# Regulatory Impact Statement: The Taxation of Trustee Income

## Coversheet

| Purpose | |
|---|---|
| Decision sought: | Agreement to increase the trustee tax rate to 39%. |
| Advising agencies: | Inland Revenue |
| Proposing Ministers: | Minister of Finance<br>Minister of Revenue |
| Date finalised: | 3 April 2023 |

| Problem Definition |
|---|
| The ability to raise more revenue from the personal tax base is significantly constrained because of misalignment between the 39% top personal tax rate and the 33% trustee tax rate. This misalignment allows the top personal tax rate to be circumvented and reduces the progressivity of the income tax system. |

### Executive Summary

***Rate misalignment constrains the ability to raise revenue from personal taxes***

Taxpayers can circumvent the top personal tax rate of 39% by retaining income in a trust as trustee income. This is because once income has been taxed as trustee income at 33%, distribution of that income to the beneficiaries of the trust is tax free. That is, trustee income is subject to a final tax of 33% imposed in the year the income is derived by a trust.

Misalignment between the 33% trustee tax rate and the 39% personal tax rate constrains the Government's ability to raise revenue from personal taxes. This is because having lower tax rates on income earned through certain structures, such as trusts, means those earning income through these lower-tax structures will not be affected by any increase in personal tax rates. This results in under-taxation and reduces both the progressivity and fairness of the tax system.

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

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

Increasing the trustee tax rate to 39% would raise revenue for Budget 2023 and can be designed and implemented by Inland Revenue for the 2024–25 and later income years (beginning 1 April 2024 for most trusts). This approach is expected to raise $350 million per annum. However, this is highly uncertain and largely dependent on the extent of the behavioural response of trustees.

Even if the trustee tax 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 portfolio investment entities ("PIEs"). However, trusts are a completely different legal structure and they are not complete substitutes for PIEs or companies. For example, some trusts have investments (such as businesses controlled by settlors or beneficiaries, like farms and small-to-medium enterprises) that could not be put into PIEs. Furthermore, trusts have certain tax advantages that companies do not, such as being able to distribute capital gains immediately to beneficiaries tax free and to stream distributions to different beneficiaries.

This reduced level of substitutability means changes to the trust taxation rules are likely to be worthwhile, even if no changes are made to the taxation of companies or PIEs. Issues relating to the taxation of companies/shareholders and PIEs are outside the scope of this RIS.

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

Some trusts with settlors and beneficiaries on lower tax rates could be over-taxed if the trustee tax rate is increased to 39%. Existing rules can mitigate this as they allow income of a trust to be taxed at a beneficiary's marginal tax rates 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).

There will be situations where income is not allocated to beneficiaries. This includes when:

- there is a lack of information regarding the beneficiaries of a trust so income cannot be allocated;
- the trustees do not yet know which beneficiaries to allocate income to; or
- non-tax reasons for keeping income in a trust are prioritised (such as protecting income from creditors or against relationship property claims).

Where the existing mechanism is clearly insufficient, special rules can be introduced to mitigate over-taxation. However, without undertaking public consultation, there is a risk that there are barriers we have not identified which would prevent trusts from mitigating over-taxation.

***Detailed design***

We consider two special rules are necessary at this stage to ensure the proposal addresses the under-taxation of trustee income and mitigates over-taxation. Public consultation is needed to determine whether any additional rules are required.

*<u>Rule to buttress a 39% trustee tax rate</u>*

We recommend a rule to prevent beneficiary income allocations to corporate beneficiaries being used to circumvent the 39% rate. A company can be a beneficiary of a trust. Under current law, income allocated as beneficiary income to a corporate beneficiary is taxed at 28% (the company tax rate). Treating such allocations as trustee income for the purposes of determining the rate of tax (39%) and who pays the tax (trustees) would ensure that trustees cannot circumvent a 39% rate by sheltering income in a corporate beneficiary. We propose limiting the application of this integrity rule to certain trusts to ensure that the use of trusts in large corporate groups would not be affected.

*Rule to mitigate over-taxation for estates*

Estates are taxed as trusts and may not be able to mitigate over-taxation by allocating income to beneficiaries if the affairs of the deceased are still being worked through. To help mitigate over-taxation, we recommend allowing trustees of estates to have the option of trustee income derived within 12 months of the deceased's date of death being taxed at the deceased's marginal tax rates. Our initial view is that 12 months is a reasonable length of time and should be adequate for most estates.

*Other situations where over-taxation may arise, but we do not have enough information to recommend special rules at this stage*

We have also considered whether a 39% trustee tax rate could result in over-taxation for trusts settled 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 (the large majority of superannuation funds, like KiwiSaver, are taxed separately under the PIE rules and would not be affected). For all these types of trusts, we recommend monitoring this situation to establish whether a problem exists and, if so, undertaking consultation to determine how best to address it.

***Other options for addressing misalignment issue***

We also considered other options to address misalignment between the trustee tax rate and the top personal tax rate, including taxing trustee income at the principal settlor's personal tax rate, or introducing an imputation-style system for trusts (which would ultimately tax beneficiaries on distributions of trustee income at their personal tax rates). An imputation-style system, in particular, could improve the long-term robustness and sustainability of the tax system. However, both options would involve fundamental reform to the taxation of trustee income. These approaches would be significantly more complex to design, implement, and administer.

## Limitations and Constraints on Analysis

***Wider misalignment issues and constraints imposed by Ministers' commissioning***

*Misalignment across the tax system*

Integrity pressures that arise from misalignment between the company, trustee, PIE and top personal tax rates make it very difficult for the Government to raise significant additional revenue in a way that is progressive and economically efficient. This is because having lower tax rates on income derived through certain entities means those earning income through these lower-tax entities will not be affected by any increase in personal tax rates, reducing the revenue gain from such a rate increase and undermining the fairness of the tax system.

While changes to the taxation of trusts, PIEs and companies/shareholders could individually raise revenue, together they can provide further, very significant long-term benefits. Combined, they would move towards a robust and sustainable tax system, giving the Government more flexibility to raise revenue from the personal tax base in a progressive way should it choose to do so in the future.

Maximising these benefits would require making compatible tax changes in all three areas – trusts, PIEs and companies/shareholders – to ensure that increases in tax rates apply as fairly as possible and to reduce income-shifting behaviour. For example, if the trustee and PIE tax rates were aligned with personal tax rates but company/shareholder taxation was unchanged, the top personal tax rate could still be circumvented by diverting income to companies. This issue is more pronounced for PIEs than for trusts because companies are more substitutable for PIEs than for trusts.

*Reduced substitutability for trusts*

Ministers have decided to progress increasing the trustee tax rate to 39% for the 2024–25 and later income years (beginning 1 April 2024 for most trusts) while considering PIE and company/shareholder misalignment issues on a longer timeframe.

Even if the trustee tax 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 small-to-medium enterprises. 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 also 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.

This reduced level of substitutability means changes to the trust taxation rules are likely to be worthwhile, even if no changes are made to the tax treatment of PIEs or companies. Raising the trustee tax rate to 39% will still raise revenue in a relatively low compliance cost way, while better meeting the Government's distributional objectives. However, we will continue to monitor the effect of the trustee rate as well as monitoring other structures that could be used to undermine a 39% trustee tax rate. Consultation with stakeholders and through the select committee process may bring to light such structures.

*Ministers' commissioning*

Ministers have commissioned development of a policy proposal to address misalignment between the trustee and top personal tax rates and to raise revenue for Budget 2023. The requirement to develop policy options and detailed design in time for Budget 2023 limits the available time for policy development.

Issues relating to the taxation of PIEs and companies/shareholders are outside the scope of this RIS.

***Administrative and delivery constraints***

Trade-offs are required in determining whether to progress any of the options analysed in this RIS. The systems, administrative and delivery impacts on Inland Revenue need to be considered in the context of other work being progressed on the wider Tax and Social Policy Work Programme.

It is expected that a large initial system development would be required to support this proposal. In addition, it is expected that any of the options outlined in this RIS will result in ongoing customer contacts. However, it is difficult to determine the exact impact on Inland Revenue until final policy decisions have been made on all Budget 2023 initiatives that impact on Vote Revenue.

***Quality of data and evidence***

*Limited available data*

Our ability to determine whether the proposals will have a disproportionate impact on certain groups or types of trusts is limited. New Zealand does not have a trusts register, and outside of the recently introduced trust disclosure rules or income tax returns filed by trusts with Inland Revenue, there is limited available data.

*Trust disclosure rules*

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. The constraint of needing to develop policy proposals in time for Budget 2023 limits the ability to use information from the recent trust disclosure rules. This is because most trusts can file their first returns under these rules as late as 31 March 2023, after the policy development of these proposals. Since the larger, more complex trusts file close to 31 March, there would have been significant limitations in using interim data as it may not have been representative of the domestic trust population.

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

*HWI research project*

Inland Revenue's HWI research project is due to be completed in April 2023. Data collected as part of that project was not used in the development of these proposals.

***Limitations on consultation***

Inland Revenue and Treasury officials worked closely together on the development of the proposals. Due to Budget sensitivity constraints, we have not been able to consult with external stakeholders on these proposals. Without undertaking public consultation, there is a risk that there are barriers we have not identified that would prevent existing rules from being fully effective in mitigating over-taxation for some trusts.

To partially mitigate the inability to undertake public consultation during the Budget preparation period, we have:

- worked closely with internal Inland Revenue trust experts;
- researched overseas jurisdictions that have broadly similar tax regimes and trust laws to New Zealand (Australia, Canada, the United Kingdom, and the United States);
- drawn on issues arising from the previous misalignment between the trustee tax rate and top personal tax rate in the 2000s;
- undertaken targeted consultation with certain public sector agencies:
    - the Financial Markets Authority – Te Mana Tātai Hokohoko
    - the Ministry of Justice – Te Tāhū o te Ture
    - the Public Trust

  - Te Tumu Paeroa – Office of the Māori Trustee
  - Whaikaha – Ministry of Disabled People; and
- liaised with the Australian Tax Office.

These steps have partially mitigated the inability to undertake public consultation during the Budget preparation period. However, trusts are complex and there is a significant risk that external consultation with stakeholders and the select committee process could bring unexpected concerns to light.

**Responsible Manager**

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Policy and Regulatory Stewardship

Inland Revenue

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3 April 2023

**Quality Assurance**

| | |
|---|---|
| Reviewing Agency: | Inland Revenue |
| Panel Assessment & Comment: | The Quality Assurance reviewers at Inland Revenue have reviewed the Regulatory Impact Statement: *The Taxation of Trustee Income* prepared by Inland Revenue, and consider that the information and analysis summarised in the Regulatory Impact Statement **partially meets** the quality assurance criteria. This is because, as disclosed in the Limitations and Constraints on Analysis section, the affected stakeholders (trustees, settlors and beneficiaries of trusts) have not had an opportunity to submit on how they would be affected by the options, and there has been no publicity about the proposal to generate any public comment. Accordingly, the analysis of how these stakeholders would be affected is limited and uncertain. |

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# Section 1: Diagnosing the policy problem

## Current tax law

1. A trust is a relationship where a person (the trustee) holds property for the benefit of another person or persons (beneficiaries). The settlor is the person who creates the trust and is the source of trust property. A settlor can also be a trustee and a beneficiary of the same trust, provided there is more than one beneficiary. The main legal feature of a trust is the separation of legal and beneficial ownership of the trust property between the trustee and beneficiaries.

2. A discretionary trust is a trust where the distributions to the beneficiaries are subject to the trustee's discretion. A fixed trust, or non-discretionary trust, is a trust where the trust deed specifies how the assets of the trust are to be distributed exactly. Tax law does not distinguish between discretionary trusts and fixed trusts, and most domestic trusts in New Zealand are discretionary trusts.

3. 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. If there is more than one trustee, each trustee is jointly and severally liable for any tax.[1]

4. **Beneficiary income** is all income earned by a trust in an income year which "vests absolutely in interest" in a beneficiary during the income year or is "paid" to a beneficiary before the trustee files the trust's tax return.[2] The definition of "pay", for an amount and a person, includes to:

    - distribute the amount to them;
    - credit them for the amount; or
    - deal with the amount in the person's interest or on their behalf in some other way.

5. That is, income does not need to be distributed 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 tax rates.

[1] Sections HC 2 and YA 5 of the Income Tax Act 2007.

[2] Section HC 6 of the Income Tax Act 2007 provides that income derived by a trustee during an income year will be taxed as beneficiary income if it vests absolutely in interest in a beneficiary of the trust in the income year, or is paid to a beneficiary by the later of:

- 6 months following the end of the income year in which the income was derived; and
- the earlier of:
    - the date on which the trustee files its tax return; and
    - the date by which the trustee is required to file its tax return under section 37 of the Tax Administration Act 1994.

***Table 1: 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>Income in a beneficiary's current account is available to be called upon at any time by that beneficiary. 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>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 rates.<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. |

6. The trustee must pay tax on behalf of the beneficiary for income allocated to that beneficiary as beneficiary income. To calculate the tax liability on beneficiary income, the trustee must first calculate the tax payable on the total taxable income of the beneficiary and then determine the portion referable to just the beneficiary income.[3] Beneficiaries are required to return all beneficiary income in their own personal tax return.

7. Beneficiary income is taxed at the beneficiary's marginal tax rates unless it is subject to the minor beneficiary rule. This rule applies to beneficiary income derived by a minor (under 16 years old) from property settled on a trust by a relative or legal guardian, or an associated person of the relative or legal guardian. If the total beneficiary income derived by the minor is >$1,000, the income is taxed at the trustee tax rate (currently 33%) to prevent parents, other relatives, or guardians from splitting their income with children.[4]

8. **Trustee income** is all taxable income derived by a trust in an income year that has not been paid or allocated as beneficiary income.[5] It is taxed at a flat rate of 33%. Once income has been taxed as trustee income, subsequent distribution of that income to the beneficiaries is tax free. That is, trustee income is subject to a final tax imposed in the year the income is derived by a trust.

9. **Corpus** means property settled on a trust.[6] Corpus is used by trustees to derive income and capital gains. Distributions of any amounts other than beneficiary income, including corpus, capital gains, or trustee income from prior years, are exempt from tax to the

[3] Section HD 7 of the Income Tax Act 2007.

[4] Sections HC 35 to HC 37 of the Income Tax Act 2007.

[5] Section HC 7 of the Income Tax Act 2007.

[6] Section HC 4 of the Income Tax Act 2007.

receiving beneficiary.[7] This is the tax treatment of the majority of domestic trusts ("complying trusts"), which are the focus of this RIS. Unless otherwise specified, trusts referred to in this RIS are complying trusts.

10. For more information on the income tax rules for trusts, refer to the reference guide [IR288: *Trusts and estates income tax rules*].

## International comparisons

11. Australia, Canada, the United Kingdom, and the United States all have broadly comparable tax regimes and trust laws to New Zealand. New Zealand is currently an international outlier in taxing trustee income below the top personal tax rate.

***Table 2: International comparison of the taxation of trustee income***

| | NZ | Australia | Canada | UK | US |
|---|---|---|---|---|---|
| Top personal tax rate | **39%** | 45%[8] | 33% | 45% | 37% |
| Top personal income threshold *(2023 tax year)* | $180,000 NZD | $180,000 AUD | $235,675 CAD | £150,000 GBP | $578,125[9] USD |
| Tax rate on trustee income | **33%** | 45% | 33% | 45% | 37%[10] |

## Tax planning using a trust

12. Trusts are often used to split income within a family unit so that tax is paid at low rates under a progressive tax scale. Trustees do not need to distribute amounts equally to the beneficiaries. This means they can allocate beneficiary income as they choose to beneficiaries on lower personal tax rates. However, the minor beneficiary rule partially limits the ability to split income in this way.

***Table 3: Personal tax rates for individuals***

| **Personal income** | **Marginal tax rate** |
|---|---|
| Up to $14,000 | 10.5% |
| Over $14,000 and up to $48,000 | 17.5% |
| Over $48,000 and up to $70,000 | 30% |
| Over $70,000 and up to $180,000 | 33% |
| Remaining income over $180,000 | 39% |

13. Due to the trustee tax rate being lower than the top personal tax rate, and trustee income being subject to a final tax in the year it is derived (and not subject to tax when it is eventually distributed to a beneficiary, if at all), trusts can be used to shelter income from higher personal tax rates. If a trust has a 39% tax rate beneficiary (who could also be a settlor), income may be accumulated in the trust and taxed at the 33% trustee tax rate;

[7] Sections CW 53 and HC 20 of the Income Tax Act 2007.

[8] Excludes a Medicare levy of 2%, which applies to both personal income and trustee income.

[9] This is the top tax threshold for single filers. The top tax bracket is $346,875 USD for married couples filing separately and $678,750 for married couples filing jointly.

[10] The 37% rate applies to trustee income over $13,450 derived by non-grantor trusts. Trustee income derived by grantor trusts, which are trusts effectively controlled by the settlor, is taxed at the personal tax rate of the settlor.

there is no further tax when the tax-paid trustee income is later distributed to the beneficiary.

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

## Other uses for trusts

15. In 2012, the Law Commission found that trusts appear to be established for the following main reasons: for family succession planning, to protect assets from creditors, to ensure separate assets (i.e., non-relationship assets) are protected from relationship property claims, to operate businesses efficiently, to provide for family members with special needs, for investment schemes and innovative commercial arrangements, and to provide for philanthropic or charitable activities. Trusts are also used for less acceptable purposes, including to avoid income and assets tests used by the Ministry of Social Development to assess eligibility for state assistance, to defeat known creditors, and to defeat the equal sharing regime under the Property (Relationships) Act 1976.[11]

16. A settlor can retain effective control of trust property by also being a trustee. They can also retain effective control by having powers to appoint new trustees, remove existing trustees, or appoint additional beneficiaries. A settlor can also retain enjoyment of trust property by being a beneficiary or having close family members who are beneficiaries. Trusts, therefore, may allow settlors to retain the benefits of ownership of property transferred to a trust while avoiding the burdens and risks of ownership.

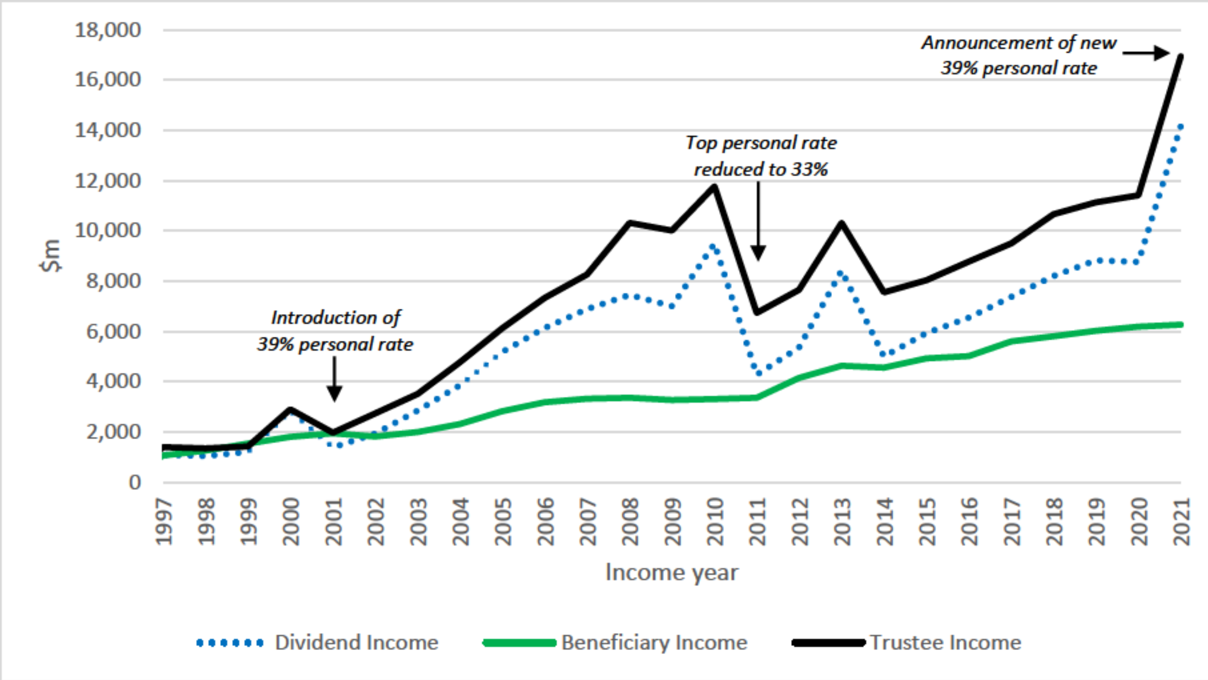
## Misalignment in the 2000s

17. Since the introduction of the current tax regime for trusts in 1989, the trustee tax rate has been 33%. This rate was chosen intentionally to achieve alignment with the top personal tax rate, and it has only fallen out of alignment during the two periods since 2000 when the top personal rate was 39%.[12]

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

[12] A 39% rate on income over $60,000 was introduced for the 2000–01 and later income years; this threshold was increased to $70,000 from 1 October 2008. The top personal rate was lowered to 38% for the 2009–10 income year and then further lowered to 33% from 1 October 2010. The current 39% rate on income over $180,000 was introduced for the 2021–22 and later income years.

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




18. Figure 1 shows how significant amounts of income were diverted into trusts and taxed as trustee income when the personal tax rate was raised to 39% in 2000 and the trustee tax rate remained at 33%. Much of the growth of trustee income was in the form of dividends.[13] Many small-to-medium enterprises reorganised as companies owned by family trusts in the early 2000s to take advantage of the misalignment.

19. After the top personal tax rate was reduced to 33% in 2010, there was no longer misalignment between the trustee and top personal tax rates. This meant that there was no longer a tax advantage in passing dividends through trusts, although existing structures often remained in place.

20. Since the 2021–22 income year, the top personal tax rate has again been higher than the trustee tax rate. In advance of this taking effect, companies paid out higher than usual dividends so that trusts or individual shareholders would earn the dividends before the 39% personal tax rate took effect. This resulted in a spike in personal and trustee income.

## 2020 decision to introduce a new top personal tax rate

21. In November 2020, Cabinet decided to introduce a new top personal tax rate of 39% for income over $180,000 for the 2021–22 and later income years. As part of the work to introduce the new 39% rate, Inland Revenue and Treasury recommended also increasing the trustee tax rate to 39%.[14]

22. Cabinet decided to defer making "a decision on whether to increase the trustee rate to a later date pending information on whether there is a behavioural response to avoid paying the new personal income tax rate". This decision was based on concerns

[13] The 2010 and 2013 spikes in trustee income were due to the expiration of a transitional rules that allowed dividends to be imputed at a higher rate. The spikes are from dividends that were distributed to trusts by companies.

[14] IR2020/454; T2020/3412: *Introducing a new top personal tax rate*. https://www.taxpolicy.ird.govt.nz/publications/2020/2020-ir-cab-20-sub-0484

regarding the potential over-taxation of trusts settled for the care of orphans or disabled people and the improvements in enforcement of tax obligations in recent years.[15]

23. Cabinet also decided in November 2020 to introduce increased trust disclosure requirements 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.

## Current landscape

24. Over 400,000 trusts are registered on Inland Revenue's systems, with approximately 180,000 filing returns reporting positive income. Table 4 shows that, in the 2021 financial year, total income derived by domestic trusts (including estates) was $23,300m, 73% of which was trustee income ($17,100m).

***Table 4: Proportion of beneficiary and trustee income***

| | FY2020 | FY2021 |
|---|---|---|
| Number of trusts<br>*(excl. trusts with nil income)* | 182,000[16] | 177,000[17] |
| Beneficiary income | $6,200m (35%) | $6,300m (27%) |
| Trustee income | $11,400m (65%) | $17,100m (**73%**) |
| Total income | $17,600m | $23,300m |

*Trustee income is concentrated in a small number of trusts*

25. Table 5 shows that, for trusts with assessable income in the 2021 financial year, the top 5% of trusts in terms of trustee income (9,000 out of 177,000) accounted for 78% of all trustee income ($13.3 billion out of $17.1 billion). This does not mean that all of this income is under-taxed, as this does not take into account the number of settlors and 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 (individuals that have, or are in control of, net wealth in excess of $50 million) based on Inland Revenue's existing HWI information, not the HWI research project population.

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[15] CAB-20-MIN-0484: *Introducing a New Top Personal Income Tax Rate*. https://www.taxpolicy.ird.govt.nz/publications/2020/2020-ir-cab-20-sub-0484

[16] Including approximately 19,000 estates and 400 foreign trusts.

[17] Including approximately 17,000 estates and 300 foreign trusts.

***Table 5: 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[18] |
| 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%) | $3,800 (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%) |

*Most trusts have relatively small amounts of trustee income*

27. Table 5 also shows that in the 2021 financial year, 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). This includes the lower 24% of trusts (43,000) that had no trustee income (i.e., only beneficiary income) and would therefore not be affected by an increase in the trustee rate.

28. 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. The large difference between the mean and median trustee income illustrates that the distribution of trustee income is skewed and not normally distributed.

***Table 6: Trustee income reported by trusts with assessable income***

| | FY2020 | | | | FY2021 | | | |
|---|---|---|---|---|---|---|---|---|
| *Trustee income per trust* | *Number of trusts* | *Aggregate trustee income* | *Median trustee income** | *Mean trustee income** | *Number of trusts* | *Aggregate trustee income* | *Median trustee income** | *Mean trustee income** |
| Nil | 47,000 (27%) | Nil | Nil | Nil | 43,000 (**24%**) | Nil | Nil | Nil |
| 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** |

** Note: Trusts with nil trustee income are excluded from the median and mean calculations.*

## Over-taxation and under-taxation

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

[18] The data has been broken down into the lower 24%, rather than the lower 25%, because these trusts had exactly nil trustee income (without rounding). Above the 24th percentile, trusts start to have small amounts of trustee income.

settings for income derived by a trust and not allocated to a particular beneficiary at that time.

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

30. A beneficiary (who could also be a settlor) with personal income of less than $70,000 has a marginal tax rate that is below 33%. If income is retained in a trust as trustee income and later distributed to a beneficiary who has a marginal tax rate below 33%, that income would be taxed at a higher rate than their personal income. This is an existing risk in the tax system that would be exacerbated if the trustee tax rate is raised. As noted above, there are cases where it is appropriate to tax a beneficiary at a rate higher than the rate that would apply to their personal income, particularly if the beneficiary is a minor and is a relative of the settlor (the minor beneficiary rule). However, there are other cases where taxing a beneficiary at a higher rate could result in over-taxation.

31. A similar argument can be made when considering the marginal tax rate of a settlor of the trust – as many trusts are effectively a gifting mechanism used by settlors to provide property to beneficiaries over time. Attributing trustee income to the principal settlor[19] (as income from property that has not yet been completely gifted to a beneficiary) could be an option for how trustee income should be taxed. This approach is explored in more detail in Section 2 (Option 2).

32. Table 6 shows that in the 2021 financial year, the median trustee income was $8,000 and 68% of trusts (120,000 trusts) reported less than $180,000 of trustee income each ($2,500m in aggregate, or 14% of trustee income). 24% of trusts (23,000) had only beneficiary income. The majority of trusts therefore have relatively small amounts of trustee income. This illustrates that while increasing the trustee tax rate as proposed would likely be progressive, some trusts with lower-rate beneficiaries may be over-taxed.

***… however, existing rules should be sufficient to mitigate over-taxation in most cases***

33. Existing rules should be sufficient to mitigate over-taxation in most cases. Trustees can allocate income to a lower-rate beneficiary as beneficiary income, instead of treating it as trustee income. This allows the income to be taxed at the beneficiary's lower personal tax rate, rather than the higher trustee tax rate. However, this may result in additional compliance costs for trusts.

34. Since a settlor can also be a beneficiary of a trust, this approach can be used in situations where the settlor is alive, is a beneficiary of the trust, and has a lower personal tax rate than the trustee tax rate. Trust income can be allocated to the settlor as beneficiary income and taxed at the settlor's lower rate. If the settlor does not want to retain the income, they can settle that income back on the trust as corpus. Distributions of corpus to beneficiaries are not subject to tax. This approach effectively allows income to be taxed at the settlor's lower rate while still being retained in the trust for later distribution to beneficiaries. This is an approach available under current law – however, in Section 2, Option 2 considers whether to make this approach mandatory for income retained as trustee income when there is a living principal settlor.

35. However, there may be situations where it is not desirable or possible for income to be allocated to lower-rate beneficiaries. As a result, some level of over-taxation may not be preventable under existing settings. This issue is covered in more detail in Section 3.

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

***Retaining income as trustee income results in under-taxation…***

36. Trustee income is currently taxed at 33% but is exempt from tax on subsequent distribution to beneficiaries, even if those beneficiaries are on a 39% personal tax rate.

> ***Example 1: 39% tax rate beneficiary***
>
> Amena has personal income of over $180,000 per annum and is a beneficiary of a trust. $50,000 has been retained in the trust as trustee income (with a tax liability of $16,500 at the 33% trustee tax rate).
>
> In the following year, the tax-paid trustee income ($50,000 less $16,500 tax = $33,500) is distributed to Amena. This distribution is not subject to tax. That income has only been subject to a 33% tax rate, and Amena does not need to pay the 6% difference between the 33% trustee tax rate and the 39% personal tax rate despite earning over $180,000.
>
> If the income was earned directly by Amena as personal income, the tax liability would be $19,500 at the 39% tax rate.

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

37. As noted in Table 5, most trustee income (78%, or $13.3 billion out of $17.1 billion, for the 2021 financial year) is concentrated in a relatively small number of trusts (5%, or 14,000 out of 177,000 trusts). That is, under-taxation is a larger problem than over-taxation in terms of total income. This does not mean that all this income is under-taxed, as it does not take into account the number of settlors or beneficiaries (or their personal tax rates), but it is an indication that there is a significant amount of under-taxation.

## What is the policy problem or opportunity?

38. The Government's stated long-term revenue objective is to "ensure a progressive taxation system that is fair, balanced and promotes the long-term sustainability of the economy, consistent with the debt and operating balance objectives".

39. Medium-term fiscal pressures may require the Government to have the flexibility to raise more revenue in the future. The primary way of doing this is through adjusting rates on the Government's chosen tax bases, rather than piecemeal reforms through the base maintenance work programme.[20]

40. The Government currently raises revenue from three main tax bases: personal income tax, company tax and goods and services tax ("GST"). The personal income base is a key tax base, raising around 50% of total tax revenue. The system of personal tax rates and thresholds is designed to reflect the Government's view on how progressive the tax system should be. However, misalignment, combined with the current tax rules for companies and shareholders, makes it difficult for governments to raise revenue through the personal tax base in a way that is consistent with the Government's revenue strategy and economic strategy objectives.

41. Misalignment arises when the marginal tax rate that applies to an individual's income is higher than the tax rate that applies when income is earned through a company or a trust. The ability to raise more revenue from the personal tax base is significantly constrained because of misalignment between the 39% top personal tax rate and the

[20] The aim of a base maintenance work programme is to repair and maintain our tax rules so that existing tax bases are as fair and efficient as they can be. While base maintenance measures will sometimes raise revenue, their primary aim is to improve the efficacy of the tax system.

33% trustee tax rate. This misalignment allows the top personal tax rate to be circumvented and reduces the progressivity of the income tax system.

## What objectives are sought in relation to the policy problem?

42. A key factor in considering options to address misalignment between the trustee tax rate and the top personal tax rate is whether an option moves in the direction of a robust and sustainable tax system. To help achieve this, any reform should:

- ensure trusts cannot be used to circumvent the 39% personal tax rate;
- minimise the over-taxation of lower-rate individuals where possible, particularly for trusts with only lower-rate settlors and beneficiaries; and
- raise revenue for Budget 2023.

# Section 2: Deciding upon an option to address the policy problem

## What criteria will be used to compare options to the status quo?

43. Options to address misalignment of the trustee tax rate and top personal tax rate have been assessed against the following criteria.

- **Under-taxation:** Does the option ensure that trusts cannot be used to circumvent the top personal tax rate?
- **Over-taxation:** Does the option result in lower-rate individuals being over-taxed?
- **Complexity:** Is the option easily understood? Does the option increase the complexity of the tax system?
- **Coherence and sustainability:** Does the option make sense in the context of the entire tax system? Is the option future-proofed?
- **Revenue impact:** How would the option impact tax revenue?
- **Administrative and delivery implications:** How would the option impact Inland Revenue? When can the option be delivered by?
- **Compliance costs:** How would this option impact taxpayers?

## What scope will options be considered within?

44. Based on Ministers' commissioning, options are considered in the context of developing policy proposals in time for Budget 2023. The level of detail on some of the more complex options is limited due to time constraints.

45. The options in this RIS focus on the tax rules for trusts. Wider issues relating to misalignment between the company, PIE and top personal tax rates are outside the scope of this RIS.

46. Changes to the trust disclosure rules introduced for the 2021–22 and later income years are outside the scope of this RIS. Inland Revenue is scheduled to undertake a post-implementation review of those rules in 2023, after a full year's worth of data has been disclosed (after 31 March 2023).

## What options are being considered?

47. We have considered the following options:

- **Option 1** – Increasing the trustee tax rate to 39% with modifications for certain trusts with lower-rate settlors and beneficiaries, if necessary.
- **Option 2** – Taxing trustee income at the principal settlor's personal tax rate.
- **Option 3** – Introducing an imputation-style system for trustee income, similar to what is currently in place for companies and Māori authorities.

48. We also explored the following alternative approaches. These options were ruled out in early policy development and are not covered in any detail due to their significant limitations in addressing the problem definition:

- **Retaining the 33% trustee tax rate but requiring 39% rate individuals (i.e., individuals that earn over $180,000) to pay a top-up tax at 6% on distributions of trustee income**. This would ensure trust income that is distributed to 39% rate individuals is taxed at 39%. This option was ruled out due to administrative complexity and because the additional 6% tax on trustee income could be deferred by delaying distributions of trustee income to 39% rate individuals. The additional 6% tax could also potentially be completely avoided by deferring distributions until a 39% rate individual is on a lower rate (e.g., when the individual is working part-time or has retired) or by streaming taxable distributions to lower-rate beneficiaries and tax-free distributions (corpus and capital gains) to higher-rate beneficiaries. This approach would also be a significant departure from the current trust taxation regime for a small group of individuals. Compared with other options, this option might only partially achieve the objective of ensuring trusts cannot be used to circumvent the 39% top personal tax rate and it is unclear if this approach would raise revenue for Budget 2023.

- **Introducing specific anti-avoidance provisions**. This was ruled out because it would involve high administrative costs and (depending on how well the provisions are enforced) may not meet the objectives of ensuring trusts cannot be used to circumvent the 39% top personal tax rate and raising revenue for Budget 2023.

- **Taxing trustee income on a progressive tax scale up to 39%**. While this option has the appeal of mitigating any over-taxation that might arise with a flat trustee tax rate, it was ruled out because it would create significant tax planning opportunities. Complex aggregation rules would be needed to ensure taxpayers do not settle multiple trusts to take advantage of the progressive tax scale and enforcing those aggregation rules would involve significant administrative costs. This option could result in a reduction in revenue compared with the status quo, especially if the aggregation rules are not applied consistently, and trusts would continue to be used to circumvent the 39% top personal tax rate. It is likely that none of the objectives being sought in relation to this policy problem would be satisfied.

## Option analysis

**Option 1 – Increasing the trustee tax rate to 39% with modifications for certain trusts with lower-rate settlors and beneficiaries, if necessary**

49. This option would align the trustee tax rate with the top personal tax rate at 39%. The trustee tax rate would continue to be a final tax imposed in the year income is derived.

*Under-taxation*

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

51. As outlined above in the limitations section, even if the trustee tax 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 usually only be extracted from a company upon liquidation or as a taxable dividend.[21] 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.

52. This reduced level of substitutability means changes to the trust taxation rules are likely to be worthwhile, even if no changes are made to the tax treatment of PIEs or companies. Raising the trustee tax rate to 39% will still raise revenue in a relatively low-cost way, while better meeting the Government's distributional objectives.

*Over-taxation*

53. Aligning the trustee tax rate with the top personal tax rate may result in distributions of tax-paid trustee income to lower-rate beneficiaries being taxed above the beneficiaries' marginal tax rates. This may be appropriate, for instance in the case of a discretionary trust where the beneficiary is a minor and a relative of the settlor (the minor beneficiary rule). In cases where it is not appropriate, there are options to mitigate this.

54. An existing rule allows income earned by a trust to be taxed at a beneficiary's personal tax rate if the income is allocated or paid to the beneficiary during the income year or within an extended period following the end of the income year. There may be situations where this existing rule would not effectively prevent over-taxation. Other jurisdictions have rules to address specific situations. Modifications to address risks of over-taxation are covered in detail in Section 3, although it is important to note that the inability to undertake public consultation during the Budget preparation period means we have had to make judgements and recommendations based on limited data. We expect further information to come to light on the over-taxation risks posed by a 39% trustee tax rate once the proposals become public.

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 tax rate. It is not over-taxation if the 39% rate applies in this situation, as the settlors/trustees have retained control over the income.

*Complexity*

56. Depending on the design of any potential modifications (Section 3), this approach is the least complex option – it fits within the existing tax regime for trusts and does not involve any significant structural reform.

[21] Available subscribed capital can also be distributed through share repurchases, funded by capital gains, without liquidation of the company.

*Coherence and sustainability*

57. Aligning the trustee and top personal tax rates supports the coherence of the tax system. The trustee tax rate was intentionally aligned with the top personal tax rate when the current trust tax regime was introduced in 1989, and it has only fallen out of alignment during the two periods since 2000 when the top personal tax rate was 39%.

58. This option improves the sustainability of the tax system by reducing misalignment pressures between the trustee and top personal tax rates. In principle, this option should be robust to changes to the personal tax system provided the trustee tax rate (once it is aligned with the top personal tax rate) remains aligned with that rate. However, we have not considered the impact of any potential changes to the personal tax system in detail.

*Revenue impact*

59. The amount of revenue this option would raise is highly uncertain and heavily dependent on the behavioural response by trustees. If more income is diverted to other entities or is allocated as beneficiary income instead of being retained as trustee income, less revenue will be raised through the taxation of trustee income. Examples of behavioural responses by trustees include:

- *Restructuring out of trusts:* Taxpayers could substitute trusts with PIEs or companies, however these entities are not fully substitutable, as noted above.
- *Reducing income derived by trusts*: A large proportion of trustee income is dividend income (see Figure 1) and could be easily diverted into other entities or retained in companies.
- *Beneficiary income allocations to individuals:* Trustees could allocate income as beneficiary income to beneficiaries of the trust on lower personal tax rates.
- *Beneficiary income allocations to companies:* Trustees could appoint a company as a beneficiary and allocate beneficiary income to the corporate beneficiary (taxed at 28%). This matter is covered in more detail in the "Rule needed to buttress proposed 39% rate" subsection of Section 3.

60. The introduction of any modifications to this option would likely reduce the revenue raised from increasing the trustee tax rate. Furthermore, any fiscal impact would also depend on whether changes to the taxation of PIEs and companies are progressed – if they are, this option could raise more revenue.

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

***Table 7: Estimated tax revenue from increasing the trustee tax rate to 39%***

| Fiscal year | 2022/23 | 2023/24 | 2024/25 | 2025/26 | 2026/27 & outyears | Total over forecast period |
|---|---|---|---|---|---|---|
| Estimated tax revenue from increasing the trustee tax rate to 39% ($m) | - | - | 13 | 770 | 350 | 1,133 |

*Administrative and delivery implications*

62. Implementation and ongoing administrative costs are estimated to be between $5 million and $11 million over the forecast period (2022/23 to 2026/27 fiscal years). This estimate will be refined when final policy decisions have been made for all Budget 2023 initiatives that are proposed to be implemented in the same delivery timeframe.

63. At the upper-end of the cost range, over the forecast period, the estimated one-off capital build costs are $2.9 million, the one-off operating build costs are $0.7 million, the ongoing administrative costs are $5.4 million, and depreciation and capital charge are $2 million.

64. 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 intermediaries, 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.

***Table 8: Implementation and ongoing administration costs***

| | $ 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 | - | - |

65. To implement this option, Inland Revenue would require time to engage with its ecosystem partners, such as software providers and tax intermediaries, and this would be aligned to Inland Revenue's annual change engagement process. Additional time would be required to develop a solution for all parties. The earliest implementation date

for simply changing the trustee tax rate to 39% and implementing some simple modifications would be 1 April 2024. More complex modifications would require additional time, and the earliest implementation date for such changes would be 1 April 2025.

*Compliance costs*

66. Depending on the design of any modifications, this option is not expected to have a significant impact on compliance costs for trusts. Relying on paying or allocating income as beneficiary income to mitigate over-taxation could result in increased compliance costs for trustees in determining who to allocate income to each year. However, this is a decision that already needs to be made by trustees.

67. Some trusts with only lower-rate settlors and beneficiaries may consider themselves unfairly impacted by the proposed 39% trustee tax rate. Such trusts may never have a 39% rate settlor or beneficiary, yet they will be forced to decide whether to allocate income to mitigate over-taxation and may face increased compliance costs as a result. Taxpayers may consider this particularly unfair when 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.

**Option 2 – Taxing trustee income at the principal settlor’s personal tax rate**

68. Instead of trustee income being taxed at a flat rate (as under the status quo or Option 1), such income could be taxed at the principal settlor’s[22] “trust-affected” personal tax rate in the year the income is derived by the trust. This rate would be determined by taking into account both the settlor’s own personal income and the trustee income of any trust for which they are a principal settlor. For trusts without a living principal settlor, trustee income would be taxed at 39% (similar to Option 1).

69. As noted above, this approach can already be voluntarily achieved by trustees under current rules. Trust income can be allocated to a settlor (as a beneficiary) as beneficiary income and taxed at the settlor’s marginal tax rates. The settlor can settle that income back on the trust as corpus – distributions of corpus to beneficiaries are not subject to tax. This option would achieve the same result but would make it mandatory. This would help ensure that trusts are not over-taxed due to the trustees/settlor not knowing about this approach or applying it incorrectly.

*Under-taxation*

70. Applying the principal settlor’s trust-affected personal tax rate to trustee income could be appropriate for many trusts, given that settlors generally retain a large degree of effective control or influence over the trusts they settle property on. Many trusts are effectively a gifting mechanism used by settlors to provide property to beneficiaries over time, so taxing trustee income (as income from property that has not yet been completely gifted to a beneficiary) at the principal settlor’s trust-affected tax rate could be appropriate.

71. This option would ensure that the 39% tax rate would be paid on trustee income when, in aggregate, the trustee income and the principal settlor’s personal income exceeds $180,000.

[22] A “principal settlor” is the settlor who has made the greatest settlement on a trust.

**_Example 2: Taxing trustee income at the principal settlor's personal tax rate_**

Baru has settled property on a trust and the trust has no other settlors. In the 2024–25 income year:

- Baru derived $160,000 of personal income.
- The trust derived $300,000 of trustee income.

Under Option 2, since Baru derived $160,000 of personal income in the 2024–25 income year, $20,000 of the trustee income would be taxed at 33%. The remaining $280,000 would be taxed at the 39% trustee tax rate.

*Over-taxation*

72. This option would significantly mitigate risks of over-taxation by applying lower tax rates for all or some of the trustee income of trusts with lower-rate settlors – provided that the trust has a living principal settlor. A 39% trustee tax rate would apply for trusts that do not have a living principal settlor.

**_Example 3: Taxing trustee income at the principal settlor's personal tax rate_**

Gideon and Harrow have settled property on a family trust. The market value of the property settled by Gideon on the trust is $1,000,000, while the market value of the property settled by Harrow is only $500,000. Gideon is considered the principal settlor of the trust.

In the 2024–25 income year:

- Gideon derived $50,000 of personal income.
- The trust derived $50,000 of income. $25,000 is allocated as beneficiary income and $25,000 is retained as trustee income.

The $25,000 of trustee income would be taxed at Gideon's trust-affected personal tax rate. Since Gideon had $50,000 of personal income in the 2024–25 income year, $20,000 of the trustee income would be taxed at 30% (as it falls within the $48,001 to $70,000 bracket), and the remaining $5,000 would be taxed at 33%. Total income tax of $7,650 would be payable on the trustee income.

| Personal income | Marginal tax rate |
|---|---|
| Up to $14,000 | 10.5% |
| Over $14,000 and up to $48,000 | 17.5% |
| Over $48,000 and up to $70,000 | 30% |
| Over $70,000 and up to $180,000 | 33% |
| Remaining income over $180,000 | 39% |

If a 33% or 39% flat tax rate had applied to tax the trustee income instead, the total income tax payable by the trustees on the income would have been $8,250 or $9,750 respectively.

*Complexity*

73. This option would introduce complexity in the tax system (or alternatively would result in inequities arising from simple arbitrary rules) for situations when there are multiple settlors of a trust with the greatest-equal share or there is a new principal settlor part way through an income year.

74. The existing trust taxation rules would need to be retained in certain situations, such as when the principal settlor is no longer alive or for trusts with no natural person settlors

(such as a trust settled by a court to hold Māori land while the beneficiaries are being determined).

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

*Coherence and sustainability*

76. This option could reduce the coherence of the tax system by introducing a new regime for the taxation of trusts with living principal settlors but retaining existing rules for other trusts. However, a settlor-attribution approach would help future-proof the tax system by ensuring there is no misalignment issue between the trustee and top personal tax rates, even if personal tax rates were to change in the future. Regardless of future changes to the personal tax system, this option would address under-taxation and mitigate over-taxation – albeit only for trusts with living principal settlors. Rules could potentially be developed for trusts that do not have living settlors, but these would be difficult to design and are likely to be complex.

*Revenue impact*

77. The fiscal impact of this option has not been estimated due to limited time and the lack of detailed design at this stage. Given the complexities involved, any estimate would be premature and highly uncertain.

*Administrative and delivery implications*

78. The estimated initial system development impact for Inland Revenue is small but this would depend on the detailed design of this option. Inland Revenue would need time to engage with its ecosystem partners, such as software providers, and this would be aligned to Inland Revenue's regular annual change engagement process. Additional time would be required to develop a solution for all parties. The earliest implementation date would be 1 April 2025.

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

*Compliance costs*

80. This option would likely result in increased compliance costs for trustees of a trust with a living principal settlor. Trustees would need to know the personal income of the principal settlor of the trust. This could potentially be challenging to comply with if there are multiple trusts that need to be aggregated or if there is a new principal settlor part way through an income year.

81. There should be no compliance cost impact for trusts without a living principal settlor, as existing rules would apply.

### Option 3 - Introducing an imputation-style system for trustee income

82. There are other options that would integrate the taxation of trustee income with the personal income tax system. However, they would involve fundamental changes to how trustee income is taxed. One approach would be to introduce an imputation-style system for the taxation of trustee income, similar to what is already in place for companies and Māori authorities.

83. Trustee tax would still be paid in the year that trustee income is derived, either at the current 33% rate or at the 39% rate (to align with the top personal tax rate). Trusts would receive imputation credits for tax paid on trustee income, and those credits would be distributed to the beneficiaries who later receive that income. Distributions of trustee income to beneficiaries would be taxed at the beneficiaries' personal tax rates, but beneficiaries would be able to offset their tax liability with any imputation credits from tax paid by the trust. Any surplus imputation credits could be refundable to the beneficiary, carried forward, or used to offset their tax liability for other income (such as employment income).

***Example 4: An imputation-style system for trustee income***

Thiago is the trustee of a discretionary trust with two beneficiaries, Indah and Matteo.

In the 2024–25 income year, the trust derives $200,000 trustee income – this is taxed at 39%, resulting in $78,000 tax paid, leaving $122,000 after tax. This gives the trust $78,000 of imputation credits for the amount of tax paid.

In the same year, Indah earns $200,000 personal income (with a marginal tax rate of 39%) and Matteo earns $30,000 personal income (with a marginal tax rate of 17.5%).

*Deferral disadvantage to lower-rate beneficiaries*

Two years later, in the 2026–27 income year, Thiago decides to distribute $30,500 trustee income, with $19,500 imputation credits attached (for a total of $50,000 tax-paid trustee income) to Matteo.

Matteo still earns $30,000 personal income. This distribution brings Matteo's taxable income to $80,000. Under the personal tax scale, $80,000 personal income results in a tax liability of $17,320. The imputation credits could satisfy the tax liability on the distribution of trustee income, and if Matteo can offset the imputation credits against his other personal income, then he would have no income tax to pay for that year. If the imputation credits are refundable, Matteo would receive a $2,180 refund at the end of the year.

Although Matteo would be able to use the imputation credits to reduce his tax liability and receive a refund, he would be disadvantaged by having to wait for the income to be distributed from the trust.

*Deferral advantage to higher-rate beneficiaries*

In the 2029–30 income year, five years after the income was derived, Thiago distributes the remaining $150,000 trustee income to Indah (comprised of $91,500 after-tax trustee income and $58,500 imputation credits). Indah is in semi-retirement and only works part-time – her personal income is now only $30,000. The $150,000 distribution brings Indah's taxable income to $180,000, with a tax liability of $50,320. Due to the amount of imputation credits, Indah could reduce her tax liability to nil and receive a refund of $8,180.

Although the trustee income was taxed at 39% in the year it was derived when Indah was on a marginal tax rate of 39%, Indah would be able to benefit from the distribution being deferred until she was on a lower marginal tax rate.

*Under-taxation and over-taxation*

84. This approach would help ensure that the ultimate recipients pay tax on distributions of trustee income at their personal tax rates in the year a distribution is received. Recipients on higher personal tax rates than the trustee rate (if the trustee rate remains at 33%) would pay additional tax. Depending on the specific design, surplus credits for recipients on lower personal tax rates could be credited against other tax liabilities, refunded, and/or carried forward for use in later years.

85. This option would likely improve the long-term robustness, sustainability, and flexibility of the tax system. It would be robust to different designs of the personal tax system. The ability to shelter income permanently in a trust would be greatly limited, regardless of the specific trustee or top personal tax rates, and concerns regarding over-taxation would be mitigated.

86. However, if the trustee tax rate remains at 33%, there would be a delay between the year in which tax is paid on trustee income by the trustees and the year in which additional tax is paid by beneficiaries. Similarly, regardless of what trustee tax rate applies, there would be a delay between the year in which tax on trustee income is paid and the year in which lower-rate beneficiaries get the benefit of surplus imputation credits. This is similar to the existing situation for natural person shareholders of a company, although a larger deferral benefit currently applies to income earned in companies.

- *Deferral benefit for high-rate beneficiaries*: There would be a deferral benefit for higher-rate beneficiaries if the trustee tax rate that applied in the year income is derived by a trust remained lower than the top personal tax rate. The Government would not receive the additional income tax payable on trustee income until that income is later distributed to the higher-rate beneficiary. If the income is not distributed until the beneficiary is on a lower rate (e.g., once the beneficiary is only working part-time or has retired), no additional tax would be paid, even if the beneficiary was on the 39% top personal tax rate when the income was originally derived by the trust. This issue could be resolved by also increasing the trustee tax rate to 39%.

- *Deferral disadvantage for beneficiaries on lower rates*: There would be a deferral disadvantage for beneficiaries on a personal tax rate lower than the trustee tax rate. The Government would receive the benefit of income retained as trustee income being taxed at the higher trustee tax rate in the year the income was derived, and lower-rate beneficiaries would not receive the benefit of surplus credits until trustee income is later distributed. This disadvantage would be exacerbated if the trustee tax rate was increased to 39%.

*Complexity*

87. This option would be significantly more complex to design than Options 1 or 2, given it would involve a significant departure from the current trust taxation regime. Further consideration would need to be given to:

- **Continuity and commonality requirements** for imputation credits – should a beneficiary be allowed to receive imputation credits for tax that was paid before they became a beneficiary of the trust? Or should it be a requirement that to receive imputation credits from a trust, a person must have been a beneficiary of the trust in the income year to which the credits relate?

- The **treatment of surplus credits –** should beneficiaries be allowed to offset these against other income (e.g., employee income)? Should surplus credits be refundable? Or should beneficiaries just be able to carry surplus credits forward to offset against any future tax liability arising from trustee income that is distributed to them in the future?
- **Anti-streaming rules** – these would be required to prevent trustees from streaming tax-exempt distributions (such as capital gains or corpus) to higher-rate beneficiaries and streaming tax-paid trustee income to lower-rate beneficiaries (who would have surplus credits, which could be refundable depending on how this option is designed).
- **Distributions to minors –** the minor beneficiary rule is currently the only defence in the law against income-splitting (apart from anti-avoidance rules, such as in the case of personal services income derived through trust structures). Would a special rule have to apply to trustee income that is distributed to a minor beneficiary to ensure allocations of trustee income are not used to split income with minors?

88. If the trustee tax rate remains at 33%, this option would allow tax planning opportunities. For example, 39% rate settlors could defer distributions of trustee income until later in life, when they have less income and lower personal tax rates. This is currently possible with closely-held companies but not with trusts.

*Coherence and sustainability*

89. This option would improve the coherence of the tax system by implementing similar rules to the imputation system for companies and the Māori authority tax regime. Parallels could be drawn from these existing systems in terms of both policy design, implementation, compliance, and education – however the unique features of discretionary trusts would mean this would not be seamless.

90. This option would also improve the sustainability of the tax system by integrating the taxation of trusts with the personal tax system. The ultimate recipients of income derived by trusts would pay tax at their personal rates – although there would be deferral issues, as noted above. An imputation system could also improve social policy targeting. Distributions of trustee income would form part of a beneficiary's personal income and therefore would count towards the abatement of social policy measures, such as Working for Families.

*Administrative and delivery implications*

91. This option would require large-scale initial system development for Inland Revenue, and the detailed design of the rules may need to take into account the requirements and limitations of software providers. Although Inland Revenue currently administers an imputation credit system for companies and Māori authority credits, it is expected that significant development would be required to achieve the policy outcomes as described. Inland Revenue would need time to engage with its ecosystem partners, such as software providers, and this would be aligned to Inland Revenue's regular annual change engagement process. However, additional time would be required to develop a solution for all parties. The earliest implementation date would be 1 April 2025.

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

*Compliance costs*

93. Despite the existing imputation systems for companies and Māori authorities, experience suggests that both taxpayers and their agents find imputation one of the most challenging aspects of the tax system, so extending it to trusts could require a significant educational effort and ongoing support for taxpayers and their agents.

94. Additional compliance costs would arise from trustees needing to maintain memorandum accounts for imputation credits and understanding and complying with complex anti-streaming and integrity rules.

## Well-being and economic considerations

95. All three options considered above would have similar well-being and economic impacts.

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

97. All options would likely have less benefit by themselves than they would as a package of three measures addressing misalignment across the tax system, including changes to the tax treatment of PIEs (or at least PIEs that are not KiwiSaver or other retirement savings schemes) and changes to the tax treatment of companies/shareholders. This is because increased taxes on trusts would inevitably result in some leakage of revenue to entities such as PIEs and companies, which would reduce the effectiveness and economic efficiency of the trust tax changes. There would also be some compliance costs incurred if assets or business activities were to be shifted from a trust to another entity. However, as discussed above, PIEs and companies are not fully substitutable for trusts.

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

### *Māori perspectives*

99. The tax system provides specific tax rules for Māori organisations who manage and own communal assets for the benefit of whānau Māori, hapū, and iwi. Māori organisations that are eligible to apply these rules are called Māori authorities and are taxed at 17.5%. These rules were purpose-built to meet the unique characteristics and circumstances of how Māori own and manage communal assets and pursue their specific development outcomes. Changes to the Māori authority tax rules are outside the scope of this RIS.

100. We would expect that most trusts used by Māori for communal ownership purposes would, in principle, be eligible to be taxed as Māori authorities. Therefore, our initial view is that the objectives and options of the proposals in this RIS are unlikely to impact Māori

development outcomes or present a barrier to sustainable prosperity and resilience for whānau Māori and future generations.

101. Due to Budget sensitivity constraints, we have been unable to publicly consult on the impact of these proposals. In the absence of full public consultation, the impact of the proposals on broader considerations of well-being beyond the use of trust structures by Māori, including any boundary matters relating to the interpretation of the Māori authority rules, is not fully understood. However, during policy development officials did undertake limited engagement with Te Tumu Paeroa – the Office of the Māori Trustee. This engagement focused on the reasons why a trust might choose not to elect to be a Māori authority. Very few trusts handled by Te Tumu Paeroa are not Māori authorities for income tax purposes, and as mentioned above, Māori authorities are not expected to be affected by these proposals.

***Distributional impacts***

102. We consider that all three options would increase the progressivity of the tax system. However, the available data is limited. As noted in Table 5, 2020–21 tax returns indicate that a relatively small number of trusts (5%) earn most trustee income (78%). In addition, data from the Household Economic Survey 2018 (HES 2018) suggests that net-worth decile 10 households[23] hold 40 percent of their wealth in non-financial (generally property) and financial assets in family trusts. Some of the non-financial assets, such as principal residences, would not generate any taxable income, so would not be impacted by any tax change. However, other assets may generate taxable income streams.

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

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

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

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

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

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

- Rental housing: Current Inland Revenue data suggests about 16% of rental properties are held in a trust.[24] A higher trustee tax rate would have a mixed impact on investments in rental housing. To the extent rental income is subject to a higher tax rate, this could reduce incentives to invest in rental property. It could therefore put downward pressure on house prices and/or increase rents. However, to the extent rental properties derive untaxed income, in the form of capital gains, any increased tax may encourage investment in rental properties over other forms of investment.

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

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

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

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

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

## How do the options compare to the status quo?

**Key for qualitative judgements:**

| | |
|---|---|
| + + | much better than doing nothing/the status quo |
| + | better than doing nothing/the status quo |
| **0** | about the same as doing nothing/the status quo |
| – | worse than doing nothing/the status quo |
| – – | much worse than doing nothing/the status quo |
| ? | unknown impact |

***Table 9: Option analysis***

| | **Option 1 – Increase trustee tax rate to 39%** | **Option 2 – Mandatory settlor attribution for trustee income** | **Option 3 – Imputation-style regime for trustee income** (33% trustee tax rate / 39% trustee tax rate) |
|---|---|---|---|
| **Under-taxation** | + +<br>Aligning the trustee tax rate and top personal tax rate would help ensure that the 39% rate applies to income attributable to individuals who earn over $180,000. | + +<br>This option would ensure that the 39% rate applies to trustee income for trusts with higher-rate settlors, helping ensure that trusts cannot be used to circumvent the top personal tax rate. | + / + +<br>Integration of the taxation of trusts with the personal income tax system would ensure that the ultimate recipients of income derived by trusts would pay tax at their personal tax rates. This option with a 39% trustee tax rate would better address under-taxation compared with the status quo because there would be no deferral benefit for beneficiaries on the 39% personal tax rate. |
| **Over-taxation** | –<br>Some taxpayers may be over-taxed. However, this should be able to be mitigated under current law in most situations. | +<br>Lower rates would apply to trustee income for trusts with lower-rate settlors – this would help mitigate over-taxation. However, there would be no benefit for trusts without a living settlor. | + + / +<br>Integration of the taxation of trusts with the personal income tax system would ensure that the ultimate recipients of income derived by trusts would pay tax at their personal tax rates. |

| | Option 1 – Increase trustee tax rate to 39% | Option 2 – Mandatory settlor attribution for trustee income | Option 3 – Imputation-style regime for trustee income (33% trustee tax rate / 39% trustee tax rate) |
|---|---|---|---|
| **Revenue impact** | + + <br>The impact is highly uncertain. A 2020 costing estimated this change, with no modifications, would raise approximately $350m per annum. | ? / + <br>We expect this option would raise revenue compared with the status quo. However, due to lack of detailed design, the revenue impact has not been estimated. | ? / + <br>We expect this option would raise revenue compared with the status quo. However, due to lack of detailed design, the revenue impact has not been estimated. |
| **Complexity** | 0 / – <br>This is the simplest option.<br>Depending on whether modifications are introduced and how these are designed, there may be a small increase in complexity for taxpayers who choose to use any modifications. | – <br>This option would be more complex than the status quo. Rules would be needed to address issues relating to trusts with multiple principal settlors, mid-year changes in principal settlor, and when a person is the principal settlor of multiple trusts. | – – <br>This option involves fundamental reform of the taxation of trusts and would introduce significant complexity. Experience suggests that both taxpayers and agents find imputation one of the most challenging aspects of the tax system. |
| **Coherence and sustainability** | + <br>Improves the coherence and sustainability of the tax system, although the trustee tax rate would need to be reconsidered if any changes were made to the top personal tax rate. | + <br>This option reduces the coherence of the tax system by introducing different trust taxation regimes depending on whether the trust has a living principal settlor. However, to counter this, when there is a living settlor, this option improves the coherence of the tax system by helping to ensure income is taxed at an appropriate rate. This option improves sustainability by future-proofing against changes to the personal tax system. | + + <br>Similarities with existing imputation rules for companies and the Māori authority tax regime. This approach would future-proof the taxation of trusts from changes to the personal tax system. |

| | Option 1 – Increase trustee tax rate to 39% | Option 2 – Mandatory settlor attribution for trustee income | Option 3 – Imputation-style regime for trustee income (33% trustee tax rate / 39% trustee tax rate) |
|---|---|---|---|
| **Administrative and delivery implications** | – <br> There is likely to be a small initial system development impact on Inland Revenue, although this depends on how any modifications are designed. There would be a medium-sized administrative cost in the first year, with minimal ongoing administration costs. Earliest implementation date of 1 April 2024. | – <br> There is likely to be a small initial system development impact on Inland Revenue, depending on the detailed design of this option. There would be a medium-sized administrative cost in the first year, with small ongoing administration costs. Earliest implementation date of 1 April 2025. | – – <br> This option would require large-scale initial system development, and a medium to large initial administrative impact in the first year. Ongoing administration costs are expected to be medium. Earliest implementation date of 1 April 2025. |
| **Compliance costs** | **0 / –** <br> Depending on detailed design, this option is not expected to result in a significant increase in compliance costs. Trustees that restructure by shifting income-producing assets out of trusts will face low one-off compliance costs. | – <br> Determining the appropriate rate of tax on trustee income based on the personal income of the principal settlor of the trust would result in increased compliance costs. No change for trusts without a living principal settlor. | – – <br> This option would result in additional compliance costs for trustees, including needing to maintain memorandum accounts for imputation credits and complying with anti-streaming rules. |
| **Overall assessment** | + + <br> This option is the most effective approach to addressing misalignment within the existing trust tax regime. It is the simplest to design, implement and administer (subject to the detailed design of any modifications). | + <br> This option would improve the status quo in terms of addressing under- and over-taxation. However, it would be complex to design, administer and implement. | + <br> This option addresses under- and over-taxation of trusts but would introduce deferral issues. This approach would require fundamental reform of the taxation of trusts and have significant complexity in policy design, administration, and implementation. |

## What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

106. Option 1 (increasing the trustee tax rate to 39% and introducing modifications to address over-taxation, if necessary) is the preferred option. It would be the simplest to design, administer and implement; however, the specific impact on Inland Revenue would depend on the detailed design of any modifications. This option would improve the robustness and sustainability of the tax system compared with the status quo by helping ensure the 39% rate applies to income attributable to individuals who earn over $180,000. Existing law should mitigate the risks of over-taxation in most situations (although public consultation would be necessary to confirm this). Provided that any modifications are relatively simple, this option could be implemented from 1 April 2024. This option is estimated to raise approximately $350m per annum, although this estimate is highly uncertain.

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

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

## What are the marginal costs and benefits of the preferred option?

***Table 10: Cost benefit analysis of Option 1***

| **Affected groups** | **Comment**<br>*Nature of cost or benefit, evidence and assumption, and risks* | **Impact**<br>*$m present value, where appropriate, for monetised impacts; high, medium or low for non-monetised impacts.* | **Evidence Certainty**<br>*High, medium, or low* |
|---|---|---|---|
| **Additional costs of the preferred option compared to taking no action** | | | |
| Trustees | • Trustees will likely face ongoing additional compliance costs in determining whether to allocate income to beneficiaries as beneficiary income to mitigate over-taxation.<br>• Some trustees will need to trade-off retaining income for non-tax reasons or allocating income to mitigate over-taxation. They may also need to consider the potential social policy impacts of allocating beneficiary income. | Unknown | Low – trustees already need to make these decisions under law. The extent to which the proposed changes would increase costs above current obligations is unclear. |

| | | | |
|---|---|---|---|
| | • Trusts that restructure in response to the proposal (e.g., by moving income-earning assets out of trusts into companies) will likely face low one-off compliance costs. | | |
| Settlors and beneficiaries | Existing rules should be sufficient to mitigate over-taxation in most situations (by trustees allocating income as beneficiary income). | Unknown | Low – it is unclear how much over-taxation might arise without undertaking public consultation. |
| Inland Revenue | Option 1 will have both one-off and ongoing implementation costs, as well as ongoing administrative costs, for Inland Revenue. This relates to implementing the new rules, responding to queries from taxpayers and tax intermediaries, and compliance activity for return filing. | Implementation and ongoing administrative costs are expected to be between $5 million and $11 million.<br>At the upper end of the cost range, over the forecast period (2022–23 to 2026–27):<br>• the estimated one-off capital build costs are $2.9 million,<br>• the one-off operating build costs are $0.7 million, and<br>• the ongoing administrative costs are $7.4 million. | Medium – the level of certainty depends on final policy decisions of all Budget 23 initiatives that impact on other projects on Inland Revenue's work programme progress. |
| **Total monetised costs** | | One-off costs: $3.6 million<br>Total ongoing costs (over 2022–23 to 2026–27): $7.4 million | Medium |
| **Non-monetised costs** | | Unknown | Low |
| **Additional benefits of the preferred option compared to taking no action** | | | |
| Taxpayers | Addressing misalignment of the trustee and top personal tax rates will ensure that trusts cannot be used to circumvent the 39% personal tax rate. This would likely strengthen the sense of fairness in the tax system (social cohesion) through improving horizontal and vertical equity. | Unknown | Medium |
| Government | Increasing the trustee tax rate will generate increased tax revenue in a relatively low-cost way. Ensuring that the top personal tax rate cannot be circumvented through the use of trusts supports the Government's distributional objectives. | Increasing the trustee tax rate to 39% is estimated to raise $350 million per annum. | Low – the impact on tax revenue is highly dependent on the behavioural response by trusts. |
| **Total monetised benefits** | | $350 million per annum | Low |
| **Non-monetised benefits** | | Unknown | Medium |

109. Due to the inability to conduct public consultation during the Budget preparation period, there is significant uncertainty regarding the exact impact of increasing the trustee tax rate to 39%.

110. The amount of revenue raised is highly uncertain and heavily dependent on the behavioural response by trusts. The more income that trusts divert to other entities or allocate as beneficiary income instead of paying tax at the trustee tax rate, the less revenue that will be raised.

## Section 3: Detailed design

111. This section covers detailed design of Option 1 (Increasing the trustee tax rate to 39% with modifications, if necessary), specifically focusing on issues relating to mitigating any risks of over-taxation and whether additional rules are necessary to buttress the proposed 39% trustee tax rate. Other consequential matters are covered in the appendix.

### Rule needed to buttress proposed 39% rate

112. To buttress the 39% trustee tax rate, we 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.

113. The real beneficiary of such an allocation is the ultimate natural person shareholder in the company. The allocation should be taxed at the marginal tax rates 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.

114. 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 tax 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.

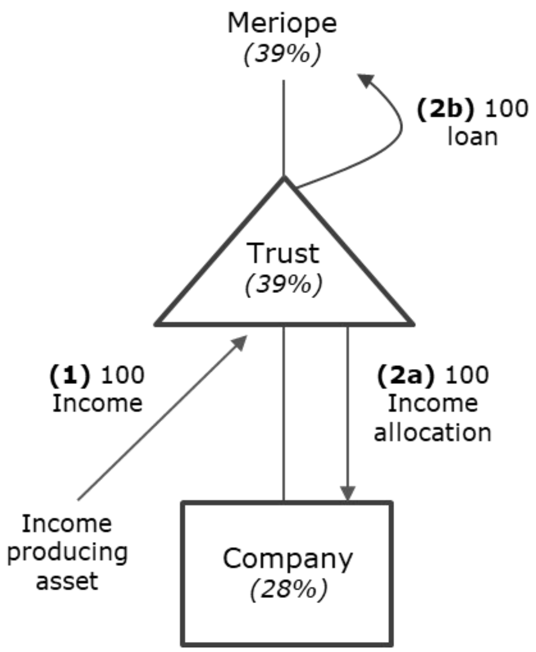
115. Currently, allocations of income to corporate beneficiaries are not common in New Zealand, outside certain specialised contexts. However, the proposed increase in the trustee tax rate to 39% would significantly increase the attractiveness of making such allocations. These allocations are a major issue in Australia, where the trustee tax 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.

116. 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 that 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.

117. Accordingly, to ensure that trusts cannot allocate beneficiary income to companies to circumvent a 39% trustee tax rate, a rule should be introduced so that income allocated to corporate beneficiaries is taxed as trustee income for the purposes of determining the rate of tax (39%), who pays the tax (the trustees) and who provides the return of income (the trustees). This rule should be limited to corporate beneficiaries that are "close

companies”[25] and where a settlor of the trust has “natural love and affection”[26] for a (direct or indirect) shareholder of the company. This ensures that the rule 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.

***Example 5: Income allocated to corporate beneficiary***




Meriope is a beneficiary of a trust. She has a personal tax rate of 39%. The trust has derived $100 of income (this is **(1)** in the diagram).

To avoid the $100 being taxed at the 39% trustee tax 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 Meriope (this is **(2b)**). The $100 is not taxable income in the hands of Meriope.

Overall, only $28 of tax has been paid on the income. However, $39 of tax should have been paid on the income, since the $100 has actually gone to Meriope (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.

118. Treating beneficiary income allocations to these corporate beneficiaries as trustee income 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.

119. We note that this rule would not prevent trusts from restructuring in response to an increased trustee tax 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.

[25] 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).

[26] “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.

*Financial implications*

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

*Administrative and compliance implications*

121. Although this rule is broadly similar to the current minor beneficiary rule, we expect that taxing beneficiary income allocations to certain corporate beneficiaries as trustee income would have a small administrative impact on Inland Revenue. This would include helping trustees understand the new rules and amending forms and guidance. This rule may result in some trusts changing their behaviour or restructuring to ensure they are not affected by the proposed 39% trustee tax rate.

## Further analysis of the risk of over-taxation

122. Beneficiary income is the primary method that trustees can use to mitigate risks of over-taxation under current law. As discussed above in the "Current tax law" section in Section 1, beneficiary income is trust income that is paid or allocated to the trust's beneficiaries before the trust's tax return is filed. There are three main types of beneficiary income:

- Income distributed or paid to a beneficiary.
- Income allocated to a beneficiary that is credited to the beneficiary's current account.
- Income that is allocated to a beneficiary for them to possess at a future date or event (e.g., when they reach a certain age).

123. 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, trustees should be able to mitigate over-taxation by 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 tax rates. This is the method that comparable jurisdictions mostly rely on to mitigate over-taxation.

124. The following sections outline the risks of over-taxation that we are aware of for various types of trusts. Due to the inability to undertake public consultation during the Budget preparation period, there may be some situations where trusts could be over-taxed at a 39% trustee tax rate that we have not been able to identify.

## Trusts for which modifications are required

### Estates

125. 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 can allocate income as beneficiary income to mitigate over-taxation.

126. 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 the estate to access the settlor's marginal tax rates 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.

127. In the 2020-21 income year, estates[27] reported $300m of trustee income. Roughly 90% of estates report total income of $20,000 or less. Only 1% of estates report trustee income over $180,000, but they 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.

***Table 11: 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 (26%) | Nil (0%) | 2,300 (13%) | Nil (0%) |
| Up to $180,000 | 105,300 (66%) | $2,190m (14%) | 14,700 (85%) | $110m (37%) |
| Over $180,000 | 13,800 (**8%**) | $14,410m (**86%**) | 200 (**1%**) | $190m (**63%**) |
| Total | 159,800 | $16,800m | 17,200 | $300m |

128. A modification should be introduced 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 rates. 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 rates 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.

27 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).

***Example 6: Modification for estates***

Ortus dies on 20 February 2025. He had received $50,000 of personal income in the income year of his death. His estate derives $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 Ortus's date of death).

The affairs of Ortus'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 derives.

Instead of the $20,000 of trustee income being taxed at 39%:

- the $10,000 of trustee income in the 2024–25 income year is taxed at Ortus's marginal tax rates. The combination of Ortus's $50,000 of personal income and the $10,000 trustee income falls within the 30% personal income tax bracket ($48,001 to $70,000); and
- the $10,000 derived by the estate in the 2025–26 income year is taxed at 10.5% because it falls within the $0 to $14,000 personal income tax bracket).

129. 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 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*

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

*Administrative and compliance implications*

131. 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.

## Trusts for which modifications should not be required

132. This section of the report sets out trusts for which we explicitly considered the risk of over-taxation but concluded that modifications should not be required based on the information we currently have. Without undertaking public consultation, there is a risk that there are barriers we have not identified that would prevent existing rules being fully effective at mitigating over-taxation for these trusts. We expect our decisions on the necessary modifications to be challenged and tested once the proposals become public and that consultation with stakeholders could bring unexpected concerns to light.

### Fixed trusts

133. A fixed trust is a trust when the trust deed specifies how the assets of the trust are to be distributed exactly.

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

134. We understand that almost all trust deeds of fixed trusts provide trustees with a power of advancement, so trustees have the 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.

135. 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 tax rates. 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.

*…so a modification should not be required*

136. Since existing rules should be able to mitigate over-taxation for fixed trusts where the trustees have a power of advancement, we do not consider it necessary to introduce a modification for these trusts.

**Trusts for disabled people**

137. The Law Commission's 2012 review of trust law noted that some trusts are established to provide for family members with special needs ("disability trusts").[28] However, the Law Commission's papers do not provide data on the number of disability trusts or how they are used. Without public consultation, it is unclear how many disability trusts there are in New Zealand or how they are used. We consulted the Ministry of Justice – Te Tāhū o te Ture, the Public Trust and Whaikaha – Ministry of Disabled People during the development of these proposals, but they were unable to provide data on how many trusts are used to support disabled people in New Zealand.

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

138. The needs of a disabled beneficiary can likely be met by trustees paying or allocating income to the disabled person as beneficiary income. Beneficiary income is taxed at the beneficiary's marginal tax rates 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.

139. For disability trusts, 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

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

behalf. In these situations, allocating income as beneficiary income would likely be sufficient to mitigate over-taxation.

140. Similar to other trusts, if trustees know they will allocate income to a particular beneficiary but do not want the beneficiary to have access to the funds until sometime in the future, they could either allocate to the settlor (as a beneficiary) to access the settlor's tax rate or allocate income to the disabled beneficiary as future possession beneficiary income. Refer to the "Current tax law" section in Section 1.

*…overseas regimes have low uptake and seem to have non-tax objectives…*

141. Australia has a special regime for disability trusts. The regime was mainly put in place for social policy reasons, although it does provide a 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.

142. 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*

143. Based on the limited information available to us at present, we do not think a modification for disability trusts is required to mitigate over-taxation. However, public consultation would help us confirm whether this is correct.

144. If a modification is necessary to mitigate over-taxation for disability trusts, we recommend consulting the disabled community on its design. Our research on similar regimes overseas shows that a modification for disability trusts would likely be complex and would require drawing boundaries that may be difficult to target correctly without input from the disabled community. Designing a modification for disability trusts would involve considering various issues, including:

- <u>What rate should apply instead of the trustee tax rate?</u> To prevent both under- and over-taxation, ideally the beneficiary's marginal tax rates would apply to any trustee income of a disability trust. This would be relatively straightforward for trusts with only one beneficiary. If a disability trust was allowed to have multiple disabled beneficiaries, or a mix of disabled and non-disabled beneficiaries, it would be challenging to determine how trustee income should be apportioned or taxed. A simplification could be to either (i) tax trustee income at a lower flat rate for disability trusts, or (ii) tax trustee income at the highest personal tax rate of the disabled beneficiaries. If Ministers decide to introduce special rules, we do not recommend either of these approaches without first consulting the disabled community to further understand how these trusts are used.

- <u>Should disability trusts be allowed to have more than one beneficiary?</u> 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 any existing trusts with multiple disabled beneficiaries would need to restructure or set up new trusts to access the modification. Multiple disabled beneficiaries could be allowed, however, as noted above, this would require arbitrary or complex rules on how trustee income should be taxed.

- How should "disability" be defined? 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 Supported Living Payment on the ground of restricted work capacity, or the Child Disability Allowance). 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 risks with creating a bespoke definition, especially without public consultation, as Inland Revenue lacks the expertise to both design and apply such a definition.

- Should specific rules apply if a trust ceases to be eligible for the modification? After tax on trustee income is paid at the disabled beneficiary's marginal tax rates 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. There is a risk that this could allow higher rate individuals to benefit from income being taxed on another person's lower marginal tax rates. We have identified three possible responses:

    i. *Clawback mechanism:* If trustee income is taxed at a lower (<39%) rate under the modification, the distribution of that income to a person other than the disabled beneficiary could be subject to a clawback mechanism. This would ensure that disability trusts do not provide tax planning opportunities and would minimise any under-taxation of trustee income. However, such a mechanism would likely be punitive.

    ii. *Specific anti-avoidance rule:* Instead of a clawback mechanism, a specific anti-avoidance provision could be introduced to target the use of disability trusts to obtain a tax benefit for non-disabled beneficiaries.

    iii. *No specific rules:* No specific rules would be introduced to prevent the use of disability trusts in tax planning, although if restrictive eligibility criteria are put in place (such as requiring these trusts to have only one disabled beneficiary) this should be sufficient to minimise tax planning opportunities. The existing general anti-avoidance rule should be sufficient if the modification is used to avoid tax.

145. Given Ministers' concerns regarding disability trusts (refer to "2020 decision to introduce a new top personal tax rate" subsection in Section 1), we have considered how such a modification should be designed.

***Table 12: Potential design of a modification for disability trusts***

| Design feature | Recommended design | Alternative design options |
|---|---|---|
| Trustee tax rate | The disabled beneficiary's marginal tax rates. | • Flat rate – e.g., 10.5%, 17.5%, or 33%.<br>• If multiple beneficiaries are allowed, the highest personal tax rate of the beneficiaries. |
| Number of beneficiaries | Only allow one – the disabled beneficiary. | Allow multiple beneficiaries (but must all be disabled). |
| Definition of "disability" | Link to receipt of Government support – the Child Disability Allowance, or the Supported Living Payment on the ground of restricted work capacity. | n/a |
| Rules if trust ceases to qualify for modification | No specific rules. | Either:<br>• a specific anti-avoidance rule to target the use of disability trusts to gain a tax benefit; or<br>• a clawback mechanism to tax distributions of tax-paid trustee income at the recipient's marginal tax rates (where distributions are made to people other than the disabled beneficiary). |
| Other features | No restrictions on:<br>• the number of disability trusts that can be settled for the care of a disabled person;<br>• who can settle property on a disability trust;<br>• what property can be settled on a disability trust; or<br>• whether the trust is an *inter vivos* trust or a testamentary trust. | n/a |

**Trusts for orphans**

146. We do not recommend a modification for trusts settled for the care of orphans, as we have no data that suggests trusts are widely used for this purpose in New Zealand or that such trusts would have specific barriers to mitigating over-taxation. Similar to disability trusts, existing rules should be sufficient in mitigating risks of over-taxation. We recommend monitoring this situation to establish whether a problem exists and, if so, undertaking consultation to determine how best to address it.

### "Widely-held" trusts

147. Although "widely-held" is a misnomer when describing a trust (because apart from a unit trust, a trust is not owned or held), it is a useful term to informally describe trusts that have a large number of beneficiaries (e.g., trusts with more than 100 beneficiaries, with beneficiaries that are associated persons treated as 1 beneficiary). Inland Revenue data shows a large variety in these types of trusts,[29] and that this group includes trusts in large corporate groups, estates and family trusts.

148. As outlined above, the main defence against over-taxation is for trustees to allocate or pay income as beneficiary income to ensure that the income is taxed at a beneficiary's lower marginal tax rates.

*Widely-held trusts may face an increased risk of over-taxation…*

149. 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 they 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.

150. 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 in the "Well-being and economic considerations" subsection of Section 2, the inability to undertake public consultation during the Budget preparation period with relevant Māori groups limits our understanding of the potential impacts of a 39% trustee tax rate.

*…but existing mechanisms should be sufficient to address risks of over-taxation for these trusts*

151. While there is a risk of over-taxation for widely-held trusts, we do not consider it appropriate to provide special rules for trusts simply because they have a large number of beneficiaries. Trustees of a discretionary trust would be able to 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.

152. 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.

### Energy consumer trusts

153. Most electricity distribution companies in New Zealand are owned by trusts or local councils. The electricity industry was reformed in the 1990s, resulting in the ownership structures of most energy companies being standardised through trusts settled in accordance with the Energy Companies Act 1992.[30]

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[29] There are significant limitations in this analysis. Trustees 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 may be less likely to be at risk of over-taxation.

[30] Some energy companies are not owned by trusts, but by local councils or have foreign ownership.

154. There are 20 energy consumer trusts ("ECTs"), or lines trusts, that are subject to tax,[31] and their objective is to hold the shares of their respective energy companies on behalf of electricity consumers. Generally, the beneficiaries of an ECT are the persons whose premises are connected to (and who are liable for payment of use of, or connection to) the energy company's distribution network.

*A small amount of income derived by ECTs is currently taxed as trustee income…*

155. Twelve of the ECTs generally retain all income as trustee income. There is a risk that increasing the trustee tax 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. However, it is possible that ECTs that retain income as trustee income could use existing rules to allocate that income to beneficiaries as beneficiary income so that the income is taxed at beneficiaries' marginal tax rates (although this may result in increased compliance costs). Most income derived by ECTs is beneficiary income and is therefore already taxed at the personal tax rates of the beneficiaries, rather than at the trustee tax rate.

*…but we expect they can use existing rules to mitigate over-taxation*

156. Without public consultation, it is difficult to determine whether there are specific barriers to these ECTs allocating income as beneficiary income. Given we expect that ECTs should be able to use existing rules to mitigate over-taxation, we think the 39% trustee tax rate should continue to apply to ECTs until we can engage with the sector to determine whether a modification is required.

***Table 13: 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

157. A "superannuation fund" is defined in the Income Tax Act 2007 as a "retirement scheme" within the meaning of the Financial Markets Conduct Act 2013. This includes:

- A registered scheme that is a KiwiSaver scheme or a superannuation scheme.
- A workplace savings scheme.
- A "Schedule 3" scheme (a single person self-managed superannuation scheme).

158. Superannuation funds that are not "widely-held" are taxed at the trustee tax rate and widely-held superannuation funds are taxed at 28%. Generally, a widely-held superannuation fund is a superannuation fund that has 100 or more investors

[31] ECTs that are registered charities are outside the scope of this RIS.

(beneficiaries), treating all associated persons as one investor.[32] Unregistered superannuation schemes (i.e., retirement schemes that do not fall within the meaning of the Financial Markets Conduct Act) are generally taxed as unit trusts[33] at 28%.

*A small number of superannuation schemes are taxed at the trustee tax rate…*

159. The schemes that will be affected by a change in the trustee tax rate are superannuation funds with fewer than 100 investors (when aggregating associated persons as one person). Based on the New Zealand Companies Office's Disclose Register for superannuation schemes, there are 275 of these funds. Of these, 239 are "Schedule 3" single-person schemes, and 211 of those were set up by judges, coroners and Members of Parliament.

***Table 14: 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 |

*…and cannot use existing rules to prevent the 39% rate applying…*

160. Superannuation funds that have fewer than 100 investors (when treating associated persons as one person) are taxed as trusts and would be subject to a 39% trustee tax rate. All income derived by these superannuation funds is taxed as trustee income. By law, these trusts cannot allocate income as beneficiary income, which is the main method of mitigating over-taxation for other trusts.[34]

*…but we expect most beneficiaries of these funds to be on the 39% top personal tax rate*

161. Although these trusts cannot access the main method of mitigating over-taxation, we consider it appropriate to continue taxing them at the trustee tax rate for two key reasons:

- At least 211 (out of 275) of these funds are likely to have 39% rate beneficiaries as they were set up by judges, coroners and Members of Parliament. Introducing a modification for these trusts would risk 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.

162. How these superannuation funds are taxed could be reconsidered when the PIE rates are reviewed, given the similarities between PIEs and the use of these trusts as retirement savings vehicles.

[32] Technically, a superannuation fund is a widely-held superannuation fund if it meets 1 or more of paragraphs (a) and (c) to (e) of the definition of "public unit trust" in section YA 1 of the Income Tax Act 2007.

[33] Registered superannuation schemes are specifically excluded from the definition of a "unit trust" (paragraph (b)(vii), definition of a "unit trust", section YA 1 of the Income Tax Act 2007), whereas unregistered superannuation schemes with contributing beneficiaries fall within paragraph (a) of the "unit trust" definition.

[34] Income derived by a trust that is a superannuation fund is excluded from the definition of "beneficiary income" under section HC 6(2)(a) of the Income Tax Act 2007.

# Section 4: Delivering an option

## How will the new arrangements be implemented?

163. Amendments to the Income Tax Act 2007 would be required to implement the proposals. These changes are proposed to be included in an omnibus taxation Bill, scheduled to be introduced on Budget night, 18 May 2023. The Bill is expected to progress through the full select committee process and be enacted after the 2023 General Election and before the end of March 2024. The proposals are recommended to apply for the 2024–25 and later income years (beginning 1 April 2024 for most trusts), with a commencement date of 1 April 2024.

164. Inland Revenue currently has a significant Tax and Social Policy Work Programme utilising the majority of the department's specialist design and delivery capacity. The Budget 23 work programme is proposed to be implemented primarily between September 2023 and April 2025 with significant implementations required for 1 April 2024 and 1 April 2025. The accumulative delivery effort during a compressed period presents potential risks to successful delivery due to the volume of design and development work, limited specialist capability and extensive testing. This will impact Inland Revenue's ability to deliver other initiatives and services to support customers.

165. Inland Revenue provides services within a wider ecosystem which includes 3rd Party Software Developers, Payroll Providers, and Intermediaries. The Budget 2023 initiatives will also require these partners to make significant system changes with short lead in times and compressed timeframes which may result in delivery risk and impacts on partnership relationships.

166. Inland Revenue will work with stakeholders and tax intermediaries on communicating the proposals to affected taxpayers. The specifics of any education campaigns and communications strategies will be considered once policy proposals are further developed. The usual guidance will be published on the proposed changes on Inland Revenue's website and in a *Tax Information Bulletin* shortly after the proposals are enacted.

## How will the new arrangements be monitored, evaluated, and reviewed?

167. The inability to undertake public consultation during the Budget preparation period is a risk. However, stakeholders and affected parties will have the opportunity to provide input on the proposals through the select committee process, refining the quality of the legislation. There will likely be issues and barriers that have not been identified due to the lack of consultation.

168. We do not expect to need to collect any further data – the recently introduced trust disclosure rules will help monitor the effectiveness of the proposals. Inland Revenue is scheduled to undertake a post-implementation review of those rules in 2023.

169. Inland Revenue will continue to monitor the outcomes through the Generic Tax Policy Process (GTPP), including a focus on the risks of over-taxation and other structures that could be used to undermine a 39% trustee tax rate. An advantage of consultation through the select committee process is that it may bring to light such issues.

170. Inland Revenue regularly reviews tax settings on an ongoing basis and provides advice and updates to the Government accordingly. Policy officials also maintain strong communication channels with stakeholders in the tax advisory community, and these stakeholders will be able to correspond with officials about the operation of the proposals

at any time. If problems emerge, they will be dealt with either operationally or by way of legislative amendment, if agreed by Parliament.

# Appendix: Consequential issues

171. This section covers a range of issues that arise as a consequence of increasing the trustee tax rate to 39%. We have considered whether changes are needed in response to these issues but do not consider any necessary at this stage.

## Minor beneficiary rule

172. 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 or older.

173. Due to the limited time for policy design, we have not considered potential changes to the minor beneficiary rule in detail. Consideration of whether the minor beneficiary rule is fit-for-purpose would benefit from public consultation and further policy consideration.

## Resident withholding tax

174. 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 to pay their tax throughout the year. We do not think it is necessary to increase 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.

## Provisional tax

175. Provisional tax for a year is generally 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% when the taxpayer has an extension of time to file their prior year’s tax return (and has not yet filed it).

176. 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.

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

178. We do not think it is necessary to make any changes to the provisional tax rules. Providing special rules to address this transitional issue would be complex and extremely difficult to implement. The provisional tax rules were not amended when the top personal tax 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.

## Taxable distributions from non-complying trusts

179. **Complying trusts** are trusts that have always paid New Zealand tax on the worldwide trustee income of the 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.

180. **Non-complying trusts** are trusts that are neither complying nor foreign trusts. Typically, this class covers trusts with New Zealand resident settlors and non-resident trustees that have not paid New Zealand tax on all worldwide income of the trust. New Zealand resident settlors are liable to pay this tax as agents of the trustees.

***Table 15: Taxation of different types of trusts***

| *Type of Trust* | *Tax rate for trustee income* | *Tax rate for beneficiary income* | *Other distributions taxable to beneficiaries* |
|---|---|---|---|
| **Complying trust** | 33% | Beneficiary's marginal tax rates | Not applicable |
| **Foreign trust** | 33% | Beneficiary's marginal tax rates | Accumulated trustee income taxed at beneficiary's marginal tax rates – corpus and capital profits excluded |
| **Non-complying trust** | 33% | Beneficiary's marginal tax rates | Accumulated trustee income and capital profits taxed to beneficiary at 45% rate – corpus excluded |

181. A distribution from a non-complying trust is a **taxable distribution** to the extent to which it is not a distribution of:

- an amount that is beneficiary income;
- a part of the corpus of the trust; or
- a payment or transaction that represents a distribution of the corpus of the trust.

182. A taxable distribution will generally be made up of accumulated income or capital gain amounts. A taxable distribution is excluded income of the recipient.[35] All taxable distributions from non-complying trusts to New Zealand resident beneficiaries are taxed at 45%. However, only New Zealand-sourced distributions from non-complying trusts are taxed at 45% to non-resident beneficiaries.

183. The higher 45% rate, and the inclusion of distributions of capital profits or gains within the taxable distribution definition, is because New Zealand income has been avoided or deferred by using trusts, which are now classified as non-complying trusts. This policy setting is also intended to encourage non-complying trusts to be converted to complying trusts by an election procedure.

*The current 45% rate was calculated based on the 33% trustee tax rate…*

184. The 45% tax rate on taxable distributions from non-complying trusts is based on the 33% trustee tax 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 when it is subsequently distributed.

[35] Sections CX 59 and HC 19 of the Income Tax Act 2007.

185. Increasing the trustee tax rate from 33% to 39%, without changing the tax rate on taxable distributions from non-complying trusts, would erode the time value of money calculation. Therefore, increasing the trustee tax rate from 33% to 39% would increase the benefit from deferring or avoiding New Zealand tax on trustee income for non-complying trusts.

*…but no change is required at this stage*

186. Although increasing the trustee tax rate to 39% would erode the time value of money factor of the 45% rate, we do not consider it necessary to increase the tax rate on taxable distributions from non-complying trusts. The rate is already relatively high, and other 45% tax rates were not increased when the 39% top personal tax rate was introduced.