# The Treasury

## Budget 2023 Tax Initiatives Information Release

## July 2023

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POLICY AND REGULATORY STEWARDSHIP

## Tax policy report: Increasing the trustee rate to 39% – detailed design

| **Date:** | 28 February 2023 | **Priority:** | High |
|---|---|---|---|
| **Security level:** | | **Report number:** | IR2023/058<br>T2023/269 |

## Action sought

| | **Action sought** | **Deadline** |
|---|---|---|
| Minister of Finance | **Agree** to recommendations | 7 March 2023 |
| Minister of Revenue | **Agree** to recommendations | 7 March 2023 |

## Contact for telephone discussion (if required)



| **Name** | **Position** | **Telephone** |
|---|---|---|
| Chris Gillion | Policy Lead<br>Inland Revenue | [39] |
| Stephen Bond | Manager, Tax Strategy<br>The Treasury | |

28 February 2023

Minister of Finance
Minister of Revenue

## Increasing the trustee tax rate to 39% – detailed design

### Executive summary

1. [33]

2. After further analysis, we still recommend increasing the trustee rate to 39%, and believe that for most trusts existing rules will be sufficient to manage over-taxation risks. However, without undertaking public consultation, there is a risk that there are barriers we have not identified which would prevent those rules from being fully effective for some trusts.

3. Given this conclusion but the remaining risks, we recommend you apply the 39% rate across the board with minimal exclusions but consider feedback on specific over-taxation risks as part of the legislative process. We are recommending this approach based on our judgement that existing trust rules provide sufficient flexibility to mitigate the possibility of over-taxation. But we do expect that judgement will be challenged and tested once legislation is introduced, and consultation with stakeholders could bring unexpected concerns to light.

4. We will report to you in mid-March on the legislative process for these proposals and other potential Budget measures. We will recommend that the corresponding legislation be subject to a full select committee process to allow tax and trust law experts to provide their input on the technical detail of the proposals. Then, if further information on the extent to which some trusts could be over-taxed comes forward, you could consider whether further exceptions are needed to mitigate the possibility of over-taxation. Any relevant exclusions are highly likely to have nil or very low fiscal costs and could be implemented when the trustee rate is increased.

5. There will also be pushback from the tax advisory community as trust taxation issues are addressed without also making changes to the taxation of PIEs and companies/shareholders.

***Aligning the trustee and top personal tax rates would address under-taxation…***

6. Aligning the trustee rate with the top personal rate would be the most effective way of ensuring that trustee income is not under-taxed within the existing regime for trusts. This would generally strengthen the sense of fairness in the tax system by ensuring that trusts cannot be used to shelter income from the 39% personal rate, although some taxpayers will be over-taxed at a 39% rate.

7. A small proportion of trusts will pay most of the additional tax. In 2021:

   - 8% of trusts with assessable income (14,000 out of 177,000) accounted for 86% of trustee income ($14.6 billion out of $17.1 billion).

- 68% of trusts with assessable income (120,000) accounted for the remaining 14% of trustee income.
- 24% of trusts with assessable income (43,000) reported only beneficiary income and would not be impacted by a change in the trustee rate.

8. Even if the trustee rate is aligned with the top personal tax rate, there will continue to be opportunities to circumvent that rate by substituting trusts with companies or PIEs. However, trusts are a completely different legal structure from companies and PIEs, and they are not complete substitutes. For example, some trusts have investments that could not be put into PIEs. These are primarily businesses that settlors or beneficiaries control, such as farms and small- to medium-sized enterprises ("SMEs"). Furthermore, trusts have certain tax advantages that companies do not, such as being able to distribute capital gains immediately to beneficiaries tax-free and stream distributions to different beneficiaries.

9. [33]

Raising the trustee rate to 39% will still raise revenue in a relatively low-cost way, while better meeting the Government's distributional objectives. However, we will continue to monitor other structures that could be used to undermine a 39% trustee rate. An advantage of consultation through the select committee process is that it may bring to light such structures.

### *… and existing rules should be sufficient to mitigate over-taxation in most cases*

10. Some trusts with lower-rate settlors and beneficiaries will be over-taxed if the trustee rate is increased to 39%. In November, we advised that existing rules were likely to be sufficient to mitigate over-taxation, but that we would undertake further analysis of existing law and consider overseas precedents.

11. Having further analysed situations that may result in over-taxation, and undertaken consultation with certain public sector agencies and Australian tax officials (BN2022/539 refers), we still consider that existing rules should be sufficient to mitigate over-taxation in most cases.

12. Existing rules allow income of a trust to be taxed at a beneficiary's marginal rate if the income is allocated to the beneficiary as beneficiary income. Beneficiary income can be credited or paid to a beneficiary, or it can be allocated to the beneficiary for them to receive at a future date (such as when they reach a particular age). Our recommended approach relies on this mechanism to mitigate over-taxation. It will be important to ensure taxpayers understand how they can use this mechanism to mitigate over-taxation when these proposals are introduced.

13. There will be instances where allocating income to beneficiaries is problematic or costly for trusts. The trustees may lack information on beneficiaries' marginal tax rates, and they may have not yet determined which beneficiaries to allocate income to. Or the trustees may have to trade-off protecting assets from creditors or against relationship property claims and allocating to beneficiaries. This would potentially be a significant issue and would be something we would like to understand further through consultation. Further consultation once the proposals are made public would help inform whether there are certain types of trusts for whom the allocation of income to beneficiaries does not mitigate the potential over-taxation of beneficiaries.

### *Specific modifications can be introduced where necessary*

14. We have specifically considered whether a 39% trustee rate could result in over-taxation for estates, trusts for disabled people, fixed trusts, trusts with a large number of beneficiaries ("widely-held trusts"), energy consumer trusts, or superannuation funds that are taxed as trusts.

*A modification is recommended to mitigate over-taxation of estates*

15. Estates are taxed as trusts. An estate may not be able to use beneficiary income allocation to mitigate over-taxation if the affairs of the deceased person are still being worked through, particularly if it takes an extended period to determine who the beneficiaries are. It is likely some estates are already overtaxed under a 33% trustee tax rate, and that this over-taxation will be exacerbated with a 39% rate. For income derived by an estate within 12 months of the person's death, we recommend that the estate should have the option of the income being taxed at the deceased person's marginal tax rate. Our initial view is that 12 months is a reasonable length of time and should be adequate for many estates. Although this will not be long enough for more complicated estates, a longer period may incentivise estates to retain income rather than distributing to beneficiaries. Engagement with stakeholders once the proposals are made public would help refine how long this modification should apply.

*Existing rules should mitigate over-taxation for trusts for disabled people…*

16. Existing rules should mitigate over-taxation for trusts for disabled people, although there may be barriers we are unaware of that would be identified in further consultation. Australia has a specific tax regime for trusts for disabled people, but it has very low uptake and is mostly aimed at achieving social policy objectives. We have consulted Whaikaha – Ministry of Disabled People on the use of trusts, and there appears to be little evidence that trusts are widely used to care for disabled people in New Zealand. The Law Commission's 2012 review of trust law noted that some trusts are established to provide for family members with special needs, but papers from the review do not provide data on the number of these trusts or how they are used.

17. If you would like to introduce a modification for these trusts, we recommend undertaking public consultation first to ensure that any special rules are fit for purpose. A modification could be introduced in legislation at a later stage. We have researched how similar regimes are designed overseas and consider that any modification introduced for these trusts in New Zealand would be complex and require arbitrary boundaries. As a result, designing a modification without consulting the disabled community could result in a policy response that is poorly targeted and ineffective. However, we have included a summary of how a modification for these trusts could be designed in the appendix.

*… and should also assist fixed trusts in mitigating over-taxation*

18. After further analysis we are now more confident that existing tax rules should generally be sufficient to mitigate over-taxation for fixed trusts. This includes trusts where, for example, the trust deed specifies that the beneficiary is to receive trust property when they reach a particular age. We expect that almost all trustees of fixed trusts have a power of advancement, which provides trustees with the discretion to allocate income to beneficiaries in advance of the future date or event specified in the trust deed, so that trust income can be taxed at the beneficiary's marginal rate. However, without public consultation, we have no data on how many fixed trusts have this power.

*Modifications are not recommended at this stage for widely-held trusts or energy consumer trusts…*

19. Simply because a trust has a large number of beneficiaries should not be a reason in itself for an exclusion from the 39% trustee rate. Generally, we expect that existing mechanisms should be sufficient to address risks of over-taxation for widely-held trusts.

20. Energy consumer trusts ("ECTs") are a type of widely-held trust; they hold the shares of energy companies on behalf of their consumers, who are the beneficiaries of these trusts. The largest ECT, Entrust, has written to Ministers regarding tax issues in recent years. Without further consultation it is difficult to identify any specific constraints or barriers for ECTs. We recommend applying the 39% rate to these trusts until we can engage with this sector to inform further advice on whether special rules should apply.

21. While it is likely that many beneficiaries of ECTs would have a marginal tax rate below 39%, we expect that ECTs, like other trusts, should be able to allocate income as beneficiary income to mitigate over-taxation. By value, most income of ECTs is beneficiary income (87% in 2021). It is difficult to determine at this stage why some smaller ECTs retain all their income as trustee income.

*…or for superannuation funds that are taxed as trusts*

22. We do not recommend introducing special rules for the small number of superannuation funds that are taxed as trusts (the large majority of superannuation funds, like KiwiSaver, are taxed separately under the PIE rules). We expect beneficiaries of these funds would provide feedback that they should be excluded from a 39% trustee tax rate, given this would effectively result in an increase to the tax rate that applies to some retirement savings. Although affected superannuation funds cannot use the beneficiary income allocation mechanism, most of these funds are single-person schemes set up by judges, coroners, and Members of Parliament, so are likely to have 39% rate beneficiaries.

***Rules needed to prevent use of corporate beneficiaries to circumvent 39% rate***

23. Under current law, there is a risk that trustees will be able to circumvent a 39% trustee rate by incorporating a company as a beneficiary, with the trustees of the trust as the shareholders. Income of the trust could be allocated as beneficiary income to the company and taxed at 28%.

24. To prevent trusts sheltering income in corporate beneficiaries, we recommend taxing certain beneficiary income allocations to corporate beneficiaries as trustee income. Affected allocations would be those where a settlor of a trust has natural love and affection[1] for a (direct or indirect) shareholder of a close company.[2] This would ensure the proposal applies primarily to family trusts and would not affect the commercial use of trusts in large corporate groups.

25. The use of corporate beneficiaries to circumvent the trustee tax rate is a major issue in Australia, where there is a large difference between their trustee and corporate tax rates. Our data suggests corporate beneficiaries are not being widely used in this way at present in New Zealand. However, in the absence of any further changes, we expect the use of corporate beneficiaries to circumvent the trustee tax rate would become increasingly common. We will continue to monitor other structures that could be used to undermine a 39% trustee rate.

***Trust disclosure rules***

26. Stakeholders will raise concerns that information from the new trust disclosure rules was not available in time to influence decisions regarding the trustee rate. However, we do not recommend progressing changes to the disclosure requirements as part

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[1] "Natural love and affection" is an existing concept in tax law. It is used to describe an action by a person where the motive is induced not by a promise of something in return, but by the natural love and affection the person has for another. Natural love and affection is generally considered to subsist between relatives, whether by blood, marriage, a non-spousal domestic relationship, or adoption. It can be present between close friends as well, although not ordinary acquaintances or colleagues.

[2] A close company is a company where five or fewer natural persons or trustees hold more than 50% of the voting interests in the company (treating associated persons as one person).

of this project. We anticipate that the disclosures will provide new insights about trust behaviour which will inform future compliance and policy decisions.

### *Financial implications*

27. Increasing the trustee rate to 39% for the 2024–25 and later income years (beginning 1 April 2024 for most trusts) is estimated to raise $350 million per annum ($1,045 million over the forecast period). However, this estimate is highly uncertain and heavily dependent on the behavioural response by trusts. The timing lag relates to information flows: the first year of affected tax returns need to be filed before the additional income tax is recognised, and the second year is simultaneously accrued on the basis of that new information. An exception is provisional taxpayers already using estimation, for whom there will be an impact within the 2024/25 fiscal year. Many trusts are not currently provisional taxpayers as much of their income is in the form of fully imputed dividends.

28. Providing a modification for estates is expected to have a fiscal cost of $5 million per annum for the 2025/26 and later fiscal years.

***Table 1: Impact of the proposals on tax revenue and the operating allowance***

| | $m – increase/(decrease) | | | | | |
|---|---|---|---|---|---|---|
| **Vote Revenue** | 2022/23 | 2023/24 | 2024/25 | 2025/26 | 2026/27 and outyears | Total over forecast period |
| Crown Revenue and Receipts:<br>Tax Revenue | | | | | | |
| *39% trustee rate* | - | - | 10.000 | 685.000 | 350.000 | 1,045.000 |
| *Estates modification* | - | - | - | (5.000) | (5.000) | (10.000) |
| **Total Revenue** | **-** | **-** | **10.000** | **680.000** | **345.000** | **1,035.000** |
| **Total Operating** | **-** | **-** | **(10.000)** | **(680.000)** | **(345.000)** | **(1,035.000)** |

29. Inland Revenue, with the Treasury, are finalising the accounting treatment for the timing of this revenue.

### *Administrative implications*

30. Implementation and ongoing administrative costs are estimated to be between $5.000 million and $11.000 million over the forecast period (2022/23 to 2026/27). This estimate will be refined when final policy design decisions have been made.

31. At the upper-end of the cost range, over the forecast period, the estimated one-off capital build costs are $2.900 million, the one-off operating build costs are $0.700 million, and the ongoing administrative costs are $7.400 million.

***Table 2: Implementation and ongoing administration costs***

| | $m – increase/(decrease) | | | | | |
|---|---|---|---|---|---|---|
| **Vote Revenue** | 2022/23 | 2023/24 | 2024/25 | 2025/26 | 2026/27 and outyears | Total over forecast period |
| One-off build costs | - | 0.700 | - | - | - | 0.700 |
| Ongoing admin costs | - | 0.800 | 3.400 | 2.700 | 0.500 | 7.400 |
| **Total Operating** | **-** | **1.500** | **3.400** | **2.700** | **0.500** | **8.100** |
| Capital Expenditure | - | 2.900 | - | - | - | 2.900 |
| **Total Capital** | **-** | **2.900** | **-** | **-** | **-** | **2.900** |
| **Total** | **-** | **4.400** | **3.400** | **2.700** | **0.500** | **11.000** |

32. The operating costs for this initiative include additional resource capacity, one-off implementation costs, depreciation, and capital charge. The resource impact of this initiative is 6 FTEs in 2023/24, 25 FTEs in 2024/25 and 19 FTEs in 2025/26. This predominantly relates to responding to customer queries (both about the changes and around the auto-calculation period), enquiries from tax agents, and compliance activity for return filing and non-compliant trusts. From 2026/27 these activities will reduce and be absorbed within business-as-usual activities, with no additional funding required.

33. Inland Revenue is reviewing the overall impact of possible Budget 2023 initiatives, including this proposal. Inland Revenue, with the Treasury, will report back to you in mid-March on the potential for Inland Revenue to self-fund the capital and/or operating impacts of this initiative and other Budget 2023 initiatives. The level of any self-funding will be dependent on the total financial, resource, and capacity impacts of all proposed initiatives. The report will also identify any new Budget 2023 funding required for all the initiatives in any package.

### *Capacity constraints*

34. During the week of 13 February 2023, Inland Revenue discussed with Ministers its capacity constraints to deliver the Government's current Tax and Social Policy Work Programme and the work Inland Revenue is undertaking to reduce these constraints. As noted above, we intend to report to you on this in mid-March.

### *Next steps*

35. Following your decisions on this report, we will provide you with a draft Cabinet paper. The Cabinet paper would need to be lodged with the Cabinet Office before 10:00am on Thursday 23 March 2023 for consideration by the Cabinet Economic Development Committee on Wednesday 29 March 2023.

36. In mid-March, we will report to you regarding the funding for the capital and operation impacts, as well as the legislative process, for these proposals and other potential Budget measures. Legislation for these proposals could be included in a bill to be introduced at Budget 2023 ("Budget Bill"), to be enacted before 1 April 2024 (the commencement date). Due to the technical nature of trusts and their taxation, we consider it would be highly beneficial for these measures to go through a full select committee process.

## Recommended action

We recommend that you:

***Trustee rate***

(a) **agree** to increase the trustee tax rate to 39%, applying for the 2024–25 and later income years (beginning 1 April 2024 for most trusts);

Agreed/Not agreed Agreed/Not agreed

***Income allocations to corporate beneficiaries***

(b) **agree** to tax beneficiary income paid or allocated to corporate beneficiaries that are close companies at the 39% trustee tax rate where the settlor has natural love and affection for one or more shareholders of the company;

Agreed/Not agreed Agreed/Not agreed

***Estates***

(c) **agree** to include a modification for estates, so that trustees have the option of trustee income derived by an estate within 12 months of a person's date of death being taxed at the deceased's marginal tax rate;

Agreed/Not agreed Agreed/Not agreed

(d) **note** that recommendation (c) has an estimated fiscal cost of approximately $5m per annum for the 2025/26 and later fiscal years;

Noted Noted

***Trusts for disabled people***

(e) **agree** to **ONE** of the following three options:

- **Option 1** – Do not include a modification in the Budget Bill for trusts for disabled people ***(officials' preference)***; OR

  Agreed/Not agreed Agreed/Not agreed

- **Option 2** – Include a modification in the Budget Bill for trusts for disabled people (as set out in the appendix); OR

  Agreed/Not agreed Agreed/Not agreed

- **Option 3** – Publicly consult on whether a modification is required for trusts for disabled people after the Budget Bill is introduced (which could be included in the legislation at a later stage);

  Agreed/Not agreed Agreed/Not agreed

(f) **note** that the options in recommendation (e) have no fiscal implications;

Noted Noted

***Widely-held trusts, energy consumer trusts, and certain superannuation funds***

(g) **agree** that a modification for widely-held trusts should not be introduced;

Agreed/Not agreed Agreed/Not agreed

(h) **agree** that a modification for energy consumer trusts should not be introduced;

Agreed/Not agreed Agreed/Not agreed

(i) **agree** that a modification for superannuation funds that are taxed as trusts should not be introduced;

Agreed/Not agreed Agreed/Not agreed

***Financial implications***

(j) **note** that we estimate that increasing the trustee rate (recommendation (a)), with a modification for estates (recommendation (c)), will generate a forecast change to tax revenue of around $1,035 million over the forecast period, with a corresponding impact on the operating balance and net debt. This is highly uncertain and heavily dependent on the behavioural response from trusts. Inland Revenue, with the Treasury, are finalising the accounting treatment for the timing of this revenue;

Noted Noted

| | $m – increase/(decrease) | | | | | |
|---|---|---|---|---|---|---|
| **Vote Revenue** | 2022/23 | 2023/24 | 2024/25 | 2025/26 | 2026/27 and outyears | Total over forecast period |
| Crown Revenue and Receipts:<br>Tax Revenue | | | | | | |
| *39% trustee rate* | - | - | 10.000 | 685.000 | 350.000 | 1,045.000 |
| *Estates modification* | - | - | - | (5.000) | (5.000) | (10.000) |
| **Total Revenue** | **-** | **-** | **10.000** | **680.000** | **345.000** | **1,035.000** |
| **Total Operating** | **-** | **-** | **(10.000)** | **(680.000)** | **(345.000)** | **(1,035.000)** |

(k) **agree** that the Cabinet paper seeks agreement that the additional tax revenue in recommendation (j) should be managed as a positive impact against the Budget 2023 operating allowance**;**

Agreed/Not agreed Agreed/Not agreed

***Administrative implications***

(l) **note** that the estimated ongoing implementation and administrative costs of this proposal are in the range of $5.000 million to $11.000 million over the forecast period (2022/23 to 2026/27), subject to the design decisions in the recommendations above;

Noted Noted

(m) **note** that at the upper-end of the cost range, the estimated costs of the up-front build, and ongoing administration costs of this proposal over the forecast period, are $2.900 million capital, $0.700 million operating and $7.400 million operating;

Noted Noted

(n) **note** that Inland Revenue, with the Treasury, will report back to you in mid-March on the overall financial, resource and capacity impact of all proposed Budget 2023 tax initiatives, including the potential for Inland Revenue to partially self-fund the capital and/or operating impacts of these initiatives;

Noted Noted

(o) **note** that we will seek delegated authority to manage the implementation and administrative costs for this initiative through the Budget process;

Noted Noted

***Legislative timing***

(p) **agree** that legislative amendments to give effect to recommendations (a) to (i) will be included in a bill to be introduced at Budget 2023, to be enacted by 1 April 2024; and

Agreed/Not agreed Agreed/Not agreed

(q) **note** that it would be highly beneficial for these measures to go through a full select committee process, given the technical nature of trusts and their taxation.

Noted Noted

**Stephen Bond**
Manager – Tax Strategy
The Treasury

**Chris Gillion**
Policy Lead
Inland Revenue

**Hon Grant Robertson**
Minister of Finance
/ /2023

**Hon David Parker**
Minister of Revenue
/ /2023

## Background

### *Current law*

37. 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.

38. **Beneficiary income** is all income earned by a trust in an income year which is paid or 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. Provided the trustees cannot change their mind about the allocation (i.e., the income is vested absolutely in the beneficiary), the income is considered beneficiary income and is taxed at the beneficiary's marginal rate.

***Table 3: Types of beneficiary income and simplified examples***

| Types of beneficiary income | Simplified examples |
|---|---|
| **Income distributed or paid to a beneficiary**. | Cash transferred to the beneficiary. |
| **Income allocated to a beneficiary that is credited to the beneficiary's current account.**<br><br>The income is available to be called upon at any time by the beneficiary, although in practice it is usually paid to the beneficiary only when the trustee or settlor thinks it is appropriate.<br><br>Trustees can allocate beneficiary income without the beneficiary having knowledge of the allocation. | Allocated amounts are available in a bank account for the beneficiary to draw upon at any time. |
| **Income that is allocated to a beneficiary for them to possess at a future date or event** ("future possession beneficiary income").<br><br>This could include where income is allocated to a beneficiary for them to possess when they reach a certain age. Provided the income will go to the beneficiary's estate if the beneficiary dies before the future date or event, the income is considered beneficiary income in the year it is derived by the trust and is taxed at the beneficiary's marginal tax rate.<br><br>Unlike beneficiary income credited to a beneficiary's current account, future possession beneficiary income is not available to be called upon by the beneficiary until they become entitled to possess the income (either once the future date or event has occurred or when the income goes to their estate on their death). | Allocated amounts are held in a bank account the beneficiary cannot access until they reach the age of 21. |

39. **Trustee income** is all taxable income derived by a trust in an income year that has not been allocated as beneficiary income. Once income has been taxed as trustee income, distribution of that income to 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.[3]

## Problem definition

40. As discussed in our November 2022 report, misalignment between the trustee rate and top personal rate significantly constrains the Government's ability to raise revenue from the personal tax system. Aligning the trustee rate with the top personal rate would be the most effective way of addressing the under-taxation of trustee income within the existing regime for trusts.

[3] This is the treatment of most domestic trusts ("complying trusts"), which are the focus of this report.

41. However, 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 (under 16 years old) and a relative of the settlor. In other cases, this may be inappropriate and result in over-taxation.

42. Since reporting to you in November, we have further explored the risk of over-taxation and whether existing rules are sufficient to mitigate this risk. We have also undertaken further analysis regarding the risk of under-taxation, and whether additional rules are necessary to buttress the proposed 39% trustee tax rate.

## Further analysis of the risk of under-taxation

43. Even if the trustee rate is aligned with the top personal tax rate, there will continue to be opportunities to circumvent that rate by substituting trusts with companies or PIEs. However, trusts are a completely different legal structure from companies and PIEs, and they are not complete substitutes.

- *Substitutability with PIEs:* Some trusts have investments that earn large amounts of income that could not be put into a PIE. These are primarily businesses that settlors or beneficiaries control, such as farms and SMEs. While the general population may not have many of these investments, they represent a large amount of the assets of high-income investors.
- *Substitutability with companies:* Trusts have certain tax advantages that companies do not. Capital gains derived in trusts can be distributed immediately to beneficiaries tax-free, whereas capital gains can only be extracted from a company upon liquidation or as a taxable dividend. Trusts can stream distributions to different beneficiaries and can be used for asset protection in a way that companies cannot. Also, the company and dividend tax rules are relatively more comprehensive than the trust tax rules. Therefore, there are some important advantages that would counteract, to a degree, the incentive for taxpayers to shift income from trusts to companies.

44. [33]

Raising the trustee rate to 39% will still raise revenue in a relatively low-cost way, while better meeting the Government's distributional objectives. However, we will continue to monitor other structures that could be used to undermine a 39% trustee rate. An advantage of consultation through the select committee process is that it may bring to light such structures.

## Income allocations to corporate beneficiaries

45. To buttress the 39% trustee tax rate, we also recommend a rule to prevent income allocations to corporate beneficiaries being used to circumvent the rate. A company can be a beneficiary of a trust. Under current law, income allocated to a corporate beneficiary is taxed at 28%. In the context of a family trust, this is generally not appropriate for a number of reasons.

- The real beneficiary of such an allocation is the ultimate natural person shareholder in the company. The allocation should be taxed at the marginal rate of that person or persons. There is no reason for taxing the income earned by a trust and allocated to a company in the same way as income earned directly by the company.
- If the shareholder of the corporate beneficiary is the trust that is making the allocation, the allocation achieves nothing. The income effectively remains

within the trust. The principal, or in many cases only, effect of the allocation is to ensure that the income is taxed at 28% rather than the trustee rate. While a subsequent distribution of the income by the company to the trust will be taxable as a dividend (with imputation credits attached), such a distribution may never be made.

46. Currently, allocations of income to corporate beneficiaries are not common in New Zealand, outside certain specialised contexts.[4] However, the proposed increase in the trustee tax rate to 39% would significantly increase the attractiveness of making such allocations. These allocations are a major issue for the Australian Tax Office, where the trustee rate is 47% and the corporate tax rate is often 25%. Australian officials have told us that it is common, for instance, for income to be allocated by a trust to a corporate beneficiary owned by the allocating trust (referred to as a "bucket company") but for the cash to be retained in the trust or lent to a high-rate individual beneficiary, with the loan outstanding indefinitely. They have told us that these kinds of transactions give rise to significant compliance problems.

47. The difference between the 28% corporate tax rate and the current 33% trustee tax rate does not seem to motivate this behaviour in New Zealand. However, we think it is likely that the proposed increase in the trustee tax rate, and the greater differential between the corporate and trustee tax rates, would lead to similar practices and problems in New Zealand to those already experienced in Australia. To give just one instance of a problem, the tax law might need to be amended to ensure that an allocation to a company which is not paid in cash gives rise to a loan by the company to the trust, which in turn gives rise to a deemed dividend if the loan is not subject to interest. Such rules would inevitably involve a high level of complexity.

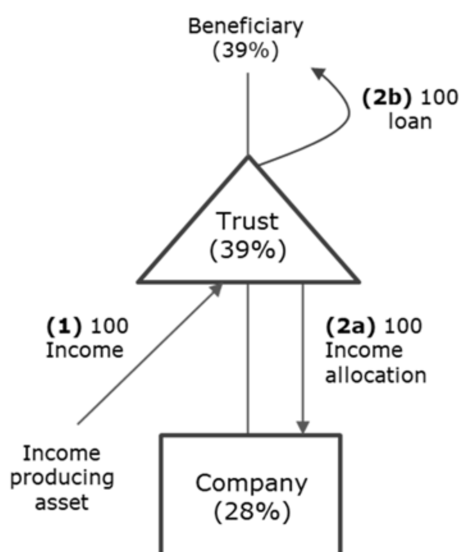
48. Accordingly, to ensure that trusts cannot allocate beneficiary income to companies to circumvent a 39% trustee rate, we recommend taxing income allocated to corporate beneficiaries as trustee income and therefore subjecting it to the higher trustee tax rate. This proposal should be limited to corporate beneficiaries that are close companies[5] and where a settlor of the trust has natural love and affection[6] for a (direct or indirect) shareholder of the company. This ensures that the proposal is targeted towards family trusts and would not affect the commercial use of trusts in large corporate groups. This is very similar to the treatment of income allocated to minor beneficiaries under the minor beneficiary rule.

[4] In the 2021 financial year, 462 unique corporate beneficiaries were allocated $503m beneficiary income from 323 unique trusts (this was 7% of $6,200m total beneficiary income). The beneficiary income allocation is not evenly distributed, with 80% ($401m out of $505m) allocated by just 8% of these trusts (26 out of 323).

[5] A close company is a company where five or fewer natural persons or trustees hold more than 50% of the voting interests in the company (treating associated persons as one person).

[6] "Natural love and affection" is an existing concept in tax law. It is used to describe an action by a person where the motive is induced not by a promise of something in return, but by the natural love and affection the person has for another. An action undertaken in consideration of natural love and affection does not entice reciprocation, i.e., nothing is expected in return. Natural love and affection is generally considered to subsist between relatives, whether by blood, marriage, a non-spousal domestic relationship, or adoption. It can be present between close friends as well, although not ordinary acquaintances or colleagues.

***Example 1: Income allocated to corporate beneficiary***




John's family trust derives $100 of income from an income producing asset (this is **(1)** in the diagram). John's personal tax rate is 39%.

To avoid the $100 being taxed at the 39% rate, the trust allocates the income to a corporate beneficiary as beneficiary income (this is **(2a)**). The income is taxed at the 28% rate in the hands of the company.

The trust then loans $100 to the beneficiary (this is **(2b)**). The $100 is not taxable income in the hands of the beneficiary.

Overall, only $28 of tax has been paid on the income. However, $39 of tax should have been paid on the income, given the $100 has actually gone to the beneficiary (via the loan from the trust).

Under the proposal, the $100 allocated to the company would be taxed at the 39% trustee tax rate. $39 of tax would be paid on the income.

49. Taxing beneficiary income allocations to these corporate beneficiaries will avoid the under-taxation that would otherwise arise if the income were taxed at the corporate rate. It should not give rise to over-taxation. A family trust will not make an allocation to a corporate beneficiary unless the company is owned by one or more of the other beneficiaries or the trust itself. If one or more of those shareholder beneficiaries is on a lower rate, the trust can allocate the income directly to that person to prevent over-taxation. If the corporate beneficiary has a real need for funds, either the shareholder beneficiary or the trust on their behalf can invest the money in the company, by way of either debt or some form of capital contribution.

50. We note that this proposal will not prevent trusts from restructuring in response to an increased trustee rate, for example by transferring the ownership of income-producing assets to companies owned by trusts or investing in PIEs. However, as discussed above, companies and PIEs are not completely substitutable for trusts. This reduced substitutability would limit the degree to which trusts are able to shift assets to circumvent the 39% rate. We will continue to monitor other structures that could be used to undermine a 39% trustee rate.

### *Financial implications*

51. This proposal will help ensure the estimated revenue raised by increasing the trustee rate to 39% is not negatively impacted by the use of corporate beneficiaries by trusts to avoid the 39% rate. The proposal is not expected to result in any additional revenue over the forecast period.

### *Administration and compliance implications*

52. Although this proposal is broadly similar to the current minor beneficiary rule, we expect that taxing beneficiary income allocations to certain corporate beneficiaries at the trustee tax rate would have a small administrative impact on Inland Revenue. This includes helping trustees understand the new rules and amending forms and guidance. This proposal may result in some trusts changing their behaviour or restructuring to ensure they are not affected by this change.

## Further analysis of the risk of over-taxation

53. If trust income is retained and taxed as trustee income, a 39% trustee tax rate may result in over-taxation, particularly for trusts with only lower-rate settlors and beneficiaries. However, in most circumstances where a trust only has lower-rate settlors and beneficiaries, we expect over-taxation can be prevented by trustees allocating income to beneficiaries (including a living settlor in their capacity as a beneficiary of the trust) as beneficiary income, so that the income is taxed at the beneficiaries' personal rates. This is the method that comparable jurisdictions mostly rely on to mitigate over-taxation.

54. The November report identified two situations where trusts may choose, or be forced, to retain income as trustee income for non-tax reasons. The first situation is where a trust is a discretionary trust, but the trustees have not yet determined which beneficiary to allocate income to. The second situation is when the deed of a fixed trust specifies who the trust's income will eventually be allocated to, but also provides that the allocation must not be made until some future event occurs (e.g., when a beneficiary reaches a certain age). After undertaking further analysis, we do not recommend introducing modifications for either situation at this stage.

### *Applying the 39% rate is appropriate if the beneficiary is not yet known*

55. If a trust retains income as trustee income because the trustees have not decided which beneficiary to allocate the income to, the income should be taxed at the trustee rate. It is not over-taxation if the 39% rate applies in this situation, as the settlors/trustees have retained control over the income. We do not recommend providing a modification for situations where there is no certainty over who the income will eventually be allocated to. Designing a modification within the existing trust regime for this situation would be difficult and would likely undermine the 39% personal rate.

56. Some trusts with only lower-rate settlors and beneficiaries may consider themselves unfairly impacted by the proposed 39% trustee rate. Such trusts may never have a 39% settlor or beneficiary, yet will be forced to decide whether to allocate income to mitigate over-taxation. They may face increased compliance costs as a result. Some taxpayers will consider this particularly unfair where they are using trusts for non-tax reasons, such as to protect assets from creditors or relationship property claims, and allocating income as beneficiary income could undermine those non-tax reasons.

### *Existing rules should mitigate the risk of over-taxation for fixed trusts*

57. Since reporting to you in November, we have analysed fixed trusts in further detail. We expect that almost all trust deeds of fixed trusts provide trustees with a power of advancement, so they have discretion to bring forward allocations of beneficiary income in advance of the future event (e.g., the beneficiary attaining a particular age) specified in the deed. However, without undertaking public consultation, we have no data on how prevalent the power of advancement is in fixed trusts.

58. To prevent over-taxation for fixed trusts with lower-rate beneficiaries, the trustees of these trusts could exercise a power of advancement to allocate income as beneficiary income, so that the income is taxed at the beneficiary's marginal rate. If the trustees do not want the beneficiary to have access to that income until the future date or event specified in the trust deed, they could allocate the income to the beneficiary as future possession beneficiary income. Future possession beneficiary income is still taxed at the beneficiary's rate in the year the income is derived, even though the income does not become available to the beneficiary for their possession until sometime in the future. However, allocating income as future possession beneficiary income may result in additional compliance costs when compared with distributing or allocating the income for immediate access.

### ***Specific cases where a 39% trustee tax rate may result in over-taxation***

59. A 39% trustee tax rate may result in over-taxation for income derived by estates, which are taxed as trusts, so we recommend modifications to mitigate over-taxation for these trusts. We have also considered whether over-taxation could arise for trusts with large numbers of beneficiaries ("widely-held trusts"), energy consumer trusts, and for the small number of superannuation funds that are taxed as trusts. However, we do not recommend modifications for these trusts.

60. We understand you may have concerns that trusts for disabled people could be over-taxed. We expect existing rules should be sufficient to mitigate over-taxation for these trusts. Our analysis regarding specific situations where over-taxation may arise under a 39% trustee tax rate, and whether modifications are required to mitigate over-taxation, is set out below.

61. We note that in this report, we have made recommendations based on the information we have available to us, but this has been constrained by our inability to publicly consult on the proposals because of their Budget sensitivity. The approach we have taken in this report is to apply the 39% rate across the board with minimal proposals for modifications. In general terms, we have made the judgement that the trust rules provide sufficient flexibility to mitigate the possibility of over-taxation. We expect that judgement will be challenged and tested once legislation is introduced and that consultation with stakeholders will bring concerns and problems to light. Once we have further information on the extent to which some trusts could be over-taxed, we will consider whether further modifications are needed to mitigate the possibility of over-taxation.

## Estates

62. Estates are taxed as trusts, with the executor or administrator of an estate considered a trustee for tax purposes. If an amount of income would have been included in a deceased person's income had they still been alive when it was received, the income is considered income of the trustee. Generally, estates are subject to the same tax rules as trusts. Therefore, estates are able to allocate income as beneficiary income to mitigate over-taxation.

63. Some estates have no choice but to retain income as trustee income if the affairs of the deceased person are still being worked through and the beneficiaries (and their interests) are not yet known. Examples include where the deceased had overseas shares (because going through probate in other countries can take time), or where there are succession issues regarding Māori land. Also, unlike trusts that have a living settlor, income cannot be allocated to the settlor of an estate to access the settlor's marginal tax rate because the settlor is the deceased person. Applying a 39% trustee tax rate to estates could therefore result in over-taxation where the deceased and/or the beneficiaries of the estate are lower-rate individuals.

64. In 2021, estates[7] reported $300m of trustee income. Roughly 90% of estates report trustee income of $20,000 or less. Only 1% of estates report trustee income over $180,000, but account for 63% of trustee income derived by estates. While over-taxing the trustee income of estates is an issue that already exists with the current 33% trustee tax rate, this over-taxation would be exacerbated with a 39% rate.

[7] Note that these figures may also include testamentary trusts, which are trusts established expressly or implicitly by a statement in a will (e.g., when property is left for a minor beneficiary to receive when they reach a particular age).

***Table 4: Trusts and estates with assessable income for the 2020–21 income year***

| | **Trusts (excluding estates)** | | **Estates** | |
|---|---|---|---|---|
| *Trustee income per trust* | *Number of trusts* | *Aggregate amount of trustee income* | *Number of estates* | *Aggregate amount of trustee income* |
| Nil | 40,700 (25%) | Nil (0%) | 2,300 (13%) | Nil (0%) |
| Up to $180,000 | 105,300 (66%) | $2,190m (13%) | 14,700 (85%) | $110m (37%) |
| Over $180,000 | 13,800 (**9%**) | $14,410m (**86%**) | 200 (**1%**) | $190m (**63%**) |
| Total | 159,800 | $16,800m | 17,200 | $300m |

63. We recommend a modification that would allow all income derived by an estate within 12 months of a person's date of death to be taxed at the deceased's marginal tax rate. The modification would provide trustees of estates with an option for mitigating over-taxation for estate income received during this period. Where the 12-month period spans multiple income years, the deceased's marginal tax rate would apply in the income year in which the person died, and the personal tax scale would apply to trustee income received in the income year after the person's death. This is illustrated in the following example.

***Example 2: Modification for estates***

John dies on 20 February 2025. He had received $50,000 of personal income in the income year of his death. His estate receives $10,000 of income before 31 March 2025, and another $10,000 after 31 March 2025 but before 20 February 2026 (i.e., within 12-months of John's date of death).

The affairs of John's estate are still being worked through, so the income received by the estate is considered trustee income for tax purposes. The estate chooses to apply the modification to the income it receives.

The estate's $10,000 of trustee income in the 2024–25 income year is taxed at 30%. The $10,000 received by the estate in the 2025–26 income year is taxed at 10.5% because it was derived within 12-months of John's death. The estate pays total tax of $4,050 on the trustee income.

If the 39% trustee tax rate had applied instead, the estate would have had $7,800 of tax to pay.

65. We understand that many estates are wound up within 12 months of a person's date of death, so allowing the modification to apply for this length of time may be sufficient for many estates. However, without public consultation, it is difficult to determine the appropriate length of time for this modification. If the time period is too long, this modification would create incentives to delay the distribution of assets to the beneficiaries. Engagement with stakeholders once these proposals are made public would help refine how long this modification should apply.

### *Financial implications*

66. Introducing a modification for estates would have an estimated fiscal cost of $5 million per annum for the 2025/26 and later fiscal years.

### *Administration and compliance implications*

67. A modification for estates is not expected to result in a significant increase in compliance costs for estates. It will likely require amending the tax return for estates, communicating the new rules to taxpayers, and assisting estates with queries regarding their tax treatment.

*Other impacts*

68. A modification for estates is unlikely to have a significant economic impact, as it would be available for all estates and is not expected to distort investment decisions.

69. While a modification would create more opportunities for tax planning, the opportunities would be constrained by only allowing the modification to apply for the first 12 months after a person's death. Depending on the marginal rates of the beneficiaries of an estate, the trustees of the estate may be incentivised to delay distributing or allocating funds to the beneficiaries in order to access the marginal rates of the deceased person for the full 12 months.

## Trusts for disabled people

70. We understand that you may have concerns about the potential over-taxation of trusts settled to provide for the care of disabled people ("disability trusts") if the trustee rate is increased to 39%. We expect the needs of a disabled beneficiary can likely be met by trustees paying or allocating income to the person as beneficiary income. Beneficiary income is taxed at the beneficiary's marginal rate rather than the trustee tax rate, so a modification for these trusts should not be necessary. However, it is possible these trusts may face barriers to using existing rules to mitigate over-taxation that we are not aware of, because we have not been able to publicly consult on the potential impacts of the proposed 39% trustee tax rate.

***Existing rules should mitigate over-taxation for disability trusts…***

71. Paying or allocating beneficiary income to an intellectually disabled beneficiary may be undesirable if it means the beneficiary has immediate access to the income. However, this is not solely a tax issue. As a general matter, we expect that beneficiaries with impaired decision-making capacity will have an agent acting on their behalf. In these situations, we expect that allocating income as beneficiary income should sufficiently mitigate over-taxation.

72. If trustees know they will allocate income to a particular beneficiary but do not want the beneficiary to have access to the funds until some time in the future, they have two mechanisms available to them.

*Mechanism 1: Allocate income to the settlor as a beneficiary to access the settlor's rate*

73. The first mechanism involves allocating the income to the settlor in their capacity as a beneficiary of the trust, provided the settlor is still alive and has included themselves as a beneficiary in the trust deed. The income would be taxed at the settlor's marginal rate, and after this the settlor could re-settle the income on the trust. The income would then become part of the corpus of the trust and could be distributed to the beneficiary tax-free at a later date.

74. The tax outcome in this situation is no different to what would occur for families with disabled family members who do not use a trust. The family member who derives personal income would have to pay tax at their marginal rate before using that income to support their disabled family member.

*Mechanism 2: Allocate income to the disabled beneficiary as future possession beneficiary income*

75. The second mechanism involves allocating the income to the disabled beneficiary as future possession beneficiary income. This would enable the income to be taxed at the beneficiary's marginal rate in the year it is derived, but the beneficiary would not be able to call on the money until the future date/event when they become entitled to possession of it.

76. Beneficiary income is considered income for social policy purposes, so allocating income as future possession beneficiary income could affect a disabled beneficiary's social policy entitlements and obligations in the year the income is allocated.

77. If a trustee is concerned about the impact of future possession beneficiary income on a disabled beneficiary's social policy entitlements or obligations, they could use the first mechanism instead if the settlor is still alive.

***… and uptake of a special regime for these trusts in Australia is very low…***

78. Australia has a special regime for disability trusts. The regime was mainly put in place for social policy reasons, although it does provide special tax treatment for disabled beneficiaries of these trusts. Uptake of the Australian regime has been very low – there are only approximately 1,000 special disability trusts in Australia. Given the population of Australia is significantly larger than the population of New Zealand, if a modification for disability trusts were to be introduced in New Zealand and uptake were similar to that of Australia's regime, it is likely that any modification introduced in New Zealand would only be used by a very small number of trusts.

***… similar regimes in place overseas seem to be focused on social assistance …***

79. Although Canada, the UK, and the US have special regimes for these trusts, like Australia these regimes seem to be predominantly focused on providing social assistance rather than tax relief for disabled people. By contrast, the objective of any modification put in place in New Zealand would be to ensure disability trusts are not over-taxed if the trustee tax rate is increased to 39%.

***…and a modification would be difficult to design***

80. A modification for disability trusts would be complex, require drawing boundaries that may seem arbitrary to taxpayers, and could have unintended outcomes. Ideally, any modification for these trusts would be designed with input from the disabled community to ensure the modification has its intended effect.

81. Designing a modification for disability trusts would involve considering various issues, including:

*What rate should apply instead of the trustee tax rate?*

82. To prevent both under- and over-taxation, ideally the beneficiary's marginal rate would apply to any trustee income of a disability trust. This would be relatively straightforward for trusts with only one beneficiary. Determining what rate to apply could be challenging however if a trust has multiple beneficiaries who are each on different marginal tax rates.

83. If disability trusts were allowed to have multiple beneficiaries, it would be much simpler to apply a flat rate to trustee income instead. These trusts are currently taxed at 33%, and the modification could enable this rate to continue to apply. Alternatively, a lower rate such as 10.5% or 17.5% could apply instead, given the purpose of the modification would be to mitigate the over-taxation that could arise with a 39% trustee tax rate for lower-rate disabled beneficiaries.

84. Applying a flat, low rate decreases the likelihood of disabled beneficiaries being over-taxed. However, it would result in under-taxation for disabled beneficiaries on higher marginal rates. A higher, 33% flat rate would ensure the trustee income of disability trusts is taxed at the same level as the status quo, but could result in both under-taxation (for beneficiaries on the 39% personal tax rate) and over-taxation (for beneficiaries on rates below 33%).

*Should disability trusts be allowed to have more than one beneficiary?*

85. The modification would be simpler to administer and comply with if disability trusts were only allowed to have one beneficiary. This is the approach taken in Australia. One disadvantage of this approach is that some existing trusts with multiple disabled beneficiaries would need to restructure or set up new trusts to access the modification.

86. Allowing the modification to apply to trusts with multiple disabled beneficiaries could be feasible if a flat rate applied to trustee income of disability trusts. However, extending the modification to trusts with a mixture of disabled and non-disabled beneficiaries would be very complex, as it would not be clear what portion of trustee income should be subject to the modification and which portion should instead be subject to the regular trust taxation rules. Anti-streaming and tracing rules would be required to ensure that beneficiaries that are not disabled are not under-taxed.

*How should "disability" be defined?*

87. There are risks with defining who the modification should apply to without consulting the disabled community. A simple way to define "disability" would be to link the definition to the receipt of Government support payments (such as the Child Disability Allowance or Supported Living Payment). A key risk of defining "disability" in this way is that disabled people who do not receive those support payments would not be able to access the modification. There are significant risks with creating a bespoke tax definition, especially without public consultation, as Inland Revenue lacks the expertise to both design and apply such a definition.

*Should a clawback apply if a trust ceases to be eligible for the modification after applying it for a period of time?*

88. After tax on trustee income is paid at a disabled beneficiary's marginal rate or a lower flat rate, the trustees may decide to add further non-disabled beneficiaries (or disabled beneficiaries with higher marginal tax rates) to the trust. The trust would no longer qualify for the modification, but trustee income that has previously been taxed at a lower rate because of the modification might still be retained in the trust. If that retained income is then distributed to those new beneficiaries, they would be able to benefit from the modification having applied to tax the trustee income at a rate other than the 39% trustee tax rate. This would be inappropriate if the new beneficiaries are on a higher rate.

89. One option would be to introduce a clawback mechanism, which would apply if trustee income of a disability trust is later distributed to a new beneficiary. If the clawback applies, the trustee income could be taxed again at the recipient's marginal rate, to ensure the income is not undertaxed. This could be harsh, but would be necessary to minimise tax planning opportunities.

### ***Recommended design of modification for disability trusts***

90. While we do not recommend a modification for disability trusts, we have included a table in the appendix that summarises the key design options for a modification in case you decide to introduce a modification in Budget night legislation. The appendix also contains details on the various impacts a modification could have (such as impacts on administration and compliance costs).

### ***Limited data on trusts for disabled people***

91. We have very limited data on the extent to which trusts are used to support disabled people. Since the November report, we have consulted Whaikaha – Ministry of Disabled People, the Public Trust, the Ministry of Justice – Te Tāhū o te Ture, and

the Australian Tax Office, to help us understand how trusts are used to support disabled people.

92. Neither Whaikaha – Ministry of Disabled People nor the Public Trust were able to provide us with data on how many trusts are used to support disabled people in New Zealand. They were also unable to provide information on the extent to which trusts for disabled people retain income as trustee income. The Law Commission's 2012 review of trust law noted that some trusts are established to provide for family members with special needs.[8] However, the Law Commission's papers do not provide data on the number of disability trusts or how they are used.

93. The lack of data on how trusts are used to support disabled people is a risk. Although we expect that trusts for disabled people would be able to mitigate over-taxation by allocating income to beneficiaries, there may be reasons we are not aware of that might prevent these trusts from allocating all their income to disabled people as beneficiary income, or which might make such allocations undesirable.

## Widely-held trusts

94. In this report, "widely-held trusts" refers to trusts with a large number of beneficiaries (e.g., more than 100 beneficiaries). Inland Revenue data shows that there is a large variety in these types of trusts,[9] and that this group includes trusts in large corporate groups, estates, family trusts and employee share schemes. Energy consumer trusts are a type of widely-held trust, however we have considered the potential impacts of a 39% trustee tax rate for energy consumer trusts separately below.

95. Widely-held trusts may have an increased risk of over-taxation because they may face practical limitations (such as difficulties collecting beneficiaries' IRD numbers), and have different behaviours and motivations when compared with family trusts with fewer beneficiaries. As a result, widely-held trusts may also choose to treat all their income as trustee income for simplicity, regardless of the specific circumstances of the individual beneficiaries.

96. Some Māori land trusts will have large numbers of beneficiaries, however we expect these trusts will be eligible to be Māori authorities. Trusts that are Māori authorities are subject to a bespoke tax regime and are taxed at 17.5%. However, as noted below, the lack of engagement with relevant Māori groups limits our understanding of the potential impacts of a 39% trustee rate.

97. While there is a risk of over-taxation for widely-held trusts, we do not recommend providing special rules for trusts solely because they have a large number of beneficiaries. Trustees of a discretionary trust could easily add beneficiaries to the trust simply to satisfy a "widely-held" definition. Generally, we expect that existing mechanisms would be sufficient to address risks of over-taxation for widely-held trusts.

98. Without undertaking public consultation, it is difficult to determine whether there are legitimate risks of over-taxation in this group. We expect affected taxpayers will want to provide feedback on this issue once the proposals are made public.

[8] Law Commission (November 2012) Review of the Law of Trusts: Preferred Approach (lawcom.govt.nz) at [1.21].

[9] There are significant limitations in this analysis. Trusts are not required to disclose details of beneficiaries that do not receive a distribution to Inland Revenue. Therefore, this analysis is based on trusts that are making distributions to beneficiaries and are less likely to be at risk of over-taxation.

## Energy consumer trusts

99. Most electricity distribution companies in New Zealand are owned by trusts or local councils. Energy consumer trusts ("ECTs") hold the shares of energy companies on behalf of electricity consumers, who are the beneficiaries of these trusts. There are 20 ECTs that are subject to tax; ECTs that are registered charities are not covered in this report. The largest ECT, Entrust, has written to Ministers regarding tax issues in recent years.

100. 12 ECTs generally retain all income as trustee income. There is a risk that increasing the trustee rate to 39% would result in many beneficiaries of these trusts being over-taxed if some ECTs continue to retain all their income as trustee income.

101. We recommend applying the 39% trustee rate to these trusts until we can engage with this sector to understand why some ECTs retain all income as trustee income, and to inform further advice on whether special rules should apply. Most income derived by ECTs is beneficiary income and is taxed at the personal tax rates of the beneficiaries. Without external consultation, it is difficult to determine why some ECTs do not allocate income as beneficiary income. We expect that ECTs would be able to allocate income as beneficiary income to mitigate over-taxation of beneficiaries, however this may result in increased compliance costs.

***Table 5: Energy consumer trusts that are subject to tax – 2020–21 income year***

| | Number of ECTs | Beneficiary income | Trustee income |
|---|---|---|---|
| ECTs that allocated some income as beneficiary income | 6 | $167m (87%) | $25m (13%) |
| ECTs that allocated all income as trustee income | 12 | Nil (0%) | $7m (100%) |
| ECTs that reported a loss | 2 | Nil | Nil |
| **Total** | **20** | **$167m (84%)** | **$32m (16%)** |

## Superannuation funds that are taxed as trusts

102. "Superannuation funds" are retirement schemes registered with the Financial Markets Authority ("FMA"). "Widely-held" superannuation funds have more than 100 investors[10] and are taxed at 28% to align with the top PIE rate. Retirement schemes that are not registered with the FMA are generally unit trusts and are taxed as companies. Therefore, widely-held superannuation funds and unregistered retirement schemes are not taxed as trusts and will not be subject to the proposed increase in the trustee rate.

103. Superannuation funds that have less than 100 investors are taxed as trusts and would be subject to a 39% trustee rate. All income derived by these superannuation funds is taxed as trustee income. Under law, these trusts cannot allocate income as beneficiary income, which is the main method of mitigating over-taxation for other trusts. The FMA has estimated that there are 275 of these funds. 239 are "Schedule 3" single-person schemes. 211 of the single-person schemes were set up by judges, coroners, and Members of Parliament.

[10] When treating associated persons as one person.

***Table 6: Number of superannuation funds by type as at 31 March 2022***

| Type of superannuation fund | Number of funds |
|---|---|
| Market retail superannuation schemes with <100 members | 2 |
| Restricted workplace savings schemes with <100 members | 34 |
| Schedule 3 (single person) schemes | 239 |

104. In the 2020–21 income year, approximately 40% of these superannuation funds (118 out of 275) reported positive income of $18m in aggregate (all trustee income).

105. Although these trusts cannot access the main method of mitigating over-taxation, we recommend continuing to tax them at the trustee tax rate for two key reasons:

- At least 211 of these funds are likely to have 39% rate beneficiaries. Introducing a modification for these trusts risks providing a tax advantage to a small group of taxpayers and could be considered particularly unfair to other taxpayers.
- A modification would reduce the overall coherence of the trust tax regime.

106. [33]

## Other issues

### *Impact of increased allocations of beneficiary income*

107. A 39% trustee tax rate is likely to result in trusts allocating increased amounts of income as beneficiary income than is currently the case.

*Trusts used for non-tax reasons*

108. In 2012, the Law Commission found that trusts appear to be established for a variety of reasons, including to protect personal assets from business risks and creditors; for traditional estate planning (e.g., to keep a farm within a family for successive generations); to protect assets from relationship property claims; for the efficient operation of a business (e.g., to share proceeds with family members who have no control over the business); to provide for family members with special needs; for investment schemes and innovative commercial arrangements; and to provide for philanthropic or charitable activities.[11]

109. An allocation of beneficiary income does not affect the underlying assets held by a trust. However, depending on why a taxpayer has settled a trust, having to allocate income as beneficiary income to prevent the 39% rate applying could undermine the non-tax reasons for which a trust was settled (such as for protection against creditors and/or relationship property claims). These taxpayers will have to make trade-offs between allocating income as beneficiary income to ensure a beneficiary's (lower) marginal tax rate applies, or retaining income in the trust so that it is protected from creditors/relationship property claims but having that income taxed at the 39% trustee tax rate.

110. Taxpayers who decide to prioritise protecting trust income against creditors/relationship property claims are likely to consider it unfair that trustee

[11] Law Commission (November 2012) Review of the Law of Trusts: Preferred Approach (lawcom.govt.nz) from [1.20] to [1.22].

income is taxed at the 39% trustee tax rate if the trust only has lower-rate settlor(s) and beneficiaries. However, it is not the task of the tax system to ensure that trust structures adopted to protect assets from creditors or relationship property claims are as tax-efficient as possible.

*Social policy implications*

111. As mentioned above in relation to trusts for disabled people, beneficiary income that is allocated to a person impacts upon their social policy entitlements and obligations (such as Working for Families, Child Support, or main benefits administered by the Ministry of Social Development – Te Manatū Whakahiato Ora), regardless of whether the income is actually paid to them in the current year. If a beneficiary can access beneficiary income in the current year (for example, where trustees have allocated beneficiary income to the beneficiary's current account), then the beneficiary can call upon those funds to offset any impact the allocation has had on their social policy entitlements or obligations.

112. We considered whether it would be appropriate to exclude future possession beneficiary income when calculating a beneficiary's social policy entitlements or obligations in the year the income is allocated to the beneficiary, and instead to only include that income for social policy purposes once the beneficiary has access to the income. However, excluding the income in the year of allocation would create opportunities for taxpayers to use allocations of future possession beneficiary income to take advantage of a beneficiary's lower marginal tax rate in the year of allocation, while also maximising the beneficiary's social policy entitlements (or minimising any social policy obligations) for that year.

113. For example, income could be allocated as future possession beneficiary income so that it is taxed at the beneficiary's lower rate while they are working part-time and caring for children. The trustees could resolve that the beneficiary only becomes entitled to possess the income once their children have all turned 18 and finished school, so that the allocation does not impact upon the beneficiary's Working for Families entitlements.

114. We would not recommend excluding future possession beneficiary income from social policy calculations in the year of allocation because of the avoidance opportunities a carve-out would create. We also do not consider a carve-out necessary because of the duties that apply to trustees under the Trusts Act 2019 and the established social policy principles regarding using one's own resources before calling on the State:

- Trustees are legally required to act for the benefit of the beneficiaries of a trust and have a general duty of care. If an allocation of future possession beneficiary income would reduce a beneficiary's social policy entitlements, or result in the beneficiary having greater social policy obligations, the trustees should take this into account when deciding how much beneficiary income to allocate. They should also take the beneficiary's social policy payments/obligations into account when deciding whether funds should be available to the beneficiary immediately or sometime in the future.

- A guiding social policy principle is that people are expected to utilise their own resources before calling on the State. If resources in a trust are available to a person and have been allocated to that person, these resources should be used to support the person before they call on Government support. There are existing provisions in the Social Security Act 2018[12] that allow income and assets to be taken into account when determining whether a person

[12] For example, the Social Security Act 2018 provides that the Ministry of Social Development may refuse to grant a benefit, cancel a benefit, or reduce a benefit if it is satisfied that a person has directly or indirectly deprived themselves of income and/or property, and the deprivation has resulted in the applicant qualifying for that benefit, any other benefit, or an increased rate of benefit.

should be entitled to means-tested Government support, to ensure people cannot deliberately deprive themselves of income or property in order to qualify for Government support.

### *Māori perspectives*

115. 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%. As noted in our November 2022 report, we would expect that most trusts used by Māori for communal ownership purposes would be eligible to be taxed as Māori authorities.

116. We have undertaken limited consultation with Te Tumu Paeroa – The Office of the Māori Trustee regarding the reasons why a trust may choose not to elect to be a Māori authority. Very few trusts handled by Te Tumu Paeroa are not Māori authorities. Due to the Budget sensitive nature of this project, we have been unable to engage with relevant Māori groups on the potential impacts of a 39% trustee rate. This has limited our understanding of the potential impact of the proposals on broader considerations of wellbeing beyond the use of trust structures by Māori.

### *Trust disclosure rules*

117. Increased trust disclosure requirements were introduced for the 2021–22 and later income years to help evaluate the effectiveness of the 39% top personal tax rate and gain insight into the use of structures and entities by trustees. Stakeholders may raise concerns that the disclosure information was not available in time to influence the proposal to align the trustee rate with the top personal rate. However, we do not recommend progressing changes to the disclosure requirements as part of this project. We anticipate that the disclosures will provide new insights about trust behaviour which will inform future compliance and policy decisions.

118. A post-implementation review of the disclosure requirements is scheduled to take place in 2023, once a full year of data has been disclosed. This review will evaluate whether the disclosures are achieving the policy objectives and whether legislative and/or operational changes can be made to improve future disclosures and reduce compliance costs. Progressing changes to the rules before this review has been completed, or without public consultation, risks undermining the policy intent of the rules.

### *Minor beneficiary rule*

119. 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, is subject to tax at the trustee tax rate. This is an integrity measure to prevent parents, other relatives, or guardians from splitting their income with children. A 39% trustee tax rate would increase the incentive for trustees to allocate amounts to beneficiaries on lower incomes, particularly children 16 years old or older.

120. We do not recommend making changes to the minor beneficiary rule at this stage because we have not had sufficient time to fully consider the issues, including whether there are any human rights implications (e.g., in relation to age discrimination). Consideration of changes to the minor beneficiary rule would benefit from public consultation. A review of the minor beneficiary rule could be considered for inclusion on the Government's Tax and Social Policy Work Programme to determine whether the rule is fit for purpose in the context of a 39% trustee tax rate.

### *Non-complying trusts*

121. Non-complying trusts are trusts that are neither complying nor foreign trusts.[13] Typically, this class covers trusts with New Zealand resident settlors and non-resident trustees where New Zealand tax has not been paid on all worldwide income of the trust. New Zealand resident settlors are liable to pay this as agents of the trustees.

122. A distribution from a non-complying trust is a taxable distribution if it is not beneficiary income and not part of the corpus of the trust. A taxable distribution is generally made up of accumulated income or capital gain amounts. Taxable distributions from non-complying distributions to New Zealand resident beneficiaries are taxed at 45%.[14]

123. The higher 45% rate, and the inclusion of distributions of capital profits or gains within the taxable distribution definition, is because New Zealand income tax has been avoided or deferred through the use of trusts which are now classified as non-complying trusts. The 45% rate is based on the 33% trustee rate with a time value of money calculation factored in, to recognise the deferral of New Zealand tax between when the income was originally derived and subsequently distributed.

124. Increasing the trustee rate to 39% will erode the time value of money factor of the 45% rate. Despite this, we do not recommend increasing the tax rate on taxable distributions from non-complying trusts, as the rate is already relatively high and other 45% tax rates were not increased when the 39% top personal tax rate was introduced.

### *Provisional tax*

125. Provisional tax for a year is paid in three instalments. Under the standard option, provisional tax is calculated based on the taxpayer's prior year's residual income tax plus 5% or 10% where the taxpayer has an extension of time to file their prior year's tax return (and has not yet filed it).

126. The use of money interest regime incentivises taxpayers to pay their entire residual income tax for the year by the final provisional tax instalment, as after that date interest will accrue on any difference between the amount paid and the taxpayer's residual income tax liability. Therefore, practically, taxpayers will pay the total tax owing on the final instalment date.

127. For the first two years of the proposed 39% trustee rate, the standard option will be based on the tax liability under a 33% trustee rate and may underestimate the amount of tax that trusts need to pay. This may result in trusts underpaying tax in their first two instalments, and having a higher catch-up third instalment.

128. We do not recommend making any changes to provisional tax rules. Providing special rules to address this transitional issue would be complex and extremely difficult to implement. Provisional tax rules were not amended when the top personal rate of 39% was introduced. Given that taxpayers are already incentivised to pay their liability at the final instalment, this issue is a small timing difference overall.

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[13] "Complying trusts" are trusts where New Zealand tax has always been paid on the worldwide trustee income of a trust settled by a New Zealand resident. "Foreign trusts" are trusts that have not had a New Zealand resident settlor at any time since 17 December 1987.

[14] Only New Zealand-sourced distributions from non-complying trusts are taxed at 45% to non-resident beneficiaries.

### *Resident withholding tax on dividends*

129. Resident withholding tax ("RWT") is deducted at 33% from dividends by the payer before the recipient receives the dividend. RWT is intended to help taxpayers that receive investment income pay their tax throughout the year. We do not recommend increasing the RWT rate on dividends. Although a significant proportion of income derived by trusts is dividend income, such a change would affect many recipients of dividends that are not subject to a 39% rate.

## Financial implications

130. Increasing the trustee rate to 39% for the 2024–25 and later income years (beginning 1 April 2024 for most trusts) is estimated to raise $350 million per annum ($1,045 million over the forecast period). However, this estimate is highly uncertain and heavily dependent on the behavioural response by trusts. The timing lag relates to information flows: the first year of affected tax returns need to be filed before the additional income tax is recognised, and the second year is simultaneously accrued on the basis of that new information. An exception is provisional taxpayers already using estimation, for whom there will be an impact within the 2024/25 fiscal year. Many trusts are not currently provisional taxpayers as much of their income is in the form of fully imputed dividends.

131. Providing a modification for estates is expected to have a fiscal cost of $5 million per annum for the 2025/26 and later fiscal years.

***Table 7: Impact of the proposals on tax revenue and the operating allowance***

| | $m – increase/(decrease) | | | | | |
|---|---|---|---|---|---|---|
| **Vote Revenue** | 2022/23 | 2023/24 | 2024/25 | 2025/26 | 2026/27 and outyears | Total over forecast period |
| Crown Revenue and Receipts:<br>Tax Revenue | | | | | | |
| *39% trustee rate* | - | - | 10.000 | 685.000 | 350.000 | 1,045.000 |
| *Estates modification* | - | - | - | (5.000) | (5.000) | (10.000) |
| **Total Revenue** | **-** | **-** | **10.000** | **680.000** | **345.000** | **1,035.000** |
| **Total Operating** | **-** | **-** | **(10.000)** | **(680.000)** | **(345.000)** | **(1,035.000)** |

132. Inland Revenue, with the Treasury, are finalising the accounting treatment for the timing of this revenue.

## Administrative implications

133. Implementation and ongoing administrative costs are estimated to be between $5.000 million and $11.000 million over the forecast period (2022/23 to 2026/27). This estimate will be refined when final policy design decisions have been made.

134. At the upper-end of the cost range, over the forecast period, the estimated one-off capital build costs are $2.900 million, the one-off operating build costs are $0.700 million, and the ongoing administrative costs are $7.400 million.

*Table 8: Implementation and ongoing administration costs*

| | $m – increase/(decrease) | | | | | |
|---|---|---|---|---|---|---|
| **Vote Revenue** | 2022/23 | 2023/24 | 2024/25 | 2025/26 | 2026/27 and outyears | Total over forecast period |
| One-off build costs | - | 0.700 | - | - | - | 0.700 |
| Ongoing admin costs | - | 0.800 | 3.400 | 2.700 | 0.500 | 7.400 |
| **Total Operating** | **-** | **1.500** | **3.400** | **2.700** | **0.500** | **8.100** |
| Capital Expenditure | - | 2.900 | - | - | - | 2.900 |
| **Total Capital** | **-** | **2.900** | **-** | **-** | **-** | **2.900** |
| **Total** | **-** | **4.400** | **3.400** | **2.700** | **0.500** | **11.000** |

135. The operating costs for this initiative include additional resource capacity, one-off implementation costs, depreciation, and capital charge. The resource impact of this initiative is 6 FTEs in 2023/24, 25 FTEs in 2024/25 and 19 FTEs in 2025/26. This predominantly relates to responding to customer queries (both about the changes and around the auto-calculation period), enquiries from tax agents, and compliance activity for return filing and non-compliant trusts. From 2026/27 these activities will reduce and be absorbed within business-as-usual activities, with no additional funding required.

136. Inland Revenue is reviewing the overall impact of possible Budget 2023 initiatives, including this proposal. Inland Revenue, with the Treasury, will report back to you in mid-March on the potential for Inland Revenue to self-fund the capital and/or operating impacts of this initiative and other Budget 2023 initiatives. The level of any self-funding will be dependent on the total financial, resource and capacity impacts of all proposed initiatives. The report back will also identify any new Budget 2023 funding required for all the initiatives in any package.

### Capacity constraints

137. During the week of 13 February 2023, Inland Revenue discussed with Ministers its capacity constraints to deliver the Government's current Tax and Social Policy Work Programme and the work we are undertaking to reduce these constraints. As noted above, we intend to report to Ministers on this in mid-March.

## Consultation

138. We have consulted the Financial Markets Authority – Te Mana Tātai Hokohoko, the Public Trust of New Zealand, Te Tumu Paeroa – The Office of the Māori Trustee, Whaikaha – Ministry of Disabled People, the Ministry of Justice – Te Tāhū o te Ture, and the Australian Tax Office. The objective of this consultation was to understand how trusts are currently used, to help us identify whether modifications to a 39% trustee rate might be required to mitigate over-taxation. Due to the Budget sensitive nature of this work, we did not explicitly seek input on the proposals in this report.

139. The Department of the Prime Minister and Cabinet has been informed of this report.

## Next steps

140. Following your decisions on this report, we will provide you with a draft Cabinet paper. The Cabinet paper would need to be lodged with the Cabinet Office before

10:00am on Thursday 23 March 2023 for consideration by the Cabinet Economic Development Committee on Wednesday 29 March 2023.

141. In mid-March, we will report to you regarding the funding for the capital and operation impacts, as well as on the legislative process for these proposals and other potential Budget measures. Legislation for these proposals could be included in a bill to be introduced at Budget 2023, to be enacted before 1 April 2024 (the commencement date). Due to the technical nature of trusts and their taxation, we consider it would be highly beneficial for these measures to go through a full select committee process.

## Appendix: Modification for disability trusts

142. We do not recommend a modification for disability trusts without first undertaking public consultation. However, this appendix sets out how a modification could be designed in case Ministers would like to include a modification in the Budget Bill. It also considers the various impacts a modification could have.

### *Recommended design features*

143. The below table sets out the recommended design features, and alternative design options, for a modification for disability trusts.

***Table 9: Key design features – modification for disability trusts***

| Design feature | Recommended design | Alternative design options |
|---|---|---|
| Applicable rate | The disabled beneficiary's marginal rate. | Flat rate – 10.5%, 17.5% or 33%. |
| Number of beneficiaries | Only allow one – the disabled beneficiary. | Allow multiple beneficiaries (but all must be disabled). |
| Definition of "disability" | Link to receipt of Government support – the Child Disability Allowance, or the Supported Living Payment on the grounds of restricted work capacity. | N/A |
| Clawback mechanism | Applies if a new beneficiary ("the recipient") is added and receives tax-paid trustee income that was taxed below 39%. Distributions of trustee income are taxed at the recipient's rate. | N/A |
| Other features | No restrictions on:<br>• the number of disability trusts that can be set up for a disabled person,<br>• who can settle property on a disability trust,<br>• what property can be settled, or<br>• whether a trust is *inter vivos* or testamentary. | N/A |

### *Impacts of a modification*

144. **Administration and compliance costs:** A modification would result in additional compliance costs for trusts that choose to apply the modification, especially if some trusts have to restructure to access it. The modification would also result in additional administrative costs for Inland Revenue, although the extent of these costs depends on the ultimate design of the modification.

145. **Revenue and economic impacts:** Disability trusts may pay less tax on trustee income than the status quo, but given the modification would provide for an outcome that is already achievable under current law (if income is allocated as beneficiary income), the fiscal impact is likely to be negligible. For the same reason, a modification is expected to have negligible economic impacts.

146. **Sustainability of the tax system:** If a clawback mechanism applies, opportunities for tax avoidance and arbitrage should be minimised, however this would need to be monitored.