New Zealand Law Society
Te Kāhui Ture o Aotearoa

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Public Consultation
Inland Revenue
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By email: policy.webmaster@ird.govt.nz

Re: ED0235: Reporting requirements for domestic trusts – draft operational statement

1. Introduction

1.1 The New Zealand Law Society | Te Kāhui Ture o Aotearoa (**Law Society**) welcomes the opportunity to comment on the draft operational statement: *Requirements for domestic trusts* (**draft operational statement**). The Law Society has prepared and filed a separate submission on the officials' issues paper: *Reporting requirements for domestic trusts* (**issues paper**). The Law Society's submissions in relation to the draft operational statement are set out below.

2. Name of operational statement

2.1 The name of the draft operational statement is "Reporting requirements for domestic trusts". That is not entirely accurate, as foreign trusts that do not have any New Zealand trustees, but are nonetheless required to file New Zealand income tax returns as they hold income-earning assets situated in New Zealand, will be subject to these rules (the New Zealand foreign trust reporting rules in sections 59B and 59D of the Tax Administration Act 1994 apply only to foreign trusts with one or more New Zealand trustees). "Reporting requirements for trusts" would be a more suitable name for the operational statement.

3. Trusts required to file income tax returns

3.1 Paragraphs 10 to 13 of the draft operational statement correctly state that trusts that do not derive assessable income are not required to file income tax returns. Paragraph 104, on the other hand, states that trustees who are excluded, under section 59BA(3) of the Tax Administration Act 1994, from the reporting requirements in section 59BA(2), "will still be required to file a return under s 59BA(1)". That will only be the case if the trustees derive assessable income during the income year (as per paragraphs 10 to 13), and paragraph 104 should be amended to make this clear.

4. De minimum threshold for "small trusts"

4.1 The Law Society supports a de minimis threshold for small trusts, but notes that the financial reporting concessions for small trusts are relatively minor. The threshold for what amounts to a small trust should be relatively generous to save compliance costs.

4.2 The proposed de minimis threshold for income and expenditure appears to be based on actual income and expenditure, rather than taxable income and deductible expenditure. Many family trusts generate little taxable income, and such trusts do not constitute a threat to the tax base. These trusts may not, however, meet the income and expenditure thresholds for a small trust (as currently proposed), as these trusts may incur significant costs relating to those properties, such as rates and body corporate fees.

4.3 The Law Society recommends that the income and expenditure thresholds for small trusts is based on taxable income and deductible expenditure. This will mean that many more family trusts that own lifestyle assets will be treated as small trusts, which will make compliance with the new reporting requirements simpler.

4.4 The proposed de minimis threshold for the total value of trust assets is also low. Given that many family trusts hold lifestyle assets, such as the family home and, perhaps, a holiday home, such a threshold prejudices against trusts which hold family homes in Auckland and other districts with higher-than-average house prices. For example, as at 27 September 2021, 23 of Auckland's 208 suburbs had a median house price exceeding $2 million.

4.5 The Law Society recommends that the asset threshold for small trusts excludes the family home. Alternatively, the asset threshold for small trusts could be decreased slightly, as long as the family home was excluded. That would be more equitable than the current proposal.

4.6 Excluding the family home from the asset threshold also means that trustees will not have to bear the cost of valuing the family home to determine whether the modified financial reporting rules for small trusts apply (or continue to apply) where the value of trust assets is close to the asset threshold. Requiring trusts which own a family home and, perhaps, a holiday home, to monitor and value those assets annually to determine whether a different set of financial reporting rules applies imposes unnecessary compliance costs.

5. Transactions involving associated persons

5.1 Sections 59BA(2)(b) and (d) of the Tax Administration Act 1994 require disclosure of full details of any settlements made on a trust including the "amount and nature" of each settlement, and also information concerning any distributions by the trust. These obligations capture the provision of in-kind benefits to a beneficiary such as the use of trust property or a loan to a beneficiary for no interest or below market interest. They also capture in-substance settlements such as low-interest and interest-free loans to the trust.

5.2 As settlors and beneficiaries will be associated persons of the trust, any non-arm's length transactions between the trust on the one hand, and a settlor or beneficiary on the other, will be fully recorded and disclosed in compliance with section 59BA(2)(c) and (d). As such, there appears to be little benefit in identifying other associated persons (potentially a broad class) whose dealings with the trust are on arm's length terms, and therefore do not give rise to either a settlement or a distribution.

5.3 The Law Society considers that the requirement to identify transactions involving associated persons involves unnecessary compliance costs and should be removed, given that Inland Revenue is primarily interested in obtaining information about transactions between settlors, trustees and beneficiaries, all of which will be captured under the reporting requirements in section 59BA(2)(b) and (d).

5.4 Paragraph 47.1.1 of the draft operational statement refers to non-beneficiaries who are associated persons and who receive loan advances at nil or below market interest rates. This will have the consequence that the borrower will be a beneficiary for tax purposes. The Law Society also notes that the provision of a low interest loan to a non-named beneficiary may amount to a breach of trust as a result of providing a benefit to a non-beneficiary.

5.5 Paragraph 47.6.1 of the draft operational statement refers to non-beneficiaries who are associated persons and who make loan advances to a trust at above market interest rates. This will have the consequence that the lender will be a beneficiary. The Law Society also notes that the provision of a high interest loan to the trust by a non-named beneficiary would amount to a breach of trust as a result of providing a benefit to a non-beneficiary.

6. Trust corpus and trust capital

6.1 Paragraph 47 of the draft operational statement requires "owners' equity" to be split between "trust corpus" and "trust capital". Paragraph 52 states that, "For the 2021-22 tax year, the net assets should be allocated as accurately as possible based on known information, between Trust Corpus, Trust Capital and the respective Beneficiary Accounts".

6.2 In most instances, trustees of "complying trusts" (as defined in section HC 10 of the Income Tax Act 2007) have never split "trust equity" into "trust corpus" and "trust capital", as distributions from complying trusts, other than distributions of "beneficiary income", are not taxable. Determining the opening balance of "trust corpus" and "trust capital" will be impossible for many "complying trusts", and trustees should not be required to troll through historic trust records in order to guesstimate the opening balances.

6.3 In the light of the above, the Law Society submits that "complying trusts" should not be required to split "trust equity" between "trust corpus" and "trust capital".

7. Opening valuation of assets and liabilities

7.1 The proposed criteria for applying the different valuation methodologies in the draft operational statement are more restrictive than the equivalent criteria that apply to foreign trusts with one or more New Zealand resident trustees in the Tax Administration (Financial Statements – Foreign Trusts) Order 2017 (the Foreign Trusts Order).

7.2 Paragraph 50.2 of the draft operational statement refers to using historical cost "when tax values are not consistent with double entry or accrual accounting or when, in the preparer's opinion, historical cost provides a better basis of valuation". In contrast, the comparable provision in the Foreign Trusts Order simply states in paragraph 4(c)(ii): "historical cost with impairment or depreciation as appropriate ...".

7.3 The Law Society recommends that the wording in the Foreign Trusts Order should also be used in the Order in Council that will apply to other trusts. This means that the preparers of financial statements for these trusts can also choose, without restriction, whether to use tax values, historical cost or market values.

8. Valuing non-cash distributions

8.1 Paragraphs 56.3.1.4 and 56.6.1.1 of the draft operational statement require non-cash distributions (e.g. the provision of trust property or services to beneficiaries at less than market value) to be disclosed, on a line-by-line basis, for each beneficiary current account. Presumably, if property is made available to more than one beneficiary at a time (e.g. the

family home), then that benefit will need to be split between each beneficiary for disclosure purposes. However, paragraphs 94 to 98 (and Example 7) of the draft operational statement provide that non-cash distributions can be valued at either market value or cost, including in the financial statements. For the avoidance of doubt, paragraphs 56.3.1.4 and 56.6.1.1 should explicitly state that if the trustees decide to value non-cash distributions at cost for financial reporting purposes, then only the cost (if any) of making those non-cash distributions needs to be disclosed in the beneficiaries' current accounts.

9. Valuing non-cash settlements that do not give rise to trust corpus

9.1 Paragraph 61 of the draft operational statement provides that settlements that do not give rise to trust corpus need to be disclosed, but are valued at nil. Paragraphs 73 to 75 (and Example 4) confirm that there will be a settlement where a beneficiary advances funds to the trustees (including where the beneficiary has a credit current account balance exceeding $25,000), and does not charge interest on that advance, but that settlement does not give rise to trust corpus, so is valued at nil. The Law Society considers it would be helpful if the operational statement set out examples of other non-cash settlements (for example. the provision of a guarantee) that do not give rise to trust corpus. Also, paragraph 47.9.2 should explicitly state that settlements that do not give rise to trust corpus (because the settlement does not give rise to value that can be distributed to beneficiaries) are not included in the statement of financial position.

10. Valuing the settlement of non-cash assets

10.1 Example 3 of the draft operational statement implies that the market value for assets should be used to determine the opening value of non-cash assets settled on a trust, such as "a recent real estate agent appraisal". In the case of real estate, the Law Society suggests that trustees should be able to use the rateable value of the property in the event that there is neither a recent registered valuation nor a real estate agent appraisal for the property. This should be the choice of the preparer of the accounts. The Law Society also recommends that there should not be any requirement to mark such assets to market on an annual basis. In other words, the preparer of the financial statements should be able to continue to use the value determined at the time the asset is settled on the trust, unless that asset has been revalued.

11. Meaning of "minor services"

11.1 Paragraph 71 of the draft operational statement notes that the provision of minor services to trustees which are incidental to the operation of the trust are excluded from being "settlements", and do not need to be disclosed. The Law Society recommends that the operational statement includes an example of what amounts to a "minor service" (e.g. bookkeeping services and maintaining trust records). In this regard, the Law Society considers that the operational statement should be a standalone document, and readers should not be required to cross reference other interpretation statements (e.g. IS 18/01, "Taxation of trusts – income tax"), in order to apply it.

12. Requirement to disclose information about historical settlors

12.1 Section 59BA(2)(c) of the Tax Administration Act 1994 requires details of settlors in past income years to be disclosed, where the identity of those persons has not previously been disclosed. This means that, for the first income year in which the trust is required to meet the

new reporting requirements (the 2021/22 income year for most trusts that derive assessable income), details of all past settlors will be required.

12.2 The Law Society considers that the obligation to disclose details of all past settlors of the trust is too onerous, particularly given the wide definition of "settlor" for income tax purposes and that some trusts have been in existence for many years. Paragraph 88 states that Inland Revenue only expects trustees to disclose details of those settlors known to them based on records held. This still requires trustees to troll through trust records to determine historical settlors of the trust.

12.3 The Law Society also considers that the Commissioner should make it clear whether the details of persons who may be deemed to be a settlor are required to be provided. For example, paragraph 2.74 of IS 18/01 sets out who may be treated as a settlor under section HC 28 Income Tax Act 2007. Such persons include a person or persons who have a control interest in a company that settles an amount on a trust, the settlor of a head trust that settles an amount on a sub-trust, a person who has control over a trustee or settlor and a person or persons to whom section HC 28(2) of the Income Tax Act 2007 applies.

12.4 While details of these persons may be able to be obtained in relation to recent settlements, it is likely to be substantially more difficult in relation to historical settlements. Also, the trustees may not even be aware that certain deemed settlements have been made in the past on the trust, so will not be in a position to report information about those deemed settlors. The Law Society is concerned that there will be widespread non-compliance with the obligation to provide information about settlors (including historical settlors) if the extended definition of "settlor" in the Income Tax Act 2007 applies for this purpose.

12.5 The Law Society notes that Parliament has specifically limited how far back the Commissioner can request past information about a trust in section 59BAB of the Tax Administration Act 1994 (such requests can only be made for the 2014/15 and subsequent income years). The Law Society submits that the requirement to disclose information about past settlors in section 59BA(2)(c) should be applied consistently with section 59BAB. That is, such information should only be required for persons who have made a settlement on the trust in the 2014/15 and subsequent income years.

13. Requirement to disclose information about appointors

13.1 The Law Society considers that the obligation to disclose details of the appointors of the trust should be confined to the persons or entities that hold the powers to appoint and remove trustees, appoint and remove beneficiaries and amend the trust deed in the income year to which the return relates. The Law Society notes that each of these powers may be held by more than one person or entity. Further, where the person nominated under the trust deed is unable or unwilling to exercise the power to appoint and remove trustees, Inland Revenue should clarify whether there will be a requirement to apply the provisions of the Trusts Act 2019 to determine who holds that power for the year in question.

14. Next steps

If you have any questions or would like to discuss these comments, please do not hesitate to contact the Tax Law Committee convenor Neil Russ, through the Law Society's Law Reform and Advocacy Advisor, Emily Sutton (Emily.Sutton@lawsociety.org.nz).

Yours faithfully

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