trustee income is currently taxed at 33% but is exempt from tax on subsequent distribution to beneficiaries, even if those beneficiaries are on a 39% personal rate.

> *Example: 39% rate beneficiary*
>
> Suppose a trust has a beneficiary with personal income of $180,000 per annum and the trust has retained $50,000 as trustee income (with a tax liability of $16,500 at 33%).
>
> In the following year, the $50,000 of trustee income is distributed to the beneficiary. This distribution is not subject to tax. That income has only been subject to a 33% tax rate and the beneficiary does not need to pay the 39% rate despite earning over $180,000.
>
> If the income was earned directly by the beneficiary as personal income, the tax liability would be $19,500 at 39%.

… and this is a much larger problem than over-taxation in terms of total income

29. As noted in Table 3, most trustee income (86% or $14,600m for FY2021) is concentrated in a relatively small number of trusts (8% or 14,000 trusts for FY2021). All of these trusts reported over $180,000 in trustee income. This does not mean that all of this income is under-taxed, as it does not take into account the number of settlors or beneficiaries of these trusts, but it is an indication that there is a significant amount of under-taxation.

Well-being and economic considerations

30. All of the options considered below would have similar well-being and economic impacts.

31. The options would all raise additional revenue in ways which support the Government's distributional objectives, as they would prevent taxpayers from circumventing the top personal tax rate on their individual income. Therefore, all options would likely strengthen the sense of fairness in the tax system (social cohesion). The counter to this is that option 1 could result in some individuals being over-taxed if income is retained in a trust as trustee income and later distributed to lower-rate beneficiaries, which could result in a perception of unfairness.

32. [33] This is because increased taxes on trusts would inevitably result in some leakage of revenue to entities such as PIEs and companies, which would reduce the effectiveness and economic efficiency of the trust tax changes. There would also be some compliance costs incurred if assets or business activities were to be shifted from a trust to another entity.

33. However, [33] the changes would likely support fairness, economic efficiency, and well-being. While an increase in the absolute amount of tax raised would inevitably give rise to some economic costs, the options discussed below would broaden an existing tax base and make it harder for people to circumvent the personal tax scale. The additional economic costs per dollar of revenue raised would likely be lower than many alternatives, because broader tax bases are generally more efficient than narrower tax bases.

Māori perspectives

34. The tax system provides specific tax rules for Māori organisations who manage and own communal assets for the benefit of whānau Māori, hapū, and iwi. Māori organisations that are eligible to apply these rules are called Māori authorities and are taxed at 17.5%. These rules were purpose-built to meet the unique characteristics and circumstances of how Māori own and manage communal assets and pursue their specific development outcomes. We are not proposing changes to the Māori authority tax rules in this report.

35. We would expect that most trusts used by Māori for communal ownership purposes would be eligible to be taxed as Māori authorities. Therefore, our initial view is that the objectives and options set out in this report are unlikely to impact Māori development outcomes or present a barrier to sustainable prosperity and resilience for whānau Māori and future generations. However, if Ministers wish to progress any of the options in this report, engagement with relevant Māori groups would deepen our understanding of the impact of the proposals on broader considerations of wellbeing beyond the use of trust structures by Māori.

Distributional impacts

36. Officials' view is that the options would increase the progressivity of the tax system. However, the available data is limited. As noted in Table 3, 2020-21 tax returns indicate that a relatively small number of trusts (8%) earn most trustee income (86%). In addition, data from the Household Economic Survey 2018 (HES 2018) suggests that net-worth decile 10 households[8] hold 40 percent of their wealth in non-financial (generally property) and financial assets in family trusts. Some of the non-financial assets, such as principal residences, would not generate any taxable

[8] Note that some individuals in net worth decile 10 would be in lower income deciles.

income, so would not be impacted by any tax change. However, other assets may generate taxable income streams.

Impact on investment, savings, economic efficiency, and broader well-being

37. The options increase tax paid by trusts so that the top personal tax rate would apply to individuals with incomes over $180,000 more so than at present. This would mean a higher level of tax on income earned in trusts, including income from business investments undertaken by trusts.

38. While there may be impacts on specific investments (for example, in business or rental properties) and savings, these are unlikely to have a large effect on aggregate capital stock, productivity or wages. It would not give rise to the same level of concern about increases in the costs of capital (or hurdle rates of return) that an increase in the company tax rate might do. This is because non-residents are unlikely to be significant participants in New Zealand-based trusts; they mainly invest in New Zealand through companies. While New Zealanders on the top personal tax rate would obtain lower after-tax returns from investing through trusts, these would be the same as the after-tax returns they receive from investing directly.

39. Some specific impacts of increasing the trustee rate to 39% (option 1) are set out here. The magnitude of all of these impacts is uncertain but is unlikely to be large. There are many factors that influence decisions to invest other than the trustee tax rate. These impacts are an inevitable consequence of reducing opportunities for individuals to side-step the top personal tax rate and seeking to have a fairer tax system:

    39.1. **Under-taxed assets:** A higher trustee rate would increase the incentive to invest in lightly-taxed assets, such as owner-occupied housing.

    39.2. **Rental housing:** Current Inland Revenue data suggests about 16% of rental properties are held in a trust.[9] A higher trustee rate would have a mixed impact on investments in rental housing. To the extent rental income is subject to a higher tax rate, this could reduce incentives to invest in rental property. It could therefore put downward pressure on house prices and/or increase rents. However, to the extent rental properties derive untaxed income, in the form of capital gains, any increased tax may encourage investment in rental properties over other forms of investment.

    39.3. **Business investment:** Increasing the trustee rate may impact incentives to invest in businesses through trusts, including farming and commercial property. To the extent that existing integrity issues remain with companies and shareholders, this may result in restructuring rather than a reduction in investments. Such restructuring would likely result in some one-off compliance costs.

    39.4. **Labour income:** Increasing the trustee rate would reduce the return on labour income earned through a trust. However, most labour income is not earned through trusts, so increasing the trustee rate would improve fairness by ensuring a broader set of individuals pay tax according to the personal scale.

    39.5. **Savings:** Increasing the trustee rate may reduce incentives for those on higher marginal tax rates to accumulate savings in trusts. Conversely, a higher tax on savings means individuals would need to save more to reach a savings goal. This makes the overall impact on savings hard to determine.

[9] Inland Revenue's Residential Rental Property Data Model suggests that 43,080 2019-20 tax returns indicated that trusts were involved with residential rental income (out of a total of 269,346 residential rental property filers).

39.6. **Investment in different entities:** Consistent taxation of income earned through different entities can also promote the efficient organisation of income-earning activities. If investors in less efficient business structures can pay less tax than those investing in more efficient business structures, investment may be distorted towards the less efficient business structures (which is not desirable). Removing distortions means businesses can be organised in the most efficient way.

Options

40. In addition to raising the trustee rate (option 1), we have explored alternative ways (options 2 and 3) to address the under-taxation of trustee income, to determine if they would better meet tax policy objectives:

Option 1 Increasing the trustee tax rate to 39% with modifications for certain trusts with lower-rate settlors and beneficiaries, if necessary ***(officials' preferred option)***.

Option 2 Taxing trustee income at the principal settlor's personal tax rate.

Option 3 Introducing an imputation-style system for trustee income, similar to what is currently in place for companies and Māori authorities.

Option 1 – Increasing the trustee rate to 39% with potential modifications

41. This option would align the trustee rate with the top personal tax rate at 39%. Modifications could be introduced for certain classes of trusts if there is a need to mitigate over-taxation, however this would require further policy work. The trustee rate would continue to be a final tax imposed in the year the income is derived.

Aligning the trustee rate with the top personal rate would limit under-taxation

42. Increasing the trustee tax rate to 39% would ensure that trustee income is not under-taxed when the income is accruing for the benefit of settlors and beneficiaries whose personal income, plus their income from trusts, exceeds $180,000. A 39% trustee tax rate would improve the robustness of the tax system by increasing the likelihood that income attributable to 39% rate individuals is subject to the appropriate amount of tax. This option would also improve the sustainability of the tax system by minimising revenue leakage under existing settings.

Over-taxation can be mitigated under current law…

43. A 39% trustee rate would mean that retaining income as trustee income in a trust with a lower-rate settlor or lower-rate beneficiaries may result in over-taxation. In most instances, this can be prevented by trustees allocating income to beneficiaries (including a settlor as a beneficiary) as beneficiary income so that the income is taxed at the beneficiaries' personal rates.

… although there may be some situations where further modification is required

44. Officials have identified two key situations where trusts may choose, or be forced, to retain income as trustee income for non-tax reasons. Trusts with lower-rate settlors and lower-rate beneficiaries in these situations may be over-taxed. The first situation is where a trust is a discretionary trust, but the trustees have not yet determined the beneficiaries to whom the income should be allocated. If the trustees do not wish to allocate income to any of the beneficiaries when the income is derived, the income will be trustee income and taxed at 39%. This can be considered over-taxation if the trust has lower-rate settlors and lower-rate beneficiaries.

45. The second situation is when the terms of a fixed trust specify who the income will eventually be allocated to, but also that the allocation must not take place until some future event occurs (e.g., when a beneficiary reaches a certain age). These types of fixed trusts may not be able to allocate income to beneficiaries until a certain date and may therefore be forced to retain income as trustee income. Similar to the first situation, if a beneficiary is a lower-rate individual, taxing income retained in a fixed trust at 39% could be considered over-taxation.

46. Comparable countries have modifications to the general taxation of trusts to address over-taxation concerns. The design of any modifications to address potential over-taxation should be on a principled basis, rather than creating bespoke exceptions for certain types of trusts. This will help protect the revenue base and the coherence of the tax system. Our initial thinking is that any modifications should satisfy the following criteria:

    46.1. The modification would allow a lower tax rate to apply to trustee income for trusts with only lower-rate settlors and beneficiaries. That is, a lower tax rate would not apply for trusts with settlors or beneficiaries that would be on a 39% rate if the trustee income was attributed to them.

    46.2. The modification would not provide a tax advantage to taxpayers just because they use a trust, when compared with other taxpayers in the same circumstances who do not use a trust.

    46.3. It is clear whose rate should be applied to trustee income in the year of derivation, if a rate other than the 39% trustee tax rate were to apply.

External engagement and further policy work would be required

47. We understand that there may be particular concerns about the over-taxation of trusts established for disabled persons. Given that minors with a child disability allowance are excluded from the minor beneficiary rule, we expect that most income derived by these trusts is already taxed at the appropriate personal rates of the beneficiaries as beneficiary income, and that specific rules for these trusts may not be necessary.

48. If there are risks of over-taxation that need to be addressed through a modification from the general tax treatment, there are precedents in overseas jurisdictions such as Australia, Canada, the UK, and the US that we can draw on.

49. If you wish to progress policy work on this option, we will undertake further analysis to determine whether existing law is sufficient to address over-taxation concerns. The development of any modifications to the general treatment of trustee income would significantly benefit from targeted, confidential engagement with external tax advisors and discussions with overseas revenue authorities.

50. Another issue that would need to be considered is the likelihood of a behavioural response from taxpayers. Examples include trusts investing in PIEs to access a final 28% rate, or allocating (but not paying) income to corporate beneficiaries wholly owned by the trust. This would ensure a 28% rate on the income, while effectively retaining the income within the trust. Planning of this kind could significantly reduce the effectiveness of aligning the trustee and top personal tax rates.

<u>*Revenue impact*</u>

51. The amount of revenue this option would raise is highly uncertain and heavily dependent on the behavioural response by trusts. The more income that trusts divert to other entities, or allocate as beneficiary income instead of paying tax at the trustee rate, the less revenue that will be raised. A large proportion of trustee income is dividend income (see Figure 1) and could be easily diverted into other entities or retained in companies. [33]

[33]

52. With these caveats, a costing produced in 2020 for the introduction of the 39% personal tax rate indicated that increasing the trustee rate to 39% with no modifications was estimated to raise approximately $350m per annum (based on the income data at that time). That estimate was based on most of the relevant income being taxed at 39%, and only assumed a moderate behavioural response.

Administrative and delivery implications

53. The estimated initial system development impact for Inland Revenue is small but dependent on the final design of any modifications. We would require time to engage with our ecosystem partners, such as software providers; this would be aligned to our annual change engagement process. Additional time would be required to develop a solution for all parties. The earliest implementation date for simply changing the trustee rate to 39% and implementing some simple modifications would be 1 April 2024. More complex modifications would require additional time, and the earliest implementation date for such changes would be 1 April 2025.

54. There would likely be a medium-sized initial administrative cost in the first year to support trustees with understanding the changes and to capture details for any modifications. This would include addressing customer enquiries about the rates at which they have been taxed and the impact on their tax assessments. Ongoing administration costs are expected to be minimal.

Option 2 – Mandatory settlor rate for trustee income

Taxing trustee income at the principal settlor's personal tax rate would likely improve the robustness and sustainability of the tax system…

55. Instead of trustee income being taxed at a set rate, such income could be taxed at the principal settlor's[10] "trust-affected" personal tax rate in the year the income is earned by the trust. This rate would be determined by taking into account both the settlor's own personal income and the trustee income. Applying the principal settlor's trust-affected personal rate could be appropriate for many trusts, given settlors generally retain a large degree of effective control or influence over the trusts they settle property on. Many trusts are effectively a gifting mechanism used by settlors to provide property to beneficiaries over time, so taxing trustee income (as income from property that has not yet been completely gifted to a beneficiary) at the principal settlor's trust-affected rate would be appropriate.

56. This option would likely improve the robustness and sustainability of the tax system compared with the status quo, because the 39% rate would be paid on trustee income when, in aggregate, the trustee income and the principal settlor's personal income exceeds $180,000. Over-taxation would be mitigated by lower rates applying for all or some of the trustee income of trusts with lower-rate settlors.

… however, it would be complex to design

57. This option would be an improvement on the status quo, but it is unclear if the additional complexity (relative to option 1) is justified. Determining the appropriate tax rate for trustee income for a year would require calculating a composite rate, based on the principal settlor's personal income and the aggregate trustee income from all other trusts where the individual is also a principal settlor. This is unlikely

[10] A "principal settlor" is the settlor who has made the greatest settlement on a trust.

to be straightforward. This option would introduce significant complexity in situations where there are multiple settlors of a trust with the greatest-equal share, or if there is a new principal settlor part way through an income year.

58. The taxation of trustee income would need to default to the current settings in cases where the principal settlor is no longer alive or for trusts with no natural person settlors (such as a trust settled by a court to hold Māori land while the beneficiaries are being determined).

Revenue impact

59. The fiscal impact of this option has not been estimated due to the lack of detailed design.

Administrative and delivery implications

60. The estimated initial system development impact for Inland Revenue is small but dependent on final design. We would require time to engage with our ecosystem partners, such as software providers; this would be aligned to our annual change engagement process. Additional time would be required to develop a solution for all parties. The earliest implementation date would be 1 April 2025.

61. There would likely be a medium-sized initial administrative cost in the first year to support customer enquiries about the rates at which they have been taxed and the impact on their tax assessments. Ongoing administration costs are expected to be small.

Option 3 – Imputation-style system for trustee income

Misalignment issues could be addressed through fundamental reform…

62. There are other options that would integrate the taxation of trustee income with the personal income tax system. However, they would involve fundamental changes to how trustee income is taxed. One approach would be to introduce an imputation-style system for trustee income, similar to what is already in place for companies and Māori authorities. Trusts would receive imputation credits for tax paid on trustee income and those credits could be distributed to beneficiaries. Distributions of trustee income to beneficiaries would be taxed at the beneficiaries' personal rates, but beneficiaries would be able to offset the tax liability with imputation credits.

63. This approach would help ensure that the ultimate recipients pay tax on distributions of trustee income at their personal rates in the year a distribution is received. Depending on the design, surplus credits could be credited against other tax liabilities, refunded, or carried forward.

… to improve the long-term robustness and sustainability of the tax system…

64. This option would likely improve the long-term robustness, sustainability, and flexibility of the tax system. It would be robust to different designs of the personal tax system. The ability to shelter income permanently in a trust would be greatly limited, regardless of the specific top personal tax rate, and concerns regarding over-taxation would be mitigated. An imputation system would also improve social policy targeting. Distributions of trustee income would form part of a beneficiary's personal income and therefore would count towards the abatement of social policy measures, such as Working for Families.

65. However, there would be a deferral benefit for higher-rate beneficiaries if the trustee rate remained lower than the top personal rate. There would be a deferral disadvantage for beneficiaries on a personal rate lower than the trustee rate. Income retained as trustee income would be taxed at the higher trustee rate, and

lower-rate beneficiaries would not receive the benefit of surplus credits until trustee income is later distributed. This is similar to the existing situation for shareholders of a company that are on personal tax rates above or below 28%, although we note that a larger deferral benefit currently applies to income earned in companies.

… but this would be complex to design and take longer to implement

66. This option would be significantly more complex to design than the other options. Consideration would need to be given to how it would interact with the minor beneficiary rule, which is currently the only defence in the law against income splitting. This option would also allow tax planning opportunities. For example, settlors with highly paid jobs could defer distributions of trustee income until later in life, when they have less income and lower personal tax rates. This is currently possible with closely-held companies, but not with trusts.

67. Although there would be similarities with the existing imputation system for companies and the Māori authority credit system, the flexibility of trusts poses special challenges. Consideration would need to be given to continuity requirements for imputation credits, the refundability of credits, and anti-streaming rules.

68. This option would significantly increase compliance costs for taxpayers. Trusts would have to establish and maintain imputation credit accounts, which they are not currently required to do. Experience suggests that both taxpayers and their agents find imputation one of the most challenging aspects of the tax system, so extending it to trusts could require a significant educational effort and ongoing support for taxpayers and agents.

Revenue impact

69. The fiscal impact of this option has not been estimated due to the lack of detailed design.

Administrative and delivery implications

70. This option would require large-scale initial system development for Inland Revenue, and the final design of the rules may depend on the requirements and limitations of software providers. Although Inland Revenue currently administers an imputation credit system for companies and Māori authority credits, it is expected that significant development would be required to achieve the policy outcomes as described. We would require time to engage with our ecosystem partners, such as software providers; this would be aligned to our annual change engagement process. Additional time would be required to develop a solution for all parties. The earliest implementation date would be 1 April 2025.

71. There would likely be a medium to large initial administrative impact in the first year, to support trustees with understanding the new rules and to help individuals understand the impact on their tax assessments. Ongoing administration costs are expected to be medium.

Conclusion

72. Trade-offs will be required in determining whether to progress any of the options outlined in this report. The systems or administrative impacts of these options should be considered in the context of other work being progressed on the wider Tax and Social Policy Work Programme.

73. Option 1 (increasing the trustee rate to 39% and introducing modifications to address over-taxation, if necessary) would be the simplest to design, administer and implement; however, the specific impact on Inland Revenue would depend on the detailed design of any modifications. This option would improve the robustness

and sustainability of the tax system compared with the status quo, by helping ensure the 39% rate applies to income attributable to individuals who earn over $180,000. Risks of over-taxation can be significantly mitigated under existing law, and there are overseas precedents that can be drawn upon if modifications are necessary. As long as any modifications are relatively simple, this option could be implemented from 1 April 2024. More time would be required to design and implement complex modifications, in which case the earliest this option could apply from would be 1 April 2025. This option is estimated to raise approximately $350m per annum (however this estimate is highly uncertain, as noted in paragraph 51).

74. Option 2 (taxing trustee income at the principal settlor's personal tax rate) would be more complex than option 1, in terms of policy design, implementation, and administration. Option 2 would likely improve the robustness and sustainability of the tax system by ensuring that, generally, the 39% rate would apply to trustee income for trusts with higher-rate settlors, and lower rates would apply to all or some of the trustee income for trusts with lower-rate settlors. Given that trusts can already allocate income to lower-rate settlors as beneficiary income (where the settlors are also beneficiaries), it is not clear whether the benefits of this option, as compared to option 1, warrant the additional complexity it would introduce. This option could be implemented from 1 April 2025.

75. Option 3 (imputation-style system) would involve fundamental reform. It would be the most complex option to design and implement, and would involve significant compliance costs (especially when it is first implemented). However, this option would improve the robustness and sustainability of the tax system by integrating the taxation of trusts with the personal income tax system. The ultimate recipients of income derived by trusts would pay tax at their personal rates. This option could be implemented from 1 April 2025.

Next steps

76. If you wish to progress one of the options in this report, we can discuss timeframes and preferred focus areas. We recommend undertaking targeted confidential engagement with external tax advisors and overseas revenue authorities to assist policy development. If you agree to proceed, we will report back to you in February 2023 on detailed design features in time for Budget 2023.