

2 March 2021

## **Foreign trust remedials**

In 2017, new disclosure requirements were enacted for foreign trusts with New Zealand resident trustees (the 2017 requirements). The Taxation (Business Tax, Exchange of Information, and Remedial Matters) Act 2017 amended the Tax Administration Act 1994 (TAA), implementing the recommendations of the *Government Inquiry into Foreign Trust Disclosure Rules* (2016).

Following implementation of the 2017 requirements, officials have identified a number of legislative errors or unintended consequences which require remedial amendments. This letter sets out the proposed amendments and invites you to make a submission on the proposed remedials. The closing date for submissions is 23 March 2021.

In summary, the remedial issues are:

1. The definition of "foreign trust" is not aligned with the requirements for the foreign-sourced income exemption in sections CW 54 and HC 26 of the Income Tax Act 2007 (ITA).
2. A power to deregister trusts does not exist.
3. The term "in the business of providing trustee services" is not defined and may be confusing.
4. Certain information may not be required for new settlors of, or beneficiaries with fixed or final interests in, a foreign trust.
5. There is no requirement to update annual return information when it changes.
6. Testamentary trusts do not have trust deeds and cannot qualify for the foreign-sourced income exemption in section CW 54.
7. The foreign trust disclosure rules in the TAA are not included in the ITA definition of "trust rules".
8. The Commissioner has no discretion to allow the foreign-sourced income exemption where the foreign trust was not registered at the relevant time.
9. The penalties have not been updated to reflect the 2017 requirements and are not fit for purpose.
10. References to a minor beneficiary's age should instead refer to their date of birth.

### **Issue 1: The definition of "foreign trust" is not aligned with the requirements for the foreign-sourced income exemption in sections CW 54 and HC 26**

New Zealand taxes trusts based on the settlor's tax residence. Accordingly, section CW 54 of the ITA exempts foreign-sourced amounts derived by resident trustees when the requirements of section HC 26 are met. Section HC 26(1)(a) requires that:

no settlor of the trust is at any time in the income year a New Zealand resident who is not a transitional resident; ...

When the trust is a foreign trust, section HC 26 also requires the trust to meet certain requirements: the trust must have a trust deed, be registered, and the trustee must comply with the foreign trust disclosure requirements in the TAA.

However, a trust can qualify for the foreign-sourced income exemption without being a "foreign trust". A "foreign trust" is defined in section HC 11:

### **HC 11 Foreign trusts**

A trust is a **foreign trust** at a moment in time if no settlor is resident in New Zealand at any time in the period that—

- (a) starts on the later of 17 December 1987 and the date on which a settlement was first made on the trust; and
- (b) ends with the moment in time.

The non-resident settlor requirements in section HC 11 and section HC 26(1)(a) are not completely aligned. The requirement in section HC 11 looks at the entire lifetime of the trust (for trusts settled after 17 December 1987), whereas the requirement in section HC 26(1)(a) only looks at the income year in which the relevant foreign-sourced amount is derived.

As such, a trust that does not have a settlor resident in New Zealand at any point in the current income year could use the foreign-sourced income exemption without technically being a "foreign trust" subject to the registration and disclosure requirements in the TAA.

#### **Example 1: settlor migrates from New Zealand**

Maia is resident in New Zealand. In the 2013 income year, she settled a family trust (the Trust) with a New Zealand trustee. The Trust holds a variety of foreign investments. The Trust is a complying trust as it has always met its tax obligations in New Zealand.

Maia moves overseas and ceases to be resident in New Zealand in the 2018 income year. In the 2019 income year, the Trust derives foreign-sourced income.

When the Trust's 2019 tax return is filed, the foreign-sourced income derived in that year could qualify for the exemption in sections CW 54 and HC 26 of the ITA, as no settlor of the trust was at any time in the income year a New Zealand resident. However, it would not technically be required (or able) to register as a "foreign trust", as it had a New Zealand resident settlor between the 2013 and 2018 income years.

The same issue arises for settlors who are transitional residents. As transitional residents are still tax resident in New Zealand, a trust with a transitional resident settlor could not be a "foreign trust" under section HC 11. However, such a trust could still use the foreign-sourced exemption in section HC 26(1)(a) as that section carves out transitional resident settlors from its non-resident settlor requirement.

#### **Example 2: settlor migrates to New Zealand**

Pierre is resident in the United Kingdom. In 2001, he settled a family trust (the Trust) with a UK trustee. The Trust holds a variety of European investments.

In the 2019 income year, Pierre moves to New Zealand and replaces the Trust's UK trustee with a New Zealand trustee. Pierre becomes resident in New Zealand on 1 June 2018 but is a transitional resident for the period from 1 June 2018 to 30 June 2022.

When the Trust's 2019 tax return is filed, any foreign-sourced income derived in that year could qualify for the exemption in sections CW 54 and HC 26, as Pierre, the only settlor of the trust, is a transitional resident. However, the trust would not technically be a "foreign trust", as it has a New Zealand resident settlor.

These outcomes are inconsistent with the original policy intent of the disclosure requirements. The intent was that only registered trusts that have met the disclosure requirements would be able to use the foreign-sourced income exemption. The issue stems from the fact that the ITA assesses eligibility for the foreign-sourced income exemption on a yearly basis, whereas the

TAA's registration and disclosure regime does not contemplate trusts changing in classification between complying, non-complying and foreign trusts.

### ***Proposed change***

Our preferred remedial change is to:

- Revert to the previous definition of "foreign trust" in section HC 11 of the ITA under which a trust can be a foreign trust in relation to a particular distribution.
- Enact a new defined term "foreign disclosing trust" for the purposes of sections HC 26(1)(c) and (d) and the disclosure regime in the TAA. The new definition would set out which trusts must comply with the TAA's registration and disclosure requirements and should include any trust qualifying for the foreign-sourced income exemption.

These remedial changes would only apply prospectively.

### **Issue 2: A power to deregister trusts does not explicitly exist**

The current legislation envisages that foreign trusts may be deregistered (see section HC 26(1)(c)(iii) of the ITA) but there is no explicit power to deregister trusts.

### ***Proposed change***

We propose to set out explicitly the circumstances where a foreign trust may be deregistered, and the effect of such deregistration.

#### *Requirements for deregistration*

The Commissioner should have the explicit power to deregister a foreign trust where she is satisfied the trust:

- is no longer a foreign trust
- no longer has a New Zealand resident trustee, or
- should not have been registered in the first place, as the requirements for registration were not made out.

The Commissioner should be allowed to backdate a deregistration to the point where the trust ceased to meet the statutory requirements for registration (for example the trust ceased to be a foreign trust).

The Commissioner should be able to exercise this deregistration power on her own initiative or on application by a trust. A trust applying for deregistration would have to provide sufficient information to satisfy the Commissioner that the trust should be deregistered.

Consistent with existing practice, the trust would need to provide the following when applying for deregistration:

- Reasons for the deregistration.
- Evidence of the termination or migration of the trust (for example, a deed of winding up or deed of appointment or removal of trustees).
- Contact details of the new trustee where the trust has migrated.
- A final annual return for the period up to its deregistration (including financial statements, details of settlements and distributions in the final period, and details of settlors making those settlements or beneficiaries receiving those distributions). This

may be a part-year return if the trust is terminated or migrated shortly after the end of its balance year.

- Such other information the Commissioner may require.

#### *Effect of deregistration*

Once a trust has been deregistered, it should not be required to notify the Commissioner of additions or alterations to details it has already provided (as required under section 59B(5) of the TAA) or provide annual returns (as required under section 59D(1)).

A trust that has been deregistered will not be able to use the foreign-sourced income exemption in section CW 54 of the ITA (for income derived after deregistration), as section HC 26 generally requires foreign trusts to be registered to qualify for the exemption.

If the foreign-sourced income exemption has been claimed for a period the trust was not registered, the Commissioner could amend the trust's returns to include the foreign-sourced income, subject to any existing time bar.

### **Issue 3: The term "in the business of providing trustee services" is not defined and may be confusing**

In some cases, the requirements are lighter for trusts with only foreign trustees that are natural persons and not "in the business of providing trustee services". Such trusts: do not have to look back as far when disclosing historical settlements on application for registration (section 59B(3)(b) of the TAA); are allowed a longer grace period to register the trust (section 59C(3)); and do not have to pay registration and annual return fees (section 59E(5)).

Some commentary has used the term "professional trustee" as a shorthand for trustees in the business of providing trustee services, even though "professional trustee" is a separately defined term. Section 3 defines "professional trustee" for the purposes of section 43B as follows:

**professional trustee**, in section 43B, means a person whose profession, employment, or business is or includes acting as a trustee or investing money on behalf of others

We consider the terms "professional trustee" and "in the business of providing trustee services" cover broadly similar concepts. It may therefore be less confusing to combine the two terms.

#### ***Proposed change***

We propose to replace references to trustees "in the business of providing trustee services" with "professional trustees".

This change would increase simplicity and certainty.

### **Issue 4: Certain information may not be required for new settlors of, or beneficiaries with fixed or final interests in, a foreign trust**

When a trustee applies for registration, they are required to provide the following for each of the persons listed in section 59B(3)(c)(i) to (vii) of the TAA:

- The name, email address, physical residential or business address, jurisdiction of tax residence, taxpayer identification number, and connection with the trust.
- A signed declaration that the trustee has informed the person of, and the person has agreed to, certain requirements of the TAA, Anti-Money Laundering and Countering Financing of Terrorism Act 2009 (AMLCFT Act) and regulations made under the AMLCFT

(section 59B(4)). Alternatively, the contact trustee may provide a signed declaration certifying that the person is dead or cannot be located.

However, the legislation may not technically require the contact trustee to provide a signed declaration for settlors making a settlement after the application for registration (new settlors), even though the other information above is required.

It is also arguable whether the information above and a declaration are required for beneficiaries with a fixed interest in the trust property (fixed beneficiaries). Although the information and declaration are required for each beneficiary of a "fixed trust", some taxpayers may consider a trust not to be a "fixed trust" if it also has discretionary beneficiaries under the same trust deed. While we consider that in these cases there would actually be multiple trusts (some fixed, some discretionary), it would be clearer to amend the relevant sections so that they refer to beneficiaries with fixed interests in the trust rather than beneficiaries of a "fixed trust".

It can also be unclear whether the information above and a declaration are required for final beneficiaries. We consider it arguable that final beneficiaries should be subject to the same requirements as fixed beneficiaries because a final beneficiary's interest in the trust can be more certain than a discretionary beneficiary's interest. On the other hand, we understand that, like discretionary beneficiaries, final beneficiaries can sometimes be hard to identify if they are part of a wider class. We welcome submissions on this point.

### ***Proposed changes***

We propose to:

- Require the contact trustee to provide the signed declaration for any new settlors at the same time as the annual return relating to the period in which the settlement was made is filed.
- Amend sections 59B(3)(c)(vi), (vii) and (d) so that they refer to beneficiaries with fixed interests in the trust rather than beneficiaries of a "fixed trust".
- Clarify whether final beneficiaries are covered by the requirements that apply to fixed beneficiaries in section 59B(3)(c) and (4) or the requirements that apply to discretionary beneficiaries in section 59B(3)(e).

### **Issue 5: There is no requirement to update annual return information when it changes**

Section 59B(5) of the TAA generally requires the contact trustee to notify the Commissioner of additions or alterations to the information provided on registration, but not for information provided in annual returns.

### ***Proposed change***

We propose to require the contact trustee to notify the Commissioner of additions or alterations to the information provided in annual returns (including information on new settlors and beneficiaries with fixed interests — see Issue 4) within 30 days after becoming aware of the addition or alteration. This is consistent with the existing time limit under section 59C(2) for disclosing changes to information provided on application for registration.

The effect of this change means that if, for example, a settlor's physical address changes, the contact trustee must notify the Commissioner within 30 days after becoming aware of it, regardless of whether the settlor's original address was provided on registration or in an annual return.

## **Issue 6: Testamentary trusts do not have trust deeds and cannot qualify for the foreign-sourced income exemption in section CW 54**

For a foreign trust to get the foreign-sourced income exemption in section CW 54 of the ITA, it must have a trust deed (sections HC 26(1)(c)(i) and (d)(i)). This requirement applies equally to foreign trusts established under a will (testamentary trusts) as it does to trusts set up during a settlor's lifetime (*inter vivos* trusts).

However, a will is not legally a trust deed. As a result, foreign testamentary trusts are not currently able to obtain the foreign-sourced income exemption. We do not consider this was the intended policy result.

### ***Proposed change***

We propose to allow testamentary trusts to obtain the foreign-sourced income exemption by allowing a will establishing a trust to be treated as a trust deed for the purposes of section HC 26.

We propose to make this change retrospective to 21 February 2017, when the new disclosure requirements came into effect.

## **Issue 7: The foreign trust disclosure rules in the TAA are not included in the ITA definition of "trust rules"**

The foreign trust registration and disclosure rules in sections 59B to 59E of the TAA are not included in the definition of "trust rules" in section YA 1 of the ITA. Accordingly, some provisions and definitions that should apply to the foreign trust disclosure rules do not. An example is section HC 28, which contains an expanded definition of "settlor" for the purpose of the trust rules.

There was never a policy intention to treat persons falling under the section HC 27 definition of a "settlor" differently from persons falling under the expanded definition in section HC 28 for the purposes of the foreign trust disclosure rules. The legislative history of section HC 28 suggests that the section was split out for legibility reasons rather than policy reasons.

We recognise, however, the intention that people who have provided minor and incidental services to a trust for consideration below market value, would not be regarded as "settlors" for the purposes of the foreign trust disclosure rules (even though they would be "settlors" for other income tax purposes).<sup>1</sup> That intention is already achieved through the specific carveouts in sections 59B(3)(b) and 59D(2)(b)(i) and will not be affected by including the foreign trust disclosure rules in the definition of "trust rules".

### ***Proposed change***

We propose to amend the definition of "trust rules" in the ITA to include the foreign trust registration and disclosure rules in sections 59B to 59E of the TAA.

## **Issue 8: The Commissioner has no discretion to allow the foreign-sourced income exemption where the foreign trust was not registered at the relevant time**

If a resident foreign trustee has satisfied the Commissioner that the trustee made reasonable efforts in the income year to comply with the requirements of sections 22, 59B, 59C or 59D of the TAA, and has corrected the failure to comply within a reasonable period after becoming

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<sup>1</sup> Taxation (Business Tax, Exchange of Information, and Remedial Matters) Bill (149-2) (select committee report) at 4 [https://www.parliament.nz/resource/en-NZ/51DBSCH\\_SCR71859\\_1/a766cca1dc215ab6c19f957d7a9d3668f18ebe8f](https://www.parliament.nz/resource/en-NZ/51DBSCH_SCR71859_1/a766cca1dc215ab6c19f957d7a9d3668f18ebe8f)

aware of the failure, the trust may still obtain the foreign-sourced income exemption under section HC 26(1B) of the ITA.

However, that same power is not available to the Commissioner if a foreign trust was not *registered* at the times required by section HC 26(1)(d)(ii) and (iii), even if the trustee had made reasonable efforts to be registered in time. There is no policy reason for this difference in treatment.

### ***Proposed change***

We are considering two ways in which this issue may be fixed. Where the trustee has made reasonable efforts to be registered in time and the other conditions for the exemption are met, either:

- give the Commissioner a discretion to allow the foreign-sourced income exemption, or
- allow the Commissioner to backdate a registration.

We invite submissions on which of the two approaches is preferred. At this stage, we consider backdating the registration would most likely be simpler and cleaner, particularly where the trust has derived multiple items of foreign-sourced income in the relevant period.

### **Issue 9: The penalties have not been updated to reflect the 2017 requirements and are not fit for purpose**

When the registration and disclosure requirements were enacted, penalties for non-compliance were not correspondingly enacted or updated. In particular, sections 143(1B) and (1C) of the TAA, which set out how the absolute liability offences in section 143(1) apply to resident foreign trustees, reflect the wording of the pre-2017 disclosure regime. For example, section 143(1C) refers only to section 59B (registration and initial disclosure requirement) but not to section 59D (annual return requirement); and section 143(1C)(b) refers to the appointment of another resident foreign trustee under section 59B(7) even though that subsection no longer provides for the appointment of a trustee.

Furthermore, the main consequence of non-compliance with the 2017 requirements is that the foreign trust will not be able to use the foreign-sourced income exemption. There is an exception in section HC 26(1B) (discussed above under Issue 8), which can apply when the Commissioner is satisfied that the trustee has made reasonable efforts to comply. However, this is all-or-nothing in its effect (that is, the exemption either applies or it does not) which means that the consequences of not complying may be disproportionate to the seriousness of, or culpability involved in, the non-compliance.

For example, a resident trustee may not have taken reasonable efforts to comply with all the disclosure requirements, but ultimately did comply. Denying the foreign-sourced income exemption altogether in such a case may be considered excessively harsh, but at the same time the Commissioner may not be satisfied that the exception in section HC 26(1B) is made out.

On the other hand, where the Commissioner is satisfied the exception is made out, it could be considered unsatisfactory that the foreign trust effectively suffered no consequences for its non-compliance. Similarly, denying the foreign-sourced income exemption would not have any effect on a foreign trust that does not derive foreign-sourced income.

Another compliance tool, such as a civil penalty, could assist the administration of the foreign trust registration and disclosure regime, having regard to the purpose of that regime. A civil penalty could be imposed in a way that is more proportionate to the offence committed.

### ***Proposed changes***

We propose to update section 143 of the TAA to take into account the 2017 requirements as follows:

- ensuring that subsection (1C) refers to section 59D, and
- removing the reference to section 59B(7).

We also propose to:

- Enact a new civil penalty based on section 142I of the TAA (penalties relating to failure to provide foreign information relating to a person or entity for a financial account) of up to \$1,000.
- Give the Commissioner a broader ability to allow the foreign-sourced income exemption in section HC 26(1B) where the trustee has made reasonable efforts to correct a failure to comply with the requirements within a reasonable period, even if the failure could not in fact be corrected.

The new civil penalty could be applied for failures to comply with the 2017 requirements, such as when a trustee misses a deadline, provides an incomplete annual return, or provides false information. This penalty can apply instead of, or in addition to, the trust being denied the foreign-sourced income exemption.

As with the section 142I penalty, the new civil penalty would not apply to failures to provide information if the Commissioner is satisfied that the failure occurred through no fault of the trustee or that the trustee made reasonable efforts to meet the requirement.

### **Issue 10: References to a minor beneficiary's age should instead refer to their date of birth**

Currently, the TAA requires the contact trustee to provide the Commissioner with the ages of minor beneficiaries to a fixed trust (sections 59B(3)(d) and 59D(2)(e) of the TAA). Technically, the updating requirements mean that the trustee would have to inform the Commissioner of the minor's new age within 30 days of the minor's birthday each year, until they ceased to become a minor. This is impractical.

### ***Proposed changes***

We propose to replace the references to age in sections 59B(3)(d) and 59D(2)(e) with references to date of birth.

### **Other issues**

If you are aware of any other remedial or technical issues that make the foreign trust disclosure rules difficult to apply in practice, please let us know.

### **Submissions**

Submissions on any aspect of the proposed remedials should be made by email to [policy.webmaster@ird.govt.nz](mailto:policy.webmaster@ird.govt.nz) by 23 March 2021.

Submissions may be the subject of a request under the Official Information Act 1982, which may result in their publication. The withholding of responses on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. If you consider that any part of your submission should properly be withheld under the Act please clearly indicate this.