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This paper contains advice that has been prepared by the Tax Working Group Secretariat for consideration by the Tax Working Group.

The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the Group or the Government.

Coversheet: **Trusts**

Background Paper for Session 14 of the Tax Working Group
July 2018

Purpose of paper

This paper responds to questions that the Group has asked about trusts. It seeks direction on what material, and conclusions, in relation to trusts that the Group would like to include in the Interim Report.

Decisions in this area are contingent on the Group's decisions on (i) whether there should be a broad-based capital gains tax and (ii) what tax treatment should apply to closely held companies. The paper has been written to reflect the outcome if the Group decides to introduce a broad-based tax on capital gains and does not recommend taxing the income of a closely-held company at the top personal tax rate.

Key points for discussion

Does the Group agree with the recommendations, particularly in relation to income streaming and income splitting?

Which part of the analysis or recommendations would the Group like to include in the interim report?

Recommended actions

We recommend that the Group:

a) **note** the work undertaken by the New Zealand Law Commission in relation to updating and improving current trust law.

b) **agree,** if the Group agrees with the recommendation in the paper *Potential revenue reducing options* that tax policy officials should work on loss continuity with a view to issuing a discussion document in 2019 or 2020, that the issue of trusts trading their losses should be considered as part of that work.

c) **indicate**
   i. whether the Group agrees the issue of streaming would be largely addressed by a broad-based capital gains tax; and
   ii. whether the Group considers that if capital gains are not taxed, evaluation of integrity measures such as anti-streaming rules is more pressing.

d) **indicate** whether the Group considers that
   i. there are sufficient constraints in place to prevent income splitting through trusts in an abusive or contrived way; or

ii. additional constraints are required to prevent income splitting through trusts in an abusive or contrived way; and/or
iii. income splitting is an issue of wider concern than just trusts.

e) **indicate** which of the above issues should be discussed in the interim report.

Trusts

Discussion Paper for Session 14
of the Tax Working Group

July 2018

Prepared by the Inland Revenue Department and the New Zealand Treasury

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Executive Summary

Trusts are used to carry out a variety of activities in New Zealand. Given this wide role it is important that activity undertaken through a trust is taxed comparably to activity undertaken through other forms of entity. Variations can have important effects on social capital through their effect on the distribution of taxation and can affect financial and physical capital by causing variation in tax rates across different business arrangements.

Loosely speaking trusts stand at an intermediate point between companies and partnerships in how they are taxed. Trustees decide whether the income earned by a trust is either retained and taxed as trustee income (at a final tax rate of 33%) or distributed as beneficiary income and taxed at the respective beneficiaries' marginal tax rates.

Many trusts are 'passive' in that they hold the family home and have few other investments, so their interaction with the tax system is either minor or non-existent. We see no tax issues with those trusts, although there may be concerns outside of tax. More generally, now that the top personal tax rate has been aligned with the trustee rate, trusts are less of a tax issue.

In the business context, a trust can be a very flexible vehicle, particularly when combined with a corporate trustee that provides investors with limited liability as well as trust flexibility. Questions are occasionally raised about whether such trusts should be more aligned with the tax treatment of companies. We note that:

- Some of the concerns about trusts having more favourable tax treatment than companies turn out to be capital gains related and, therefore, would be potentially resolvable by a broad capital gains tax. They can also be related to timing mismatches that are not specific to trusts but rather reflect the way that certain types of businesses are taxed.

- The effective on-selling of trust losses to parties who have not incurred the economic loss is not an issue that can be dealt with simply by applying an ownership continuity test. This is because beneficiaries do not have the same fixed entitlements as shareholders. The Secretariat has recommended in the paper *Potential revenue reducing options* that tax policy officials should work on loss continuity with a view to issuing a discussion document in 2019 or 2020. If the Group agrees with that recommendation, the issue of trusts trading their losses could be incorporated into that work.

Trusts can be used to "stream" different types of income from a business or investment to different beneficiaries of the trust. There can be good non-tax reasons for this, but it can also be tax driven. In the tax context, the issue of streaming arises because not all forms of "income" are taxed. The largest form of untaxed income is realised capital gains. The Secretariat considers that while at the moment there might be a case for thinking about anti-streaming rules, if there is a capital gains tax that case is weaker.

Therefore, the issue of streaming should be considered in the context of decisions that the Group makes on the taxation of capital gains more generally.

By making family members on different tax rates beneficiaries of trusts, income can be split to minimise overall household tax liabilities.[1] Income splitting is not, however, unique to trusts and there are already limitations and anti-avoidance rules in place. Our conclusion is that although a trust may be a more flexible vehicle for income splitting (e.g. distribution amounts are largely discretionary and do not require giving beneficiaries shareholding rights), the numbers do not show that trusts are being used in this way on any material scale. However, if it is of concern to the Group, the focus should be on income splitting more broadly, not just income splitting using trusts.

The use of corporate trustees can create issues for collecting debts, including tax debts, as it is relatively easy to wind up a company, and it has limited liability. These issues are discussed in the separate paper *Collection of tax debt*.

The broader issue of whether trusts are still appropriate was considered by the New Zealand Law Commission who identified a number of areas of concern, none of which were tax related. The Commission's work has resulted in a new Trusts Bill, which is currently before the House. It is designed to make trust law more accessible, to clarify and simplify core trust principles and essential obligations for trustees, and preserve the flexibility of the common law to allow trust law to continue to evolve through the courts.

[1] This is more easily done with income from capital than labour income.

1. Introduction

1. The Working Group has sought advice on a number of issues in relation to trusts:

- What is the framework for taxing trusts?
- What issues are caused by trusts?
- Are trusts still appropriate?
- Information on utilisation of trusts for income splitting.

2. Background

1. Trusts are a longstanding legal arrangement dating back to medieval times. Traditionally, trusts were used for estate succession and asset and income protection, including the avoidance of tax liabilities, particularly estate taxes. Today, trusts are still used for these passive, asset transfer and protection purposes, but over time their uses have expanded to include:

- charitable activities;
- business trading activities;
- a means of low-profile investment by non-residents;
- to hold Maori land, and to govern and hold assets from the Treaty settlement process; and
- a means to pool investments that are widely held.

2. A trust is not a separate legal entity. A trust is a legal relationship whereby someone (the settlor) gives property to someone (the trustee) to look after it and use it for the benefit of someone (the beneficiary). The relationship places legally enforceable obligations on the person holding the property to manage it for the benefit of the person entitled to receive the benefits of the property. A settlor can also be a trustee and a beneficiary of the trust, but they cannot be the sole trustee and beneficiary as this would not amount to an equitable obligation to another person.

3. Unlike companies, there is no registration of trusts in New Zealand. While there is not good data yet[2], we expect that a large proportion of trusts are "passive trusts" that hold only the family home.[3] These trusts are formed for asset protection purposes (for example, ensuring that certain assets are ultimately passed on to children and grandchildren of the settlor). An extreme example of this type of trust is the very short-term trusts established to transfer estate assets to beneficiaries following probate of a will. These trusts are commonly known as bare trusts.

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[2] Since 1 October 2015, data has been collected about trusts who own residential property via the land transfer tax statement brought in by the Taxation (Land Information and Offshore Persons Information) Act 2015.

[3] The Law Commission compared what is known about the number of trusts in New Zealand with the situations in England, Australia and Canada, concluding that trust use is considerably greater in proportion to the population in New Zealand. They noted that there were at least around 250,000 trusts, based on Inland Revenue returns filed, but potentially up to 400,000 taking into account those trusts not earning income.

4. In the business context, the main way that trusts are used involves a trust owning a company that carries out the business activity. Alternatively, the trust may carry out the business activity directly, but have a corporate trustee.

3. Framework for taxing trusts

5. Loosely speaking trusts stand at an intermediate point between companies and partnerships in how they are taxed. Income earned by a trust is either retained and taxed as trustee income (at a final tax rate of 33%) or distributed as beneficiary income and taxed at the respective beneficiaries' marginal tax rates. The trustee decides which treatment applies although income has to be distributed to beneficiaries within certain timeframes for it to qualify as beneficiary income. An exception is where the income is derived by a beneficiary who is a child under 16 years old, in which case the income is generally treated as if it had been earned by the trustee and is, therefore, taxed at 33%. This is to prevent income streaming/splitting.

6. Trust losses cannot be passed through to offset beneficiaries' other income, but they can be carried forward for use against future trustee income.

7. The tax residence of the settlor is also a factor in determining the tax treatment of a trust distribution that is not beneficiary income, and the applicable tax rate. At the time a distribution is made, a trust is categorised as either a complying trust, a foreign trust, or a non-complying trust. Distributions of "beneficiary income" are taxed at the beneficiaries' marginal tax rates regardless of the category of trust. Rather, the categorisation affects other types of distribution, as outlined below.

Complying trusts

8. Most trusts with a New Zealand resident settlor are categorised as "complying trusts". Complying trusts comprise the vast bulk of the approximately 250,000 trusts that file tax returns. A complying trust is a trust for which the trustees have always been liable for tax at the trustee rate on all their worldwide trustee income, and have always met their income tax obligations. Distributions of accumulated trustee income, capital gains and corpus from a complying trust are tax-free to the recipient beneficiary. The analysis later in this paper is confined to complying trusts. Trading trusts would generally be complying trusts and are subject to ordinary trust rules.

Foreign trusts

9. A foreign trust is defined as a trust that has no settlors who have been tax residents of New Zealand from the later of 17 December 1987 or the date the trust was first settled until the date in question. All distributions other than arm's length capital gains and the corpus of the trust, are taxed at the beneficiary's marginal tax rates. Non-resident beneficiaries are only taxed on beneficiary income and taxable distributions comprising New Zealand sourced amounts.

10. Foreign trusts are subject to certain record keeping requirements and there are disclosure requirements for New Zealand resident trustees of foreign trusts. Foreign trusts have been under close scrutiny in recent years, resulting in their having to comply with strengthened registration and annual return filing requirements. As a result, foreign trusts are probably on the decline/ less popular, as anonymity was one of their reasons for existence. They are not discussed further in this paper.

Non-complying trusts

11. Likewise, non-complying trusts can be ignored for the purposes of this paper, and are not discussed further. A non-complying trust is any trust that, at the time that a distribution is made, is neither a complying trust nor a foreign trust. In broad terms, this will be a trust where a settlor does not meet the requirements of a foreign trust. All distributions made by a non-complying trust, other than beneficiary income and the corpus of the trust, are taxed to beneficiaries at a penal rate of 45%.

Widely held trusts

12. Widely held trusts are often used as a means of pooling investment, with investors in effect being beneficiaries of the fund. A unit trust is an example of a widely held trust where the unit holders provide the trust's capital. Generally, these are very similar to investing in a widely held investment company. Accordingly, such trusts are treated as companies for tax purposes.

Charitable trusts

13. Charitable trusts are subject to the tax rules that apply to charities in general; that is, they are exempt from income tax provided they are on the list of registered charitable entities under the Charities Act 2005.

Bare trusts

14. Bare trusts are largely ignored for tax purposes, with the trustee being treated as an agent of the beneficiary. Likewise, many 'passive' trusts holding the family home on a longer term basis will have few, if any, other investments so their interaction with the tax system will be either minor or non-existent.

3. What issues are caused by trusts?

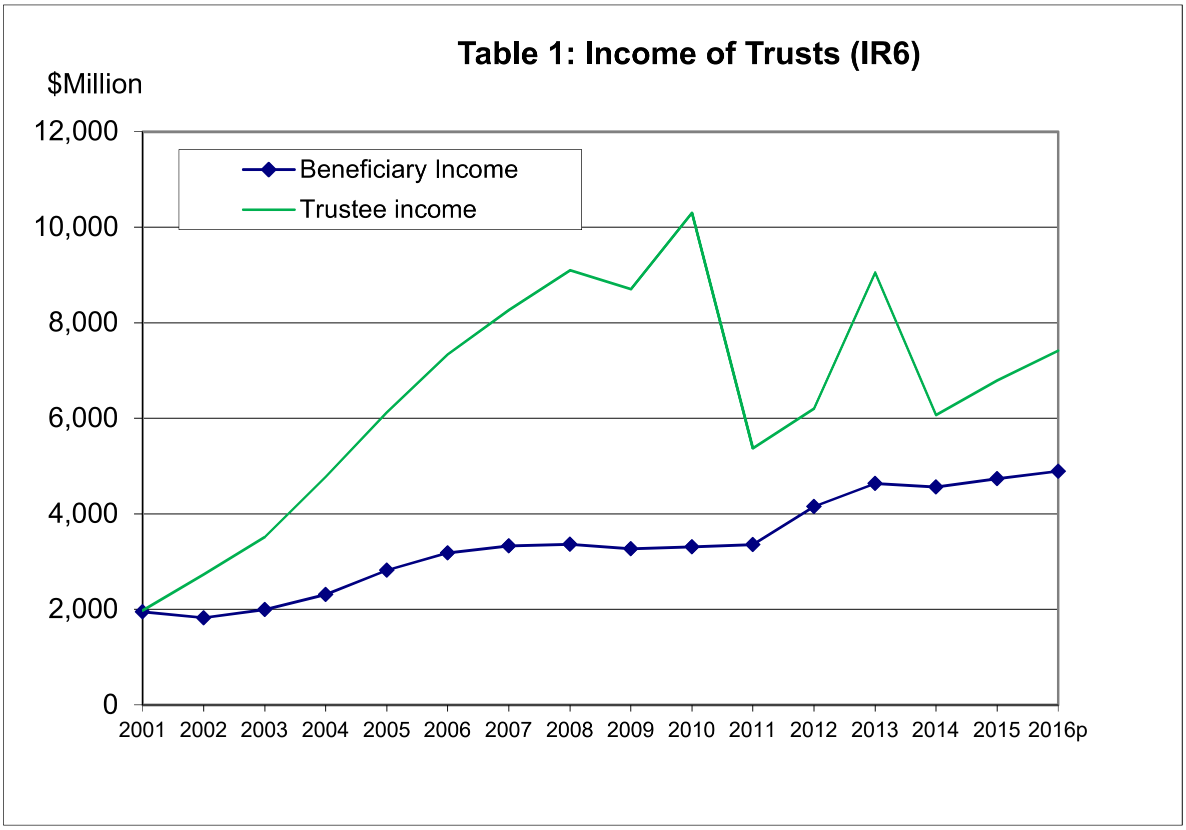
Past issues

15. Trusts became increasingly popular during the 2000s, especially in the SME sector. Formerly family-owned companies were placed in the ownership of trusts. This was a direct reaction to the tax rate structure at that time. Before 1 April 2009[4] the top personal tax rate was 39% and the trustee rate was 33%. Since the trustee tax rate is a final tax rate, it was possible to avoid the top 39% personal tax rate by interposing the trust between the owner and the company.

[4] The top personal rate was lowered to 38% in 2009 pending a more fundamental change in the following year.

16. Unlike companies, the distributions from the trust can be made free from personal tax so that the trustee tax rate is a final tax rate. Because of this difference there was a substantial permanent tax benefit from earning income through a trust structure rather than directly or from a company. Previous Inland Revenue Briefings for the Incoming Minister documented a substantial rise in the amount of trustee income prior to 2011 as taxpayers arranged their affairs to take advantage of these differences.

17. In 2010, the top personal tax rate was aligned with the trustee tax rate and since then trustee income has fallen, as illustrated in the table below. Indications are that now the difference between the top personal rate and the company tax rate is being exploited instead. This issue was discussed in the paper *Dividend avoidance* at the Group's meeting on 6 April 2018.



18. Nevertheless, trusts can still be used to reduce income tax liabilities.

Current issues

19. As noted earlier, many trusts are 'passive' in that they hold the family home and have few, if any, other investments, so their interaction with the tax system is either minor or non-existent. We see no tax issues with those trusts, although there may be other planning/avoidance matters outside of tax.

20. Rather it is in the business context that tax issues arise because a trust is a very flexible vehicle, and trusts are often used in business structures. Trusts can generally be shareholders in various company and alternative business structures, such as look-through companies, and partnerships. Moreover, using a corporate trustee is a way to make a trust look more like a company, and investors are then able to invest by becoming shareholders in the corporate trustee. This provides those investors with limited liability and the flexibility of a trust.[5]

Example
Trust A is settled by Person A. Person A is the sole shareholder in company A. Company A is appointed the trustee of Trust A. Person A is also the sole beneficiary of Trust A. New shareholders, persons B and C are added into Company A. The trust deed enables the trustee to also make persons B and C beneficiaries of Trust A, as it is a discretionary trust.

21. If a trust wishes to operate more like a company, should company tax treatment apply to such trusts? Generally, the answer is no as there are various other vehicles through which a business can be operated, such as partnerships and look-through companies, which do not have the same tax restrictions on distributions of capital gains and losses that apply to companies. We note that one of the options in the paper *Closely-held Companies Follow up* is that closely-held companies be taxed at the top personal tax rate, which would reinforce the closely-held/widely-held split. In this context, it could equally be argued that many trusts should be aligned with the tax treatment of individuals given that many trusts are family based and/or have relatively few beneficiaries. Individual treatment already applies where income earned by a trust is distributed as beneficiary income.

22. Acknowledging this dichotomy, the Tax Review 2001 recommended that entities, including trusts, be allocated into two categories, closely-held entities - that would be subject to partnership/individual tax treatment - and widely-held entities - that would be subject to company tax treatment.

23. Furthermore, a number of the trust issues that first appear as more favourable tax treatment than companies turn out to be capital gains related and, therefore, would be potentially resolvable by a broad-based capital gains tax[6], or are related to timing mismatches that are not specific to trusts but rather reflect the way that certain types of businesses are taxed. There is one issue, however, that is worthy of discussion – the ability of trusts to trade their losses.

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[5] The use of corporate trustees raises issues for collecting debts, including tax debts, as it is relatively easy to wind up a company, and it has limited liability. The issue of interposing corporates generally is being considered in the separate paper *Collection of tax debt*.

[6] Other countries, such as Australia and the United Kingdom, have dis-incentivised the transfer of assets to a trust by applying a capital gains tax to property sold, including property transferred to a trust.

Trust losses

24. This section discusses the comparative treatment of company and trust tax losses and whether it would be appropriate to apply some restrictions to ensure that any trust losses are utilised primarily by those who incurred the economic loss.

25. Losses made by a company cannot be used by parties who have not economically incurred the loss. This is achieved through measuring ownership interests to establish whether certain minimum thresholds have been breached. Broadly, a company can carry forward losses only if, at all times during the period from the beginning of the year of loss to the end of the year of carry-forward, a group of persons holds an aggregate of at least 49% of the minimum voting interests in the company. A company can make its tax loss available for offsetting against the net income of another company when they are both part of the same group of companies. This requires the two companies to be at least 66% commonly owned.

26. As noted in *Appendix 6: Measures to improve efficiency* (a paper tabled for session 6 of the Tax Working Group), without these rules, taxpayers would be able to trade losses. For example, a profitable company could purchase a dormant company with a stock of losses. This would open government up to similar revenue risks as cashing out losses directly. However, this treatment of losses will, at the margin, distort business decisions as it deters risk-taking – profits are taxable but losses are not realisable now. This issue is discussed further in the paper on revenue reducing options.

27. Like companies, trust losses are ring-fenced within the entity and cannot be distributed. However, in contrast, there are no restrictions on trust losses being used by other parties. Property development through trading trusts is becoming increasing common. Such projects may be profitable but, because of timing differences between the recognition of expenses and income, may nevertheless produce substantial tax losses in the interim. If those losses were held in a company then the ability to sell those losses to other parties through a change in ownership or to offset those losses against other companies' profits would be limited by the continuity of ownership requirements.

28. In some cases the losses are artificial in that the gains are treated as capital gains rather than income of the company. Those losses would be soaked up if the gains were taxable, such as through a general capital gains tax. However, another situation is, arguably, more problematic:

Example
A trust with $1m in losses (the loss trust) approaches other taxpayers and offers to effectively sell the losses to a taxpayer. A taxpayer who has a business operating in an existing trust (the profit trust) agrees to pay 10 cents in the dollar for the losses in the loss trust. The settlor of the loss trust receives $100k and appoints the taxpayer as the new trustee and confers upon them the sole power to appoint trustees and beneficiaries. The loss trust is then added as a beneficiary to the profit trust and $1 million of taxable income from the profit trust (on which $330k of tax would otherwise be paid) is distributed to the beneficiary loss trust and is offset so that no tax is paid. Beneficiaries from the profit trust are subsequently added as beneficiaries of the loss trust.

29. The effective cashing in or transfer of tax losses is not available to individuals who make tax losses. The losses are able to be carried forward to be offset against the individual's future income, and therefore stay with the person who incurred the economic loss. The unrestricted treatment of trust losses is therefore unique, so would it be appropriate to apply some restrictions on the use of trust losses?

30. The Tax Review 2001 touched upon this issue when discussing their suggestion to categorise entities according to whether they are closely-held or widely-held entities. The review acknowledged the difficulty of applying this split approach to discretionary trusts because:

- beneficiaries do not hold defined entitlements to the underlying income and assets of the trust. This makes it difficult to design effective anti-imputation streaming and continuity rules; and

- unlike a corporate or partnership situation, contributors of capital (settlors) have no rights to returns of, or returns on, trust capital.

31. Furthermore, the review noted that widely-held discretionary trusts are rare in practice and that discretionary trusts are typically closely-held. The monitoring and other transaction costs of a number of unrelated people dealing at arm's length with each other generally means that entitlements to the assets and income of any trust in which they hold an interest are better defined. In a widely-held context, a trust is more likely to be a fixed trust and subject to the unit trust regime.

32. In the above example, potentially both the loss trust and the profit trust could have operated alternatively as look-through companies, which have a maximum of 5 owners, with persons associated by up to 2 degrees being counted as one. If this was so, the losses would have been distributed to the owners for tax purposes (i.e. the persons that had incurred the economic cost) and the profitable entity would not have been able to utilise the losses. That treatment is not open to a trust so, as a second best solution, the trust sells the losses to another trust to realise some value from them.

33. This loss trading, however, raises some policy concerns in that entities that could never utilise their losses, such as tax-exempt charitable trusts, could on-sell their losses. Therefore, if the Group agrees with the recommendation in the paper

Potential revenue reducing options that tax policy officials should work on loss continuity with a view to issuing a discussion document on it in 2019 or 2020, the Secretariat recommends that the issue of trusts trading their losses should be considered as part of that work.

3. Use of trusts for streaming

34. The issue of streaming arises because some forms of income are taxed, and other types of income (such as capital gains) are not taxed. To what extent is this issue a concern?

35. We note that trusts can be used to "stream" different types of income from a business or investment to different beneficiaries of the trust. There can be good personal/commercial reasons for this. For example, a surviving partner might receive the income from bonds, while the children receive the income from the family farm that they operate. However, this feature of trusts can be exploited for tax purposes to stream income to beneficiaries on low tax rates and capital gains to beneficiaries on high incomes. Trusts are a more effective vehicle than companies for streaming different types of income (and for splitting income, as discussed in the next section) to low rate recipients because distributions from most trusts are discretionary and, unlike companies, are not based on shareholdings. This may negatively impact horizontal equity.

Example –

- Through a partnership, person A and person B directly earn $100 in taxable income and a further $100 in capital gain, ($200 in total). The taxable income and capital gain are split and allocated pro rata to the partners. The income is taxed at person A and person B's respective marginal tax rates of 33% and 17.5%, and the capital gain is tax-free. Total tax paid is $25.25.

- Alternatively, the business activity could be undertaken through a trust where person A and person B are beneficiaries. The capital gain could be streamed to person A as a distribution of a capital gain, and be non-taxable, while the $100 of taxable income could be allocated to person B and therefore be taxed at 17.5%. Total tax paid is then $17.50.

- If the income is earned through a company, in which person A and person B are the shareholders, the $100 of taxable income will be taxed initially at the company tax rate of 28%, and the capital gain of $100 will be non-taxable. However, ultimately when distributed by the company (outside of liquidation) as dividends, both the income and capital gain (i.e. the full $200) will be taxed at the respective shareholders' marginal tax rates, through the imputation system. Total paid is $50.50.

36. Unfortunately, there is no data to provide evidence of the extent of the problem. Given the legitimate commercial reasons for streaming different types of income, it would be difficult to develop anti-avoidance rules to deter this type of tax planning without interfering with legitimate arrangements. Also, trusts have traditionally been flexible with a trustee given the discretion to apply income for the benefit of beneficiaries.

37. This is not exclusively a trust issue. With a partnership it would be possible for profits to be split in some fashion other than a pro-rata basis. But this would mean that actual shares of profits vary according to whether assets generate predominantly taxable income or predominantly capital gains. Further, tax-favoured income (such as capital gains) are not allowed to be streamed disproportionately to particular partners. *Amounts* of income may be streamed, but their *tax nature* may not be streamed. There is not the same opportunity to provide a split of profits in ways which maximise tax benefits that there is if income is earned in a trust.

38. We consider that the issue of streaming is primarily caused by some forms of income being taxed (and therefore streamed to people on low tax rates), and other types of income not being taxed (and therefore streamed to people on high tax rates). Accordingly, the issue of income streaming would be largely addressed by a broad-based capital gains tax. For the interim report, the Group is asked to not only indicate whether it agrees with this conclusion but also whether it wants to consult on whether there would be any remaining concerns in relation to streaming even with a broad-based capital gains tax.

4. Income splitting

39. A related issue, "income splitting", has also been raised in the context of trusts. Income splitting reduces tax payable by transferring taxable income from a high tax rate taxpayer to related persons (generally partner or children) who have less other income and, therefore, pay tax at lower tax rates.

40. Undistributed current income (trustee income) is taxed at 33%. Distributions of income that were taxed as trustee income are not taxed again.

41. Beneficiary income is income that is transferred to beneficiaries within approximately a year of it being earned. It is taxed as income of the beneficiary instead of trustee income. This means the progressive personal tax scale applies to up to $70,000 of beneficiary income for each beneficiary receiving a current distribution.

42. Income splitting can be accomplished by establishing a trust that directs income to related beneficiaries who are taxed at lower rates. As noted earlier, New Zealand has rules to prevent the use of trusts to direct income to minor beneficiaries by taxing such income as trustee income at 33%.

43. The same arrangements can occur if income is earned through a partnership or look-through company with multiple partners/shareholders, or when income is earned in an ordinary company that has family members as shareholders and then is paid out as an imputed dividend, at which point the tax rate automatically adjusts to the shareholders' rates.

44. In all cases this is a consequence of treating entities as intermediate taxing entities when the ultimate owner of the income is a shareholder, partner or beneficiary.

45. As long as this is not being done in an abusive or contrived way, the Secretariat considers this treatment appropriate in terms of tax policy[7]. Our assessment is that on balance, there are sufficient constraints in place in this area in relation to trusts and that although a trust may be a more flexible vehicle for income splitting, the numbers do not show that trusts are being used in this way on any material scale. In fact, trusts are clearly only a relatively small contributor to income splitting. Further background information on this point is provided in the appendix. If there is an issue, it is of a wider concern than just trusts.

4. Appropriateness of trusts

46. This is one of the issues that the Law Commission considered in its long-term project that reviewed trust law, particularly in its Issues Paper No.20, *Some issues with the use of trusts in New Zealand*.

47. The Commission was interested in why people establish trusts, and whether some purposes of trusts are more acceptable than others, noting that in some cases they are established for little benefit but involve material compliance costs.

48. The Commission noted that a motivation for the use of trusts has been to protect assets from being subject to claims from creditors. Family trusts in particular have long provided a way for people with businesses to ensure that their private assets are not available to business creditors and can be kept for beneficiaries in the event of a bankruptcy. This is particularly of value in situations when the protection of limited liability is not available.

49. The Commission was concerned that some trust advisors have actively sought to sell the trust concept as a way to make someone appear poor without their 'suffering the rigours of poverty', or to more generally use trusts to thwart legal obligations, leaving others to bear the costs. Examples include:

- intentionally disadvantaging creditors when the debtor knew they would not be able to meet their debts;
- side-stepping the equal sharing regime in the relationship property legislation;
- avoiding tax; and

[7] An example of a contrived way is the Penny and Cooper case (*Penny and Hooper v CIR [2011] NZSC 95*). See subsequent footnote for more detail.

- artificially minimising assets or income in order to access government benefits or subsidies (especially the residential care subsidy).

50. More generally, the inherent flexibility of trusts has enabled the blurring of the difference between trust and agency, with settlors seeming to be acting as a principal would in an agency. Settlors appear to retain effective control over assets they have transferred to a trust while being able to access the various benefits offered by a trust that people without a trust cannot access.

51. The Commission, therefore, considered whether trusts should be ignored or dispositions to trusts should be set aside for overriding public policy purposes. They noted that the courts have also gone some way to “busting trusts” by disregarding trust structures, to allow third parties to gain access to trust assets, particularly in relation to relationship property.

52. The Commission also considered whether further legislative responses were necessary to provide greater traction in this area. They noted the efforts of various governments to use legislative responses that in effect “look through” the trust in certain situations, so that trust assets can be considered to be the settlor’s or beneficiaries’ own assets in those cases. The common policy objective underlying this legislation, and the judicial response, is that trusts ought not to be permitted to frustrate public policy considerations of equity and fairness.

53. The Law Commission evaluated the effectiveness of these legislative interventions. Their perception was that they might not always be adequate. However, in the tax area the Commission noted the outcome of the Penny and Hooper case[8], in which the redirection of personal service income to a company and ultimately distributed to the family via a trust, was considered to be tax avoidance, the existence of the minor beneficiary rule, and the tightening of the associated persons definition which extends to beneficiaries of trusts.

54. More generally, the Commission noted that trusts give rise to complex legal obligations. Trustees have complicated duties that require them to act for the benefit of the beneficiaries of the trust. The precise content of those duties, and the extent to which a trust deed can be used to vary or limit those duties, is the subject of on-going legal argument and debate and their scope is not always easy to define.

55. The Commission concluded that trusts were still appropriate as one of the ways that individuals hold and transfer property, but that a new Trusts Act was needed that would be fit for both current New Zealand purposes and consistent with overseas trust law. In particular, the new Act would need to provide a common understanding of what a trust is, set out the core duties and obligations of trustees, and provide simplified procedures so that the business of trusts could be undertaken at minimal expense.

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8 This case involved two surgeons who had redirected much of their personal service income to companies, to take advantage of the company tax rate, and the trustee rate, being lower than the top personal tax rate. The income was subsequently distributed to family trusts.

56. A bill to replace the Trustee Act 1956 and the Perpetuities Act 1964 was introduced in December 2017 with the stated objective to make trust law more accessible, clarify and simplify core trust principles and essential obligations for trustees, and preserve the flexibility of the common law to allow trust law to continue to evolve through the courts.

5. Glossary

Complying trust: Generally, a complying trust is a trust with income that has been taxed in New Zealand and which has met all of its income tax obligations.

Income streaming: Different types of income from a business or investment earned through an entity or structure are paid to different owners (shareholder, partner, beneficiary or trustee). This may be done in order to take advantage of the differences in the owners' tax status and therefore to minimise the tax burdens of the owners. For example, taxable income might be paid out to an owner who is on a low or nil tax rate, and tax-free income might be paid out to an owner on a high tax rate.

Income splitting: Business or investment income earned through an entity or structure is split amongst various related recipients, and those recipients pay tax accordingly to their marginal tax rate. This can be used to minimise overall household tax liabilities, by making family members on lower marginal tax rates shareholders in family businesses or beneficiaries of trusts that own family company businesses.

Appendix: Trusts and income splitting

57. There is evidence that taxpayers manage their distributions from trusts and companies, unsurprisingly, to minimise the tax they pay. Previous BIMs demonstrated clearly that such tax planning was occurring. Tax minimising benefits are maximised when income is transferred just up to the top of a tax bracket. That this was occurring was illustrated by the fact that the number of taxpayers spikes just below the top of the respective tax brackets. This was very apparent in the 2000s. The spikes still exist today, but are more muted.

Table 2: Main source of taxable income 2015-16

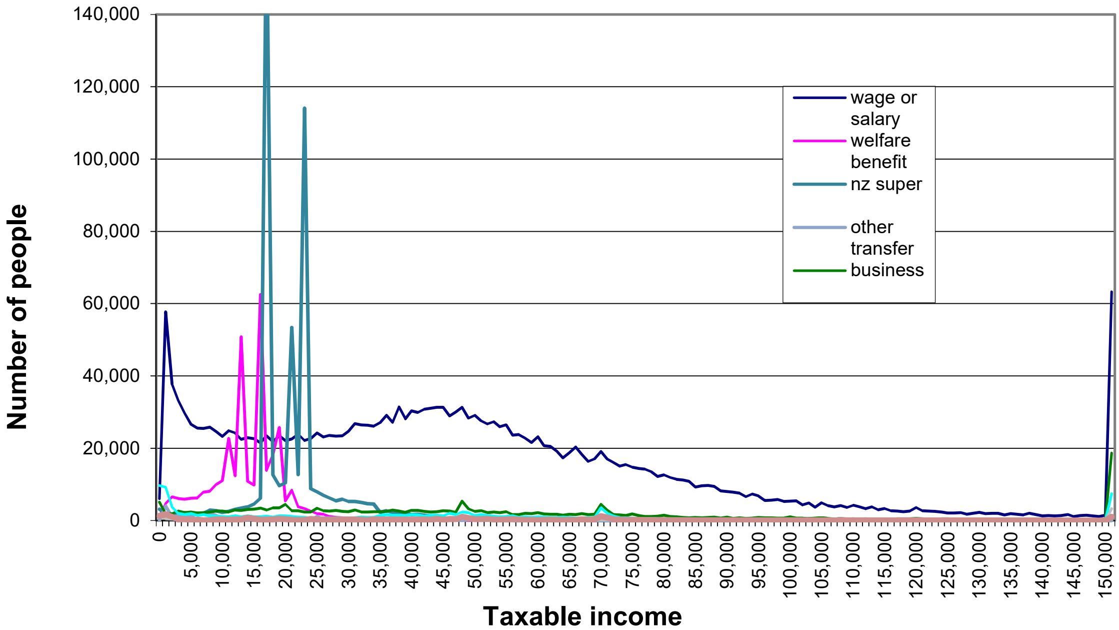
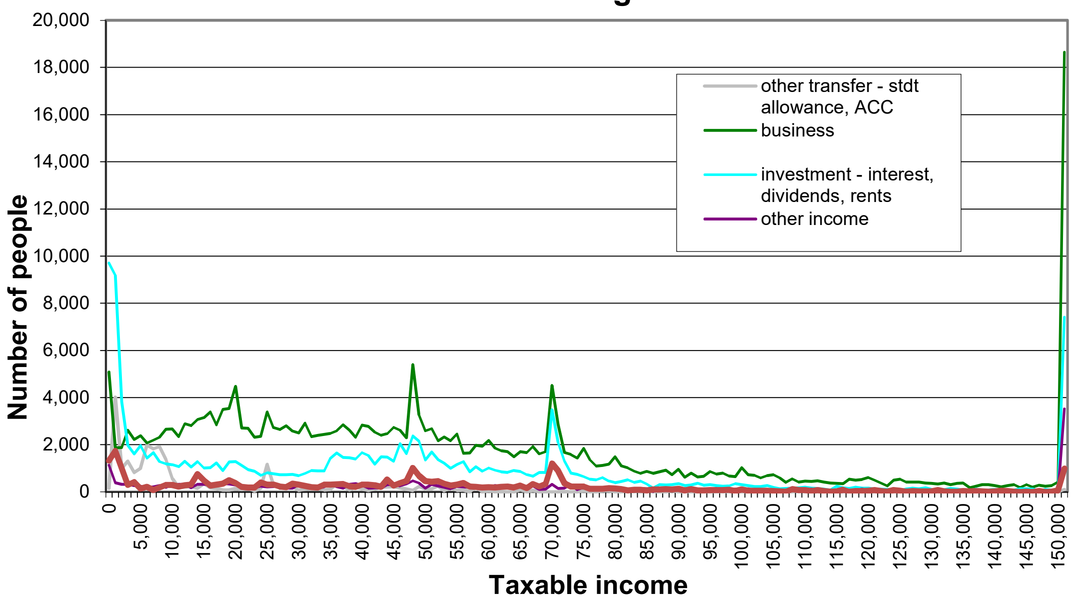


Table 3: Main source of taxable income 2015-16 - smaller categories



58. To a large degree the spikes at lower income levels arise from peaks of income of individuals earning exclusively New Zealand Super or beneficiary income.

59. The main reason for the spikes at $48,000 and $70,000 is payments of shareholder salaries. Shareholder managers have an incentive to pay themselves salaries up to the point where their marginal personal tax rate exceeds the 28% company tax rate. The number of taxpayers receiving shareholder salaries is the principal component of the peaks at higher income thresholds (see the "business" category in table 2). This income is likely related to business activities, giving rise to salaries that are earned through companies.

60. This phenomenon is an example of taxpayers implementing a self-help progressive tax system for business income; a possibility that was noted in the paper to the Group on that topic.

61. There is also a lesser peak of beneficiary trust income at these thresholds. The total number of "extra" taxpayers in this category at the bracket thresholds is under 2000. This may well arise from investment income earnt through a trust being split to minimize household tax liabilities. The trust minor beneficiary rules restrict such income splitting by taxing trust income received by children at the top personal tax rate.

62. There are also peaks in investment income that has been earned directly. In that case income can be split by having different members of a family hold the investment income and pay the tax on the income at their lower marginal tax rates.

63. Even when income is earned in a company, having a trust rather than natural persons as shareholders provides a more flexible mechanism for streaming income to low rate beneficiaries when the settlor does not want the beneficiaries to be shareholders.

64. Given that trusts are inherently flexible structures that enable income splitting/streaming, tax provisions, such as the minor beneficiary rule and income attribution rule,[9] have been introduced over the years to counter the most blatant forms of income splitting/streaming.

65. However, a key point to remember, as illustrated in the tables above, is that income splitting is not primarily a trust issue. Companies can also be used for the same purpose, as well as sharing investment assets among related parties.

66. It is a question of whether the problem of income splitting is sufficiently extensive to warrant the development of complex rules, such as extending the attribution rules

[9] The minor beneficiary rule treats income derived by a minor as trustee income so that it is taxed at 33%, irrespective of the minor beneficiary's marginal rate. The attribution rules are designed to prevent higher income earners from diverting personal services income to associated entities (such as trusts and companies) by attributing the amount of income that is derived by the associated entity, to the higher income earner.

[2] In a particular case (*Krukziener v Commissioner of Inland Revenue*, TRA Case Z23) the Courts considered those loans to be income under the general anti-avoidance rule and, therefore, taxable.

to other types of income beyond personal services income. As long as this is not being done in an abusive or contrived way, the Secretariat considers the current treatment appropriate in terms of tax policy. This data suggests that there is not enough evidence that this is a major problem relative to the other issues that the Working Group has to consider.