

In Confidence

Office of the Minister Revenue

Chair, Cabinet Economic Development Committee

## **TAX ADMINISTRATION (FINANCIAL STATEMENTS—DOMESTIC TRUSTS) ORDER 2022**

### **Proposal**

1. In 2020, Cabinet agreed to increase the disclosure requirements for trusts, including the requirement to prepare financial statements for the 2021–22 and later income years (CAB-20-MIN-0484 refers). This paper seeks Cabinet's approval of the minimum level of detail required in those financial statements. Approval is also sought for the Order in Council required to bring the minimum standards into law, and for authority to submit the Order directly to the Executive Council.

### **Relation to Government Priorities**

2. The Taxation (Income Tax Rate and Other Amendments) Act 2020 introduced a new top personal income tax rate of 39% on income exceeding \$180,000 for the 2021–22 and later income years. The introduction of a 39% tax rate formed part of the Labour Party's manifesto for the 2020 General Election. Labour campaigned explicitly that we would not increase the trustee income tax rate but would monitor behaviour around avoidance and the success of enforcement measures.
3. The Act also introduced additional information reporting and disclosure obligations for trustees for the 2021–22 and later income years. The objective of these obligations is related to the integrity of the tax system. The disclosure rules will help evaluate the effectiveness of the new 39% rate and gain insight into the use of structures and entities by trustees in New Zealand.

### **Executive Summary**

4. The increased trust disclosure requirements include a requirement to prepare a statement of profit or loss and a statement of financial position. This requirement does not specify what level of detail the statements must be prepared to.
5. I propose to set, by Order in Council, minimum requirements for financial statements prepared by trusts subject to the new disclosure rules. This will provide increased certainty for trustees regarding their reporting obligations, support compliance with the disclosure rules and will improve the quality of data collected. The proposed Order would apply for the 2021–22 and later income years for most trusts.
6. Inland Revenue officials undertook targeted and public consultation on the proposed content of the Order in 2021. Submitters supported setting minimum standards by Order in Council, as it would provide certainty regarding trustees' reporting obligations and help mitigate the compliance costs imposed by the disclosure rules.

7. The proposed Order has been designed based on feedback received in consultation and is aimed at striking a balance between supporting the Government's objectives for the disclosure rules and minimising compliance costs for trusts. The proposed minimum standards provide simplified reporting requirements for certain trusts.

## **Background**

8. On 23 November 2020, Cabinet decided to defer the decision on whether to increase the trustee income tax rate to 39% to a later date pending information on whether there is a behavioural response to avoid paying the new 39% top personal income tax rate. Cabinet agreed to collect information from trustees to test compliance and effective operation of the new 39% rate and provide better information to understand and monitor the use of structures and entities by trustees (CAB-21-MIN-0484 refers).
9. The Taxation (Income Tax Rate and Other Amendments) Act 2020 was enacted on 7 December 2020 and introduced increased disclosure requirements for trusts that derive assessable income. The rules apply for the 2021–22 and later income years and require trustees to prepare a statement of profit or loss and a statement of financial position. Trustees must disclose the following information to the Commissioner of Inland Revenue:
  - 9.1 the amount and nature of settlements received (settlements do not need to be disclosed if they are minor services incidental to the activities of the trust and are provided to the trustee at less than market value);
  - 9.2 settlor details, including details of previous settlors if not previously supplied to the Commissioner of Inland Revenue;
  - 9.3 the amount of distributions made and details of beneficiaries who received the distributions; and
  - 9.4 appointer details.
10. Certain trusts are excluded from these rules. These exclusions largely relate to trusts that already have reporting requirements under other regimes. Examples include non-active trusts, trusts eligible to be Māori authorities, foreign trusts and charitable trusts.
11. The total volume of trusts in New Zealand has been estimated to be over 400,000. 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.
12. There would be uncertainty regarding the level of detail the financial statements must be prepared to if minimum standards were not set. This would affect the quality of data collected and possibly lead to non-compliance with the rules.
13. Section 21C of the Tax Administration Act 1994 (TAA) provides that the Governor-General can prescribe minimum requirements for financial reporting. Before

recommending the making of an Order under this section, the Minister of Revenue must consult with professional accounting bodies. This requirement has been satisfied by consultation undertaken by officials in 2021, as detailed below.

## Objectives

14. The minimum standards should be consistent with the following objectives:
  - 14.1 **Minimising compliance costs:** The minimum standards should strike a balance between ensuring the Commissioner of Inland Revenue will have sufficient financial information to meet the objectives of the disclosure rules and minimising unnecessary compliance costs.
  - 14.2 **Achieving the Government's objectives:** The minimum standards should positively impact on the quality of data collected to help evaluate the effectiveness of the new 39% rate and gain insight into the use of structures and entities by trustees.
  - 14.3 **Ensuring consistency with existing frameworks:** The minimum standards should be consistent where possible with previous minimum standards set for companies and foreign trusts and should align with accounting standards and principles where appropriate.
  - 14.4 **Proportionality:** The minimum standards should be tailored to the size of the trust. Smaller trusts should have simplified reporting requirements.

## Consultation

15. Inland Revenue officials undertook targeted and public consultation on the proposed minimum standards in 2021. Officials also consulted on operational guidance for the disclosure rules to address practical matters for trustees. The main themes arising from consultation were:
  - 15.1 **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 the trust disclosure rules, to allow trustees to restructure out of the rules or give them more time to prepare for implementation of the rules. In addition, legislative amendments could provide smaller trusts an exemption from all the disclosure requirements.
  - 15.2 **Support for Order in Council:** The proposal to set minimum financial reporting standards by Order in Council was supported, as it would increase certainty for trustees regarding reporting obligations.
  - 15.3 **Relief for small trusts:** Submitters engaged on how small trusts should be defined for the purposes of the Order in Council relief and the scope of that relief.
  - 15.4 **Technical matters:** Submitters engaged on a range of technical matters that should be covered by the Order in Council, the most significant relating to valuation methods, associated person disclosures, and disclosures relating to beneficiary accounts.

16. In addition to consulting with members of the tax and accounting community, the External Reporting Board, the Department of Internal Affairs, the Ministry of Business, Innovation and Employment, the Ministry of Justice, the Office of the Privacy Commissioner, Statistics NZ and the Treasury were consulted during the development of the proposed minimum standards.

### **Minimum standards**

17. The key features of the proposed Order are set out below. These features have been developed based on feedback received in consultation and the objectives set out above. The annex contains further detail on the proposed minimum requirements.

### **Application date**

18. A small number of trusts have an early balance date and will have already filed their annual return before the Order is proposed to come into force. Inland Revenue data indicates approximately 0.2% (400 out of 180,000) of trusts subject to these rules are in this situation.
19. To prevent retrospectively imposing requirements on these trusts, I propose that the minimum standards apply for income years that end after the Order comes into force. This will be 2021–22 and future income years for the large majority of trusts that do not have an early balance date.
20. There are several areas where compliance for the first year (2021–22) could be on a 'best endeavours' basis and these are expected to be addressed in the Commissioner's Operational Statement on the disclosure rules. For example, this could include the calculation of opening balances in the first year and the reporting of transactions with associated persons.

### **Simplified reporting requirements for certain trusts**

21. The proposed Order provides simplified reporting requirements for certain trusts. A trust with less than \$100,000 assessable income, less than \$100,000 tax deductions and less than \$5 million total assets in an income year will have simplified reporting requirements. These thresholds would exclude income and expenditure relating to the residential property brightline rules to reduce the risk of trusts not qualifying for the simplified reporting requirements due to large one-off transactions.
22. Officials estimate that these thresholds will result in 75% (135,000 out of 180,000) of trusts qualifying for simplified reporting requirements.
23. While these trusts will have to meet fewer requirements for their financial statements, all trusts will provide the same financial information in forms prescribed by the Commissioner of Inland Revenue. This helps reduce compliance costs for a significant number of trusts, while continuing to support the objectives of the disclosure rules of evaluating the effectiveness of the new 39% rate and gaining insight into the use of structures and entities by trustees in New Zealand.

### **Asset valuation**

24. Assets will be valued at either market value, cost or tax adjusted value, at the discretion of the trustees. For the purposes of calculating the market value of properties, the use of rating valuations will be an acceptable proxy. This helps ensure trustees are not forced to re-value assets, or engage valuers, to comply with the disclosure rules.
25. The valuation method for certain assets must be disclosed. This helps support the quality of the data collected.

### **Associated person disclosures**

26. Trustees must disclose associated persons transaction details, except for trustees of “simplified reporting trusts” who only need to disclose associated person transactions when required to do so in prescribed forms.
27. Disclosures will not be required for transactions at market value. Disclosure of transactions with associated persons not at market value is important to assess compliance with the 39% personal income tax rate.

### **Financial Implications**

28. This proposal has no financial implications.

### **Timing and 28-Day Rule**

29. The proposed Order will come into force on 31 March 2022, the end of the 2021–22 income year for trustees with standard balance dates. The minimum standards set by the Order will apply for income years ending on or after the Order comes into force. That is, the Order will not retrospectively impose requirements on trustees with balance dates prior to the Order coming into force.
30. A waiver of the 28-day rule is sought to allow the Order to come into force by 31 March 2022 on the grounds that the Order needs to be in force before the end of the 2021–22 income year for trustees with standard balance dates, to provide increased certainty regarding reporting obligations for the 2021–22 and later income years.

### **Compliance**

31. The Order in Council complies with:
  - 31.1 the principles of the Treaty of Waitangi;
  - 31.2 the rights and freedoms contained in the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993;
  - 31.3 the principles and guidelines set out in the Privacy Act 2020;
  - 31.4 relevant international standards and obligations;
  - 31.5 the Legislation Guidelines (2021 edition), which are maintained by the Legislation Design and Advisory Committee.

## Regulations Review Committee

### Application date

32. The short time between the proposed making of this Order and the application date of the minimum standards may be a basis for the Regulations Review Committee to draw the Order to the attention of the House of Representatives under Standing Order 327. Officials consider this risk to be low and that the application date is appropriate for the following reasons:
- 32.1 The disclosure rules were enacted in December 2020. Trustees have had a reasonable amount of notice regarding the requirements in the disclosure rules in section 59BA of the TAA.
- 32.2 Trustees will have until 7 July 2022 to file returns for the 2021–22 income year. Trustees with tax agents (the large majority) will be able to file returns as late as 31 March 2023.
- 32.3 During consultation in 2021, submitters broadly supported applying the minimum standards for the 2021–22 income year. Submitters considered that this would provide increased certainty regarding trustees' reporting obligations. Deferring the application of the Order to a later date would provide no relief from the requirement in section 59BA to prepare financial statements for the 2021–22 income year.
- 32.4 Inland Revenue has been engaged with tax agents, accountants and software providers regarding the implementation of the disclosure requirements.

### Sub-delegation issue

33. Clause 1(e) of the Schedule to the Order requires that the financial statements must include all relevant amounts that are required to be copied from financial statements into a form prescribed by the Commissioner of Inland Revenue (for example, the IR10 form – *financial statements summary*).
34. There is a low risk that this clause may be a basis for the Regulations Review Committee to draw the Order to the attention of the House of Representatives under Standing Order 327. This is because there is a risk that the Order could be seen to sub-delegate to the Commissioner the legislative power to set requirements for financial statements for domestic trusts.
35. Taxpayers that derive business income are required to either file an IR10 form or provide a set of financial statements to Inland Revenue. Clause 1(e) of the Schedule is an important integrity measure to ensure that taxpayers cannot avoid the requirements in the IR10 form by filing a set of financial statements prepared to a lower standard. This clause ensures that the financial statements are an appropriate proxy for the IR10 form. This approach follows the precedent set by the minimum standards for financial reporting for companies.<sup>1</sup>
36. Clause 1(e) of the Schedule to the Order only relates to forms that the Commissioner is already authorised to prescribe under section 35 of the TAA. To ensure the

<sup>1</sup> Clause 1(e) of the Schedule to Tax Administration (Financial Statements) Order 2014.

financial statement requirements are workable, it is important that they interface with these forms. In these circumstances, officials are satisfied that this approach is within the scope of the regulation making power contemplated by Parliament.

### **Certification by Parliamentary Counsel**

37. The Order in Council has been certified by the Parliamentary Counsel Office as being in order for submission to Cabinet.

### **Impact Analysis**

#### **Regulatory Impact Statement**

38. A Regulatory Impact Statement has been completed and is attached.
39. The Quality Assurance reviewers at Inland Revenue have reviewed *Regulatory Impact Statement: Minimum standards for financial statements prepared by domestic trusts* and consider that the information and analysis summarised in it **meets** the quality assurance criteria of the Regulatory Impact Statement framework.

#### **Climate Implications of Policy Assessment**

40. The Climate Implications of Policy Assessment (CIPA) team has been consulted and confirms that the CIPA requirements do not apply to this proposal as the threshold for significance is not met.

### **Population Implications**

41. There are no population implications arising from these proposals.

### **Human Rights**

42. The proposals do not give rise to any human rights implications.

### **Communications**

43. I will publish a press statement regarding the minimum standards for financial statements prepared by domestic trusts before the end of the 2021–22 income year.
44. The Order will be published in the *Gazette* and Inland Revenue will include details of the new minimum standards in a *Tax Information Bulletin* after the Order is made.
45. To date a number of submitters and media articles have focused on the increased compliance costs for trustees as a result of the new domestic trust disclosure rules. They have noted these rules go further than reporting requirements under the Trusts Act 2019 and suggested that because the disclosure rules were enacted in December 2020 with no consultation it would be preferable to defer their application for a year. While the proposed Order goes some way to reducing compliance costs based on submitter feedback, it is likely that concerns about the timing and the amount of information being collected will continue to be raised.

## Proactive Release

46. I propose to proactively release this Cabinet paper, associated minutes, and key advice papers with appropriate redactions within 30 working days of Cabinet making final decisions.

## Recommendations

The Minister of Revenue recommends that the Committee:

1. **note** that the Taxation (Income Tax Rate and Other Amendments) Act 2020 introduced increased disclosure requirements for certain trusts, including the requirement to prepare financial statements for the 2021–22 and later income years.
2. **note** that section 21C of the Tax Administration Act 1994 allows the Governor-General to prescribe, by Order in Council, minimum requirements for preparing financial statements for certain classes of taxpayers.
3. **note** that before recommending the making of an Order in Council under section 21C of the Tax Administration Act 1994, the Minister of Revenue must consult with professional accounting bodies. Targeted and public consultation undertaken by officials in 2021 satisfies this requirement.
4. **agree** to the minimum financial reporting requirements as set out in the attached Order, Tax Administration (Financial Statements—Domestic Trusts) Order 2022.
5. **agree** that the proposed Order should apply to all trusts subject to the disclosure rules introduced by the Taxation (Income Tax Rate and Other Amendments) Act 2020.
6. **agree** that the proposed Order should apply for income years that end on or after 31 March 2022.
7. **authorise** the submission to the Executive Council of the Tax Administration (Financial Statements—Domestic Trusts) Order 2022.
8. **note** that the Tax Administration (Financial Statements—Domestic Trusts) Order 2022 will come into force on 31 March 2022, the end of the 2021–22 income year for trusts with standard balance dates.
9. **note** that a waiver of the 28-day rule is sought so that the Order in Council can come into force by 31 March 2022 on the ground it needs to be in force before the end of the 2021–22 income year.

10. **agree** to waive the 28-day rule so that the Order in Council can come into force by 31 March 2022.

Authorised for lodgement

Hon David Parker  
Minister of Revenue

## **Annex – minimum standards for financial statements prepared by domestic trusts**

For the purposes of the Order in Council, the term “financial statements” includes any notes and other supporting materials forming part of the financial statements.

The standards set out below are “minimum” standards. Financial statements may be prepared to any level above these minimum requirements.

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 approval from the Commissioner of Inland Revenue for non-standard balance date reporting – section 38 of the Tax Administration Act 1994 (TAA)).

### ***Valuation***

Valuation of assets and liabilities can be either at market value, cost or tax adjusted value, at the discretion of the trustee. The use of ‘tax value’ will be limited to assets and liabilities that are in the tax base (i.e., assets and liabilities that are used in the production of assessable income).

### ***Simplified reporting trusts***

A trust is a “simplified reporting trust” for a relevant income year if the trustee reports:

- less than \$100,000 assessable income, AND
- less than \$100,000 deductible expenditure, AND
- total assets reported in the statement of financial position (including both private and income producing assets) valued at less than \$5 million as at balance date.

The \$100,000 assessable income and deductible expenditure thresholds used in this test do not include income assessed under the brightline rules or related deductible expenditure. Assets will be valued using the valuation principles set out above and must be consistent with the prepared financial statements.

### ***Core requirements for all trusts***

The following minimum standards apply to all trusts subject to the disclosure rules.

The financial statements must consist of:

- A statement of financial position setting out the assets, liabilities, and net assets of the trust as at the end of the return year; and
- A statement of profit or loss statement showing income derived, and expenditure incurred, by the trust during the return year.

Financial statements must be prepared using the double-entry method of recording financial transactions.

Financial statements must use the prescribed valuation principles (set out above) and disclose the valuation method adopted for land, buildings, and shares/ownership interests.

A trustee can choose to adopt a different valuation method for each of these categories. If there are multiple assets within one category (e.g., multiple buildings), each asset may be valued using a different method.

Financial statements must contain all relevant amounts that any forms prescribed by the Commissioner under section 35 of the TAA require to be copied from the company's financial statements.

***Additional requirements for trusts that are not “simplified reporting trusts”***

For trusts that do not qualify for simplified reporting for an income year, the financial statements must:

- Be prepared applying the principles of accrual accounting.
- Include a statement of accounting policies
- Disclose comparable figures for the previous income year to the extent that the trustee has that information.
- Disclose several specific items:
  - a reconciliation between the profit or loss in the statement of profit or 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.
  - Disclose 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 trust.
    - Transaction details include the names of the associated persons, the nature of the association, the nature of the transactions and the amounts involved.
    - Disclosure is not required if the transaction is at a market rate.
    - If associated person disclosures have been made separately in any forms prescribed by the Commissioner, this information does not need to be duplicated in the financial statements.