The Treasury

Budget 2023 Tax Initiatives Information Release

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Tax policy report: **Draft Cabinet paper – Increasing the trustee tax rate to 39%**

Date:	23 March 2023	**Priority:**	High
Security level:		**Report number:**	IR2023/098 T2023/443

Action sought

	Action sought	**Deadline**
Minister of Finance	**Agree** to recommendations **Authorise** lodgement of the attached paper to the Cabinet Office	3 April 2023 10 am Wednesday 5 April 2023
Minister of Revenue	**Agree** to recommendations **Authorise** lodgement of the attached paper to the Cabinet Office	3 April 2023 10 am Wednesday 5 April 2023

Contact for telephone discussion (if required)

Name	**Position**	**Telephone**
Stephen Bond	Manager – Tax Strategy, The Treasury	[39]
Chris Gillion	Policy Lead, Inland Revenue	

23 March 2023

Minister of Finance
Minister of Revenue

Draft Cabinet paper – Increasing the trustee rate to 39%

1. You have agreed to increase the trustee rate to 39% from the 2024–25 and later income years, with some modifications (IR2023/058; T2023/269 refers).

2. This report provides a draft Cabinet paper for lodgement with the Cabinet Office by 10 am Wednesday 4 April so that it may be considered by Cabinet at its meeting on Tuesday 11 April.

3. The attached paper seeks Cabinet's agreement to the following recommendations.

   3.1 Increasing the trustee tax rate to 39% for the 2024–25 and later income years (beginning 1 April 2024 for most trusts).

   3.2 Applying special rules where beneficiary income is paid or allocated to a corporate beneficiary in certain circumstances.

   3.3 Providing a modification for estates for the first 12 months after a person's death.

   3.4 Including a modification for disability trusts, which would allow trustee income of an eligible trust to be taxed at the marginal tax rate of the trust's disabled beneficiary.

4. Statistics further illustrating how trustee income is unevenly distributed is included in Appendix One.

5. Examples illustrating how existing rules can be used to mitigate over-taxation, as well as the modification for disability trusts, are included in the Appendix Two.

Key features of the proposed modification for disability trusts

6. To qualify for the modification for disability trusts, all of the following requirements would need to be satisfied by a trust:

   6.1 The trust must have only one beneficiary (although "residual beneficiaries", who would only receive trust property once the disabled beneficiary has passed away, would be allowed).

   6.2 The beneficiary must receive either the Supported Living Payment (on the ground of restricted work capacity), or be a child for whom the Child Disability Allowance is paid.

7. There would be no restrictions on the number of trusts that can be settled for a disabled person; who can settle property on these trusts; or on what property can be settled.

8. If a trust is wound up while a disabled beneficiary is still alive, any remaining trust property would be required to go to the disabled beneficiary, not to the residual beneficiaries of the trust.

9. In the February report, we considered that a clawback should apply in certain circumstances to prevent the modification providing inappropriate tax advantages to beneficiaries who are not disabled. After further consideration we do not think a

clawback is needed. The requirement that these trusts only have one beneficiary should be sufficient to restrict the application of the modification to trusts with a disabled beneficiary. Furthermore, to ensure this requirement is adhered to, the rules for this modification would specify that the deed of a disability trust must not allow any additional beneficiaries (aside from residual beneficiaries) to be added to the trust. If through consultation as part of the select committee process it becomes apparent that additional safeguards are needed, these could be included in the legislation at a later stage.

Minor clarifying amendment

10. We recommend including in the proposals a minor technical amendment to clarify that amounts allocated as beneficiary income and then settled on a sub-trust for future possession by the beneficiary are included in the corpus of the sub-trust. This ensures that such amounts are not subject to tax twice and can be distributed tax-free from the sub-trust.

11. The proposed amendment is consistent with the policy intent of the rules for corpus and has no financial implications.

Financial implications

12. Since reporting to you in February, we have revised the fiscal estimate for the proposals. 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 approximately $350 million per annum ($1,133 million over the forecast period). This is higher than our earlier estimate of $1,045 million over the forecast period to take into account how tax revenue is recognised.

13. However, this estimate remains 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 needs to be filed before the additional income tax is recognised, and the second tax year and part of the third tax year is simultaneously accrued on the basis of that new information.

14. 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. The modification for trusts for disabled people has no fiscal impact.

	$ million – increase/(decrease)					
Vote Revenue	2022/23	2023/24	2024/25	2025/26	2026/27 & outyears	Total
Crown revenue and receipts:						
Tax revenue						
39% trustee rate	-	-	13.000	770.000	350.000	1,133.000
Estates modification	-	-	-	(5.000)	(5.000)	(10.000)
Total revenue	**-**	**-**	**13.000**	**765.000**	**345.000**	**1,123.000**
Total operating	**-**	**-**	**(13.000)**	**(765.000)**	**(345.000)**	**(1,123.000)**

15. Increasing the trustee rate will have a consequential impact of $4.300 million on the impairment of debt and debt write-offs expenditure with a corresponding increase on the operating balance and net debt.

	$ million – increase/(decrease)					
Vote Revenue	2022/23	2023/24	2024/25	2025/26	2026/27 & outyears	Total
Non-departmental other expenses:						
Impairment of debt and debt write-offs	-	-	0.100	2.900	1.300	4.300
Total operating	**-**	**-**	**0.100**	**2.900**	**1.300**	**4.300**

Administrative implications

16. 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 for all Budget 2023 initiatives that impact upon Vote Revenue.

17. 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, the ongoing administrative costs are $5.400 million, and depreciation and capital charge is $2.000 million.

	$ million – increase/(decrease)					
Vote Revenue	2022/23	2023/24	2024/25	2025/26	2026/27 & outyears	Total
One-off build costs	-	0.700	-	-	-	0.700
Ongoing admin costs	-	0.600	2.700	2.100	-	5.400
Depreciation and capital charge	-	0.200	0.600	0.600	0.600	2.000
Total operating	**-**	**1.500**	**3.300**	**2.700**	**0.600**	**8.100**
Capital build costs	-	2.900	-	-	-	2.900
Total capital	**-**	**2.900**	**-**	**-**	**-**	**2.900**
Total	**-**	**4.400**	**3.300**	**2.700**	**0.600**	**11.000**
Administrative FTEs	-	6	25	19	-	-

18. 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 six 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. The ongoing funding impact from 2026/27 is for depreciation and capital charge.

19. We have provided a separate report on the mix of Crown funding and Vote Revenue self-funding for this initiative and all initiatives that impact Vote Revenue in Budget 2023 (IR2023/096 refers). This separate report provides a consolidated view of the revenue, expenditure, resource and capacity impacts for the existing tax and social policy work programmes, Budget 2023 initiatives, and international tax initiatives that impact Vote Revenue.

Next steps

20. A regulatory impact statement will be provided to you separately before lodgement of the Cabinet paper.

21. The Cabinet paper needs to be lodged with the Cabinet Office by 10 am Wednesday 4 April so that it may be considered by Cabinet at its meeting on Tuesday 11 April.

Recommended action

We recommend that you:

a) **agree** that no clawback should apply to distributions made by a disability trust that has ceased to qualify for the disability trust modification;

Agreed/Not agreed Agreed/Not agreed

b) **agree** to a minor technical amendment to clarify the rules regarding corpus and settlements on other trusts;

Agreed/Not agreed Agreed/Not agreed

c) **note** the estimated additional tax revenue from this initiative is $1,123.000 million over the forecast period (2022/23 to 2026/27);

Noted Noted

d) **note** that this initiative will have an estimated consequential impact of $4.300 million on impairment of debt and debt write-offs expenditure, resulting from the additional tax revenue;

Noted Noted

e) **note** at the upper end of the cost range, over the forecast period, the estimated cost of this initiative is $11.000 million, including one-off capital build costs of $2.900 million, one-off operating build costs of $0.700 million, ongoing administrative costs of $5.400 million, and depreciation and capital charge of $2.000 million;

Noted Noted

f) **note** that Inland Revenue has provided a separate report on the mix of Crown funding and Vote Revenue self-funding for this initiative and all initiatives that impact Vote Revenue in Budget 2023 (IR2023/096 refers);

Noted Noted

g) **authorise** the lodgement of the attached paper with the Cabinet Office by 10 am Wednesday 4 April 2023 for Cabinet to consider at its meeting on Tuesday 11 April 2023.

Authorised/Not authorised Authorised/Not authorised

Stephen Bond
Manager – Tax Strategy
The Treasury

Chris Gillion
Policy Lead
Policy and Regulatory Stewardship

Hon Grant Robertson
Minister of Finance
/ /2023

Hon David Parker
Minister of Revenue
/ /2023

Appendix One – statistics

22. Since reporting to you in February 2023, we have further analysed ways to illustrate how trustee income is distributed unevenly. Unless otherwise stated, all of the following statistics relate to trusts that derived assessable income in the 2021 financial year.

Trustee income is concentrated in a small number of trusts

23. The **top 1%** of trusts in terms of trustee income (1,800 out of 177,000) accounted for **49% of trustee income** ($8.4 billion out of $17.1 billion).

24. The **top 5%** of trusts in terms of trustee income (9,000) accounted for **78% of trustee income** ($13.3 billion)

25. This does not mean that all this income is under-taxed, as this does not take into account the number of settlors or beneficiaries of these trusts, but it is an indication of a significant amount of under-taxation.

26. Most of the largest trusts, in terms of trustee income, are linked with high wealth individuals (based on Inland Revenue's existing HWI information, not the HWI research project population).

Most trusts have relatively small amounts of trustee income

27. The **lower 75%** of trusts in terms of trustee income (133,000 out of 177,000) accounted for only **2.5% of trustee income** ($0.4 billion out of $17.1 billion).

28. This includes the **lower 24%** of trusts (43,000) that had **no trustee income** (i.e., only had beneficiary income) and would therefore not be affected by an increase in the trustee rate.

29. Similarly, this does not mean that all of these trusts would be over-taxed as this does not take into account the number of settlors or beneficiaries of these trusts.

Trusts with assessable income in the 2021 financial year

Percentiles based on trustee income	Number of trusts	Aggregate trustee income
Lower 24%	43,000 (24%)	Nil
Lower 50%	89,000 (50%)	$30m (0.2%)
Lower 75%	**133,000 (75%)**	**$400m (2.5%)**
Lower 90%	160,000 (90%)	$1,900m (11%)
Lower 95%	169,000 (95%)	$3,800m (22%)
Top 5%	**9,000 (5%)**	**$13,300m (78%)**
Top 2%	3,500 (2%)	$10,500m (61%)
Top 1%	1,800 (1%)	$8,400m (49%)
Total	177,000 (100%)	$17,100m (100%)

Trustee income reported by trusts with assessable income

	FY2020				**FY2021**			
Trustee income per trust	*Number of trusts*	*Aggregate trustee income*	*Median trustee income per trust (excl. trusts with nil trustee income)*	*Mean trustee income per trust (excl. trusts with nil trustee income)*	*Number of trusts*	*Aggregate trustee income*	*Median trustee income per trust (excl. trusts with nil trustee income)*	*Mean trustee income per trust (excl. trusts with nil trustee income)*
Nil	47,000 (27%)	Nil	n/a	n/a	43,000 (24%)	Nil	Nil	n/a
Up to $180,000	123,500 (66%)	$2,500m (22%)	$6,000	$20,000	120,000 (68%)	$2,500m (14%)	$5,000	$21,000
Over $180,000	11,500 (6%)	$8,900m (78%)	$386,000	$778,000	**14,000 (8%)**	**$14,600m (86%)**	$430,000	$1,017,000
Total	182,000	$11,400m	$7,000	$85,000	177,000	$17,100m	**$8,000**	**$128,000**

30. This table has been updated to include the median and mean trustee income per trust. In the 2021 financial year, for trusts with some trustee income, the mean trustee income was $128,000 but the **median trustee income** was only **$8,000**.

31. This further illustrates that across the population of trusts, most trusts have relatively small amounts of trustee income. The distribution of trustee income (and the mean trustee income) is skewed by the large amounts derived by a small proportion of trusts.

Appendix Two – modification examples

32. This appendix includes two examples. The first illustrates how existing rules can be used to mitigate over-taxation. The second illustrates how the proposed modification for disability trusts would apply in practice.

Example 1: Using existing rules to mitigate over-taxation

John's family trust has $100,000 of income in the 2024–25 income year. John knows that he wants the trust's income to be split equally – and eventually go to – his two children, Millie and Harold. By allocating the income to Millie and Harold as beneficiary income, John can ensure the income is taxed at their personal tax rates in the year the income is derived.

John has a number of options open to him.

Option 1: Paying income to, or on behalf of, the beneficiaries

John's first option is to pay the income to, or on behalf of, Millie and Harold. Millie and Harold are both undertaking tertiary study, so John applies the money on their behalf: he pays $40,000 for accommodation for them both, along with another $20,000 for their tuition and course-related costs.

After John pays for accommodation, tuition, and course fees for Millie and Harold, there is $40,000 of trust income remaining. John is certain that Millie and Harold will exercise good judgement, so he decides to transfer the $40,000 to their bank accounts.

Option 2: Allocating income to the beneficiaries' current accounts

John's second option is to allocate the income to Millie and Harold's beneficiary current accounts. If he does this, the income will still be taxed at Millie's and Harold's personal tax rates even though it hasn't actually been paid to them. If Millie and Harold want to access the beneficiary income that has been allocated to them, they are legally able to call on it at any time.

Option 3: Allocating income to the beneficiaries for them to possess at a future date or event

John's third option is to allocate the income to Millie and Harold for them to possess once a future date or event takes place.

John decides to spend the $60,000 referred to in option 1 above on their accommodation, tuition, and course-related fees. However, he doesn't want to allocate or pay the remaining $40,000 to Millie or Harold for the current year, because he's worried they'll spend it on holidays or fancy new electronic gadgets. So, he decides to allocate them $20,000 each for them to possess once they reach 25 years of age.

In order for John's allocation for future possession to be valid, and recognised as beneficiary income, the allocation must be unconditional. This means:

- If the income is allocated to Millie and Harold to possess **only if** they reach 25 years of age, the income would not be considered beneficiary income because the allocation is conditional on Millie and Harold reaching that age. If they do not reach that age, the income reverts back to the trust – it does not go to their estates.
- If, on the other hand, the income is allocated to Harold and Millie to possess **when** they reach 25 years of age, **or to their estates** if they die before reaching that age, the allocation is considered beneficiary income. If they die before reaching 25 years of age, the income does not revert back to the trust – instead, it goes to their estates.

If John makes the allocation in the manner described by the second bullet point above, the allocation would result in the trustees creating a sub-trust for each of Millie and Harold, which would administer the $20,000 prior to their each attaining the age of 25. The $20,000 might remain co-invested with the head trust, but any resulting income from the $20,000 would be allocated to the relevant sub-trust. Alternatively, the sub-trusts could invest the $20,000 separately from the investments of the head trust. The corpus of the sub-trusts and any further income derived from that corpus would no longer be included in the head trust.

Example 2: Modification for disability trusts

Matilda has significant intellectual and physical disabilities, as a result of which her capacity to work is severely restricted. She doesn't work, so her only income is the supported living payment, which she receives on the ground of restricted work capacity.

Matilda's parents currently look after her, but are both retired now and want to ensure Matilda will continue to receive a similar level of care once they have passed away. Her parents decide to settle two rental properties on a disability trust for Matilda. They arrange for Matilda's siblings, their lawyer, and their accountant to be trustees of the trust. Matilda is the only beneficiary of the trust. The trust satisfies the requirements of the disability trust modification for the 2024–25 income year.

The trust derives $50,000 of rental income in the 2024–25 income year. The entire amount is retained in the trust and taxed as trustee income, but at Matilda's marginal tax rate rather than the 39% trustee tax rate. A combination of the 17.5% and 30% tax rates apply to the trustee income (this is because Matilda receives the supported living payment, which is taxed at a combination of the 10.5% and 17.5% personal rates). The average tax rate that applies to the trustee income is therefore 23%, so the total amount of tax payable by the trustees on the income is $11,334.

While Matilda's marginal tax rate is used to calculate the amount of tax owing on the trustee income, the obligation to return and pay tax on the trustee income lies with the trustees of the trust. When the trustee income is later distributed to Matilda, no further tax will be payable.

If the 39% trustee tax rate had applied instead, $19,500 of tax would have been payable on the trustee income (an extra $8,167).

<u>Trust is wound up upon Matilda's death</u>

In 2040, Matilda passes away. The trust names Matilda's siblings as residual beneficiaries of the trust, so when the trust is wound up upon Matilda's death, any remaining property in the trust is distributed to her siblings.

No further tax is payable on any tax-paid trustee income remaining in the trust at that time, even though it was taxed at Matilda's marginal tax rates when it was derived.

Any other income derived between Matilda's date of death and the date the trust is wound up is distributed to her siblings, the residual beneficiaries, as beneficiary income. This income is taxed at her siblings' marginal tax rates.