

POLICY AND REGULATORY STEWARDSHIP

Tax policy report: Order in Council: minimum standards for financial statements prepared by domestic trusts

Date:	21 January 2022	Priority:	High
Security level:	In Confidence	Report number:	IR2022/002

Action sought

	Action sought	Deadline
Minister of Revenue	Agree to recommendations	28 January 2022
	Authorise the lodgement of the attached Cabinet paper	10 am Thursday 24 February 2022

Contact for telephone discussion (if required)

Name	Position	Telephone
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21 January 2022

Minister of Revenue

Order in Council: minimum standards for financial statements prepared by domestic trusts

Executive summary

Purpose

1. In September 2021 you gave approval for officials to consult on minimum financial reporting standards for domestic trusts (BN2021/319). Consultation is now complete. This report seeks your agreement to set the minimum standards by Order in Council (OIC).

Background

2. The Taxation (Income Tax Rate and Other Amendments) Act 2020 introduced increased disclosure requirements for trusts to support the Commissioner's ability to assess compliance with the new 39% personal income tax rate and assist the Commissioner in understanding and monitoring the use of structures and entities by trustees.
3. The new rules require trustees of a trust that derives assessable income, and does not fall within a specific exclusion category, to prepare financial statements. This is in addition to requirements to disclose settlors, settlements, distributions and appointer details.
4. An OIC will set minimum standards for the financial statements. This will provide certainty regarding the level of detail to which the statements must be prepared and will impact on the quality of data collected.

Consultation

5. Policy officials undertook targeted and public consultation on the content of the OIC from June to December 2021. Officials also consulted on operational guidance to address practical matters for trustees, which is planned to be issued in an operational statement in March 2022.
6. The main themes arising from the OIC consultation involved a concern about high compliance costs, a preference for a one-year deferral of all disclosure requirements, general support for the OIC, recommendations concerning the definition and extent of relief for small trusts, and suggestions concerning various technical matters including related legislative amendments.

Analysis

7. Officials acknowledge that the trust disclosure rules will result in increased compliance costs. This was addressed in the 2020 Regulatory Impact Assessment (RIA) "Introducing a new top personal income tax rate". The RIA included the recommendation to conduct a post-implementation review of the new disclosure rules. An appropriate time would be in 2023, after trustees using agents have filed

their first returns under the new rules (these trustees have until 31 March 2023 to file their returns for the 2021-22 year).

8. Throughout the OIC consultation process in 2021, policy officials attempted to strike a balance between ensuring the OIC does not generate unnecessary compliance costs and ensuring the Commissioner will have sufficient financial information to meet the objectives of the disclosure rules. We believe the proposed OIC content will achieve this.
9. The proposed key features of the OIC are:
 - 9.1 **Date of application:** Officials propose that the OIC will apply for the 2021-22 and future income years.
 - 9.2 **OIC requirements:** Officials propose that the OIC specifies core requirements for financial statements that must be met by all trusts and additional requirements that must be met for trusts that are not small trusts.
 - 9.3 **Limited relief for small trusts:** Officials propose limited relief in the OIC for small trusts. This would simplify their reporting obligations and significantly reduce compliance costs. However, all trusts will provide the same financial information in forms prescribed by the Commissioner to ensure the Commissioner has sufficient financial information to meet the objectives of the disclosure rules.

Small trusts would be defined as having less than \$100,000 assessable income, \$100,000 tax deductions, and \$5 million total assets in the relevant income year. The income and deduction thresholds would exclude income and expenditure relating to the residential property bright-line rules. Officials estimate that these thresholds will provide limited relief for approximately 75% or 135,000 out of 180,000 trusts subject to the new disclosure rules.
 - 9.4 **Asset valuation:** Valuations will be market value, cost or tax adjusted value, at the discretion of the trustees.
 - 9.5 **Associated person disclosures:** Associated person transactions must be disclosed in the financial statements if not disclosed in prescribed forms. Disclosures will not be required for transactions at market value. The definition of associated person will be the general definition to be consistent with prescribed forms, however the Commissioner's operational statement will accept a best endeavours approach to reporting all associated persons transactions in the first year if information is not available.
10. Officials have recommended three legislative amendments to the trust disclosure rules in the separate policy report for including amendments to the Taxation (Annual Rates for 2021-22, GST, and Remedial Matters) Bill at the Finance and Expenditure Committee stage (IR2022/017 refers).

Timing

11. Officials recommend that the OIC come into force by 31 March 2022. Subject to Cabinet Committee and Cabinet meeting dates, this will require a waiver of the 28-day rule.
12. Officials have been liaising with the Parliamentary Counsel Office (PCO) regarding the drafting of this OIC. Due to the compressed timeframes, there is not sufficient time to obtain Cabinet approval to provide drafting instructions to PCO, and then separately obtain Cabinet Legislation Committee approval to submit the OIC to Executive Council. Officials recommend seeking policy and legislative approval for the OIC in the same Cabinet paper. PCO will begin drafting the OIC following your agreement to the minimum standards set out in this paper.

13. A regulatory impact assessment of the proposed minimum standards will be provided to you before the attached Cabinet paper is lodged with the Cabinet Office.

Recommended action

We recommend that you:

- a. **agree** that the minimum standards for financial statements as set out in Appendix A to this report, which will apply to domestic trusts that are subject to the disclosure rules in section 59BA of the Tax Administration Act 1994, should be set by Order in Council.

Agreed/Not agreed

- b. **agree** that the Order in Council will apply for income years ending from the date the Order is made.

Agreed/Not agreed

- c. **direct** officials to provide drafting instructions to the Parliamentary Counsel Office.

Directed/Not directed

- d. **agree** to seek a waiver of the 28-day rule to allow the Order in Council to come into force by 31 March 2022.

Agreed/Not agreed

- e. **authorise** the lodgement of the attached Cabinet paper with the Cabinet Office by 10 am Thursday 24 February 2022 for consideration at the Cabinet Economic Development Committee meeting on 2 March 2022.

Authorised/Not authorised

- f. **note** that a regulatory impact assessment will be provided to you before the attached Cabinet paper is lodged with the Cabinet Office.

Noted

- g. **agree** to the release of the attached Cabinet paper, associated minutes, and key advice papers, within 30 days of Cabinet making decisions, subject to minor redactions under the Official Information Act 1982.

Agreed/Not agreed

s 9(2)(a)

Stewart Donaldson
Principal Policy Advisor
Policy and Regulatory Stewardship

Hon David Parker
Minister of Revenue
/ /2022

Background

14. The Taxation (Income Tax Rate and Other Amendments) Act 2020 introduced increased disclosure requirements for trusts to support the Commissioner's ability to assess compliance with the new 39% personal income tax rate and assist the Commissioner in understanding and monitoring the use of structures and entities by trustees. Amendments to reduce compliance costs for some trusts were subsequently enacted in March 2021 in the Taxation (Annual Rates for 2020-21, Feasibility Expenditure, and Remedial Matters) Act 2021.
15. The increased disclosure requirements apply to trustees of trusts that derive assessable income and are not subject to specific exclusions. These new rules apply for the 2021-22 and later income years and require trustees to include with their annual return:
 - 15.1 A statement of profit or loss and a statement of financial position
 - 15.2 The amount and nature of settlements received
 - 15.3 Settlor details, including details of previous settlors if not previously supplied to the Commissioner
 - 15.4 The amount of distributions made and details of beneficiaries who received the distributions
 - 15.5 Appointer details.
16. Officials propose setting minimum standards for the financial statements by an Order in Council made under section 21C of the Tax Administration Act 1994 (TAA). In the absence of minimum standards, there would be uncertainty regarding the level of detail the statements must be prepared to. This would affect the quality of data collected.
17. Two similar Orders have been made under the same section in the past:
 - 17.1 The Tax Administration (Financial Statements) Order 2014 sets out the minimum standards for financial statements of companies, and
 - 17.2 The Tax Administration (Financial Statements—Foreign Trusts) Order 2017 sets out the minimum standards for financial statements of foreign trusts.

Impact

18. The total volume of New Zealand trusts has been estimated to be up to 500,000. Inland Revenue records indicate that approximately 180,000 domestic trusts report assessable income each year and may be affected to some extent by the new disclosure requirements. The financial statement disclosure requirements will primarily affect approximately 55,000 of these domestic trusts. These are trusts that report assessable income to Inland Revenue but do not currently report business income or file any financial statements.

Objectives

19. Officials proposed minimum standards that are consistent with the following objectives:
 - **Minimise compliance costs while supporting policy objectives.** The minimum standards will strike a balance between minimising unnecessary compliance costs and ensuring the Commissioner will have sufficient financial information to meet the objectives of the disclosure rules.

- **Improve the quality of data.** The minimum standards will positively impact on the quality of data collected.
- **Ensure consistency with existing frameworks.** The minimum standards will be consistent with previous minimum standards set for companies and foreign trusts and they will align with accounting principles where appropriate.
- **Follow the proportionality principle.** The minimum standards will be tailored to the size of the trust. Small trusts will not be required to meet all of the minimum standards set for large trusts.

Consultation

20. Policy officials undertook targeted and public consultation on the content of the OIC from June to December 2021. Officials also consulted on operational guidance to address practical matters for trustees. The main themes arising from the OIC consultation were:
- 20.1 **High compliance costs.** The new disclosure rules will result in some trusts incurring significant compliance costs. Submitters suggested this could be addressed by legislating a one-year deferral of all of the trust disclosure rules, to allow trustees to structure out of the rules or give them more time to prepare for implementation of the rules. In addition, legislative amendments could provide small trusts an exemption from all of the trust disclosure rules.
- 20.2 **Support for OIC.** The proposal to enact an OIC to set minimum financial reporting standards was supported, as it would provide guidance for trustees.
- 20.3 **OIC relief for small trusts.** Submitters engaged on how small trusts should be defined for the purposes of the OIC relief and the scope of that relief.
- 20.4 **Technical matters.** Submitters engaged on a range of technical matters that should be required in the OIC, the most significant relating to valuation, associated person disclosures, and disclosures relating to beneficiary accounts.

Analysis

21. The proposed key features of the OIC content, largely supported by submitters and outlined below and in detail in Appendices A and B, are:
- 21.1 **Date of application:** Officials propose that the OIC will apply for the 2021-22 and future income years. There are several areas where compliance for the first year (2021-22) could be on a 'best endeavours' basis and these will be addressed in the Commissioner's operational statement. For example, the calculation of opening balances and the reporting of transactions with associated persons. Compliance with the OIC will not impact on the financial information the Commissioner will collect in prescribed forms.
- 21.2 **OIC requirements:** Officials propose that the OIC specifies core requirements for financial statements that must be met by all trusts and additional requirements that must be met for trusts that are not small trusts.
- 21.3 **Limited relief for small trusts:** Officials propose limited relief in the OIC for small trusts which would be defined using income, expense and asset thresholds. The proposal is to set these thresholds at \$100,000 assessable income, \$100,000 tax deductions, and \$5 million total assets. The income

and deduction thresholds would exclude income and expenditure relating to the residential property bright-line rules. Officials estimate that these thresholds will result in 75% (135,000 out of 180,000) of trusts will be classified as small trusts for the purpose of OIC relief. This means small trusts will have to meet fewer minimum requirements for their financial statements set out in the OIC, but the information they provide to the Commissioner in prescribed forms will remain the same for all trusts (information to be collected in prescribed forms is summarised in Appendix A).

- 21.4 **Asset valuation:** Valuations will be market value, cost or tax adjusted value, at the discretion of the trustees. The valuation method for certain assets must be disclosed.
 - 21.5 **Associated person disclosures:** Associated person transactions must be disclosed in the financial statements if not disclosed in prescribed forms. Disclosures will not be required for transactions at market value. The general definition of associated persons will be applied, however for practical purposes the Commissioner's operational statement will accept a best endeavours approach to reporting associated persons transactions in the first year if information is not available to trustees.
 - 21.6 **Beneficiary account movements:** Beneficiary account movement details will not be set out in the OIC but movements disclosed in prescribed forms would, at a minimum, be part of the materials supporting the financial statements.
22. Officials have recommended three legislative amendments to the trust disclosure rules in the separate policy report for including amendments in the Taxation (Annual Rates for 2021-22, GST, and Remedial Matters) Bill at the Finance and Expenditure Committee stage (IR2022/017 refers). These proposed changes will:
- 22.1 Exclude non-cash distributions that are minor services incidental to the operation of the trust from the disclosure requirements.
 - 22.2 Clarify that the new rules require trusts to disclose the nature of each distribution made by the trustee of the trust.
 - 22.3 Exempt all foreign trusts from the new domestic disclosure rules.

Administrative implications

- 23. Implementation and on-going administration costs will be met through baseline funding.

Appendix A – Summary of proposed minimum requirements for the preparation of financial statements by domestic trusts subject to section 59BA of the Tax Administration Act

25. The OIC will contain minimum requirements for the preparation of financial statements by trusts subject to section 59BA of the Tax Administration Act 1994 (TAA), as summarised below. For the purpose of the OIC, the term “financial statements” includes any notes and other supporting materials forming part of the financial statements.

Tier 1: Core requirements – for all trusts subject to s 59BA

- i. Prepare a statement of financial position and a profit and loss statement.
- ii. Apply the double-entry method of recording financial transactions.
- iii. Use the prescribed valuation principles and disclose the valuation method adopted for shares/ownership interests, land and buildings.
- iv. Financial statements must contain all relevant amounts that any forms prescribed by the Commissioner of Inland Revenue under section 35 of the TAA require to be copied from the company’s financial statements (for example, the IR10 Financial Statements Summary and the financial statement disclosure section in the IR6 income tax return and the IR6B movement in beneficiary accounts).

Tier 2: Additional requirements for trusts that are not “small trusts”

- v. Apply the principles of accrual accounting.
- vi. Provide a statement of accounting policies.
- vii. Disclose comparable figures for the previous income year to the extent that the trustee has that information.
- viii. Disclose several specific items:
 - A reconciliation between the profit or loss in the statement of profit and loss to taxable income;
 - An appropriately detailed schedule of the trust’s fixed assets and depreciable property used for tax purposes;
 - Matters relating to trusts with forestry and livestock businesses: information about the cost of timber as at the end of the income year and a reconciliation of movements in the cost of timber during the income year; if the trust is a specified livestock owner, details of livestock valuation methods, valuations, and calculations for tax purposes.
- ix. Disclose associated persons transaction details. For the purposes of the disclosure rules:
 - The disclosure should include details of transactions between the trust and any associated person of the trustee, unless the transaction is minor and incidental to the activities of the trustee;
 - Transaction details include names of the associated persons, the nature of the association, the nature of the transactions and the amounts involved;
 - Disclosures are not required if transactions are at a market rate;
 - If associated person disclosures have been made separately in any forms prescribed by the Commissioner of Inland Revenue, this information does not need to be duplicated in the financial statements.
 - Associated persons are as defined in subpart YB of the Income Tax Act 2007.

26. Officials note that from the 2021-22 and later years, the following financial information will be collected by the Commissioner in prescribed forms for all domestic trusts subject to section 59BA:

Income Tax Return for trusts

- i. Total accounting profit before tax
- ii. Tax adjustments to reconcile accounting income with assessable income in tax return
- iii. Untaxed realised gains
- iv. Total assets
- v. Associated persons financial arrangements
- vi. Shares/ownership Interests
- vii. Land
- viii. Buildings
- ix. Total liabilities
- x. Associated persons financial arrangements
- xi. Total equity
- xii. Drawings
- xiii. Closing current account balances

Trust beneficiary form

Beneficiary account movements

- i. Opening balance
- + *Distributions*
- ii. Accounting income and other distributions
- iii. Corpus
- iv. Capital
- v. Use of trust property for less than market value
- vi. Distribution of trust assets
- vii. Forgiveness of debt
- *Withdrawals*
- viii. Amounts withdrawn from the trust during the income year
- ix. Closing balance

Appendix B – Summary of policy recommendations

27. The policy recommendations following discussions with stakeholders are summarised below.
28. **Minimum standards:** Officials propose the OIC will state it contains 'minimum' standards for trustees of trusts required to comply with the disclosure requirements set out in section 59BA of the TAA. Financial statements may be prepared to any level above the minimum specified by the OIC. These minimum standards will not directly affect other disclosures required under section 59BA(2), which include details of settlements, settlors, distributions and appointers.
29. **Date of application:** Officials propose the OIC be enacted by 31 March 2022 and apply it to the 2021-22 income year for balance dates ending 31 March or later. There are several areas where compliance for the first year (2021-22) could be on a 'best endeavours' basis and these will be addressed in the Commissioner's operational statement rather than the OIC. Changes proposed as a result of consultation remove significant compliance costs so there is no advantage in deferring its application. Making the OIC before 31 March 2022 and applying it for the 2021-22 year onwards will provide useful guidance for trustees. Setting out in an operational statement where the Commissioner will accept a 'best endeavours' approach for the first year will reduce transition costs for many trusts. Early balance-date trusts will not be required to follow the OIC (approximately 400 out of 180,000 trusts with assessable income are early balance date trusts and about half will be able to access the OIC small trust concessions).
30. **Financial statement notes and supporting materials:** Officials propose the domestic trust OIC will clarify that, for the purposes of the OIC, the term 'financial statements' includes any notes and other supporting materials. Section 59BA(2)(a) requires trusts to provide "a statement of profit or loss and a statement of financial position". Where the OIC refers to financial statements it will align with the companies OIC which states that the term *financial statements* "includes any notes and other supporting materials forming part of the financial statements". This is an important compliance cost savings measure – making it clear that items required in the OIC can simply be supporting materials rather than in the actual financial statements.
31. **Non-standard balance date reporting:** Officials propose that financial statements may be prepared to a non-standard balance date (i.e. a balance date that is not 31 March) used for accounting purposes, provided the trust does not derive business income which would require Commissioner approval for non-standard balance date reporting. This concession will relieve passive investment trusts from having to re-state their financial statements to the 31 March tax year if they have non-standard balance dates for accounting purposes.
32. **Small trust thresholds:** Officials propose that small trust relief thresholds be as follows:
- i. To qualify as a small trust, a trustee must report, for the relevant income year:
 - less than \$100,000 assessable income (before allocation); and
 - less than \$100,000 deductible expenditure; and
 - total assets (including assets that are not in the tax base) valued at less than \$5m as at balance date.
 - ii. The \$100,000 assessable income and deductible expenditure figures used for the purpose of determining whether a trust is small will not include income assessed under the bright-line rules or related deductible expenditure.

- iii. Assets will be valued using the valuation principles in the OIC and must be consistent with financial statements.
33. Officials estimate that raising these thresholds will provide relief for approximately 75% or 135,000 out of 180,000 trusts subject to the new disclosure rules. Threshold increases remove significant compliance costs but allow IR to continue to collect sufficient information in prescribed forms.
34. Officials considered suggestions from submitters to minimise trusts 'flipping' in and out of the disclosure rules if they have one-off transactions which would put them above the thresholds. Officials recommend the approach suggested by some submitters that the calculation be limited to assessable income (and deductible expenditure) in the current year but that assessable income derived from the bright-line residential property sale rules (and related deductible expenditure) be excluded to avoid anomalies involving residential property sales.
35. **Small trust scope of relief:** Officials propose the scope of relief for small trusts will mean only four minimum standards will apply to small trusts:
- i. Prepare a statement of financial position and a profit and loss statement.
 - ii. Apply the double-entry method of recording financial transactions.
 - iii. Use the prescribed valuation principles and disclose the valuation method adopted for shares/ownership interests, land and buildings.
 - iv. Financial statements must contain all relevant amounts that any forms prescribed by the Commissioner of Inland Revenue under section 35 of the TAA require to be copied from the company's financial statements (for example, the IR10 Financial Statements Summary and the financial statement disclosure section in the IR6 income tax return and the IR6B movement in beneficiary accounts). These increases in the scope of the relief for small trusts remove significant compliance costs but allow the Commissioner to continue to collect sufficient information in prescribed forms.
36. **Valuations:** Officials propose the valuation method will be left to the judgement of the trustees.
37. The OIC will clarify that for the purposes of calculating market value of properties, the use of rating valuations is an acceptable proxy.
38. In order to prevent inappropriate use of a 'tax value' option, this option will be restricted to assets and liabilities that are in the tax base.
39. **Associated person disclosures:** Officials propose:
- i. Trustees must disclose associated persons transaction details, with the exception of trustees of small trusts who must only disclose associated person transactions when required to do so in prescribed forms.
 - ii. Transaction details include names of the associated persons, the nature of the association, the nature of the transactions and the amounts involved.
 - iii. Associated persons are defined in subpart YB of the Income Tax Act 2007.
 - iv. The disclosure should include details of transactions between the trust and any associated person of the trustee, unless the transaction is minor and incidental to the activities of the trustee.
 - v. Disclosures are not required if transactions are at a market rate.

- vi. If associated person disclosures have been made separately in any forms prescribed by the Commissioner of Inland Revenue, this information does not need to be duplicated in the financial statements.
40. The approach will reduce duplication with disclosures in prescribed forms, provide more clarity as to what disclosure is required, and reduce the extent of disclosures required (for example, by excluding minor and incidental transactions).
41. **Beneficiary account movements:** Officials propose there will be no requirement in the OIC to provide a line-by-line reconciliation in beneficiary accounts. Instead, the OIC will clarify that financial statements must contain all relevant amounts that any forms prescribed by the Commissioner of Inland Revenue including the IR6B movement in beneficiary accounts. The beneficiary account movements disclosed in the prescribed form will be sufficient for the purpose of the OIC. This will save compliance costs.
42. **Gross-up options:** Officials propose the OIC will not prescribe dividend gross-up for imputation credits and interest/dividend gross-up for RWT. The gross-up option will be left to the judgement of the trustees.
43. **Trusts Act 2019:** Officials propose the OIC will explicitly note that there are requirements for trustees to keep records under section 45 of the Trusts Act 2019. Section 45 of the Trusts Act 2019 requires each trustee of a trust to keep, so far as is reasonable, records of the trust property that identify the assets, liabilities, income, and expenses of the trust and that are appropriate to the value and complexity of the trust property.
44. This requirement differs from the OIC as it does not explicitly require trustees to compile financial statements and it allows the trustee to exercise judgement as to what is reasonable and appropriate in respect of record keeping. However, it is a legislative provision that could be usefully referenced in the OIC, while clarifying that the minimum reporting standards in the OIC are more prescriptive and in some cases apply income tax concepts (for example, the use of tax valuations).
45. **Fixed asset schedule:** Officials propose the financial statements will include an appropriately detailed schedule of the trust's fixed assets and depreciable property used for tax purposes. Fixed assets with a tax value are typically tracked through a tax fixed assets register. For the purpose of the OIC it will only be required to be included in financial statements as supporting materials.