To Trust or Not to Trust

3rd edition

A **PRACTICAL GUIDE** TO FAMILY TRUSTS

NZLAW
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Foreword

The need to protect a family's assets is not a recent phenomenon. For hundreds of years people have wanted to safeguard their family's assets by sheltering them in a trust.

The use of family trusts has, however, increased significantly in recent times as the complexity and risk of conducting business increases, more levels of compliance are introduced, relationship property laws have been extended and society in general has become more litigious.

At the time of writing this, trusts have been in the news recently. This is mainly concerned with 'foreign trusts' set up under New Zealand law by people who have never lived here. If the trust assets and the beneficiaries are all outside New Zealand, then no tax is payable in New Zealand. This book is not intended for those who hope to evade tax in this way. This book is for New Zealanders who fully intend to meet all their legal and tax obligations but, equally, want to protect their family assets from external risks.

This booklet, the third edition of *To Trust or Not to Trust*, provides an introduction to trusts if you are starting to think about asset protection. It also offers useful information if you're quite familiar with the concept of trusts.

Whatever stage you're at, we recommend that you read through this booklet and then talk with us about the best way to meet your family's needs and to achieve the outcomes you desire. You will want to know about the options available to you and what impact they will have on the way you and your family protect, use and enjoy your assets in the future.

We do emphasise that a family trust may or may not suit your specific family circumstances, nor does one size fit all. However, for most families who want to safeguard their family's wealth a trust structure to ring-fence their assets is the best solution.

After reading *To Trust or Not to Trust*, do talk with us, and we will advise you on the best structure to suit your family's requirements. Alternatively, look on **www.nzlaw.co.nz** for your nearest NZ LAW Limited member law firm.

Kristine King
Chair, NZ LAW Limited
December 2016

Establishing a Family Trust

What is a family trust? Is it for us?

Trusts are a popular way for New Zealanders to protect their assets. There may be a number of reasons why you are considering setting up a trust or have been advised to do so. A trust can offer a number of benefits and these are explained in this booklet. Before you make any decisions about this, however, it's important that you understand what a trust is and how it works.

This booklet sets out some of the important features of a trust and what is required in order for your trust to work as intended. If the legal obligations are not met or you have retained too much control, your trust may not be legally effective or you may be treated as still an owner so that there is no benefit to you.

New Zealand trust law is the result of centuries of development by Acts of Parliament and by the courts both here and, in earlier times, in England. We cannot cover all the detailed rules here. If you need further explanations about some aspects or you have any questions, you should talk with us.

A trust is a legal arrangement under which a person (the trustee) holds money, property or other assets for the benefit of a specified person or people (the beneficiary or beneficiaries). Usually, the original owner of the assets (the settlor) will transfer the assets to the trustee after they have both signed a deed to record the terms of the trust. Of course, a trust may have two or more settlors, several trustees and a number of beneficiaries. It's possible, and quite common, for one person to be a settlor, as well as being one of the trustees and one of the beneficiaries.

At the heart of a family trust is the relationship between trustees and beneficiaries. There are other types of trust; charitable trusts, for example, are established not for the benefit of individual people but for charities or for charitable purposes.

The other essential element is trust property or assets: a trust arises whenever a trustee holds an asset on trust, but without an asset there is no trust.

The benefits of a trust

For many people the principal purpose of a family trust is to protect your family's assets and wealth against risk. This is done for a variety of reasons, some of which are to:

- Protect assets from business risk (if you own a business or have a senior management role in a business)
- Provide for special family needs, such as a child with a disability
- Protect your assets in a second marriage/relationship situation and/or relationship breakdown
- Prevent claims on your estate when you die (family protection and testamentary promise claims)
- Minimise tax liability
- Defer liability for a possible future capital gains tax or similar taxes
- Protect against income and asset testing for, say, rest home charges
- Provide funding for children's or grandchildren's education costs
- Allow family assets, such as a business or farm or holiday home, to pass to the next generation without exposing inheritances to relationship property or other claims, or
- Give to the community through a charitable trust.

Important things to think about

Once you have decided to go ahead with a trust, you need to decide which of your assets to transfer to the trust. There can be tax and other practical considerations. You may need accounting and legal advice about this, and also about how your assets need to be transferred. While there is no gift duty (it was abolished in October 2011) or tax law to prevent you transferring all your chosen assets into the trust at once, there can be other factors to consider, see pages 17–19.

You also need to think about the trust deed which sets out the rules for your trust and how you want it to work.

Trustees will need to be appointed to run your family trust. This may be you as settlor, and also perhaps your spouse or partner. One possibility that you could discuss with us is to use a company as a trustee.

In addition to the terms of the trust which are in the trust deed, trustees also have a number of legal duties. These are set out on pages 33–34. The trust deed may override some, but not all, of these duties. For example, one of their duties is to treat the beneficiaries in an even-handed manner, but a deed may say that priority is to be given to the needs and interests of a defined group of 'primary beneficiaries' (usually the settlors and their children). Most family trusts now have two groups of beneficiaries: 'discretionary beneficiaries' who may benefit at any time while the trust is running; and 'final beneficiaries' who receive any remaining assets when the trust comes to an end.

Unlike a company or an incorporated society, a trust is not treated in law as if it were a separate person or entity. It's the trustees who represent the trust. All trust assets must be held in the name of the trustees who will be personally liable for trust debts unless the creditors agree to limit the trustees' liability.

Doing it right is important

Even after you have set up your trust and put your major assets into it, you cannot just put the family trust papers away and forget about them. It's important to keep careful record of trust assets and trustees' decisions. If you don't do this, or if you are able to treat trust assets as if they still belong to you, you may be considered to be still an owner or part-owner. In that case all the benefits of having a trust to protect your assets could be lost.

Mistakes are not always fatal

You may have seen media coverage suggesting many trusts in New Zealand are shams or won't stand up to scrutiny. If you never intended to operate a real trust, then it may be a sham and can be set aside. If trustees are doing their best, however, and always intended to act as genuine trustees, then the courts are unlikely to say this is a sham.

Sham trust case: *Official Assignee v Wilson*[1]

Mr R set up a trust and transferred his home in Invercargill to it. Later on, because of difficulties in borrowing more money on the mortgage to obtain finance for Mr R's business, the trustees transferred the property back to Mr R. No trustees' resolutions or deeds were signed to record the decision; the trustees just did what Mr R wanted.

Eventually the trust acquired a new property in Queenstown where Mr R and his partner and their children lived.

Mr R's business failed and the Official Assignee was appointed to take over and get the money back for the creditors. The Official Assignee claimed the trust was a sham and the property in reality still belonged to Mr R which would have meant the Official Assignee could sell it to pay off some of Mr R's debts.

The Court of Appeal decided the trust was not a sham. It said the trustees had not done a good job; there were inadequate trust records and it was impossible to understand why property was moved in and out of the trust. Nevertheless, everyone intended to create and run a valid trust. The court looked at Australian cases about alter ego trusts, where the trust is just the puppet of the settlor, but decided that in New Zealand this would just be one factor in deciding whether a trust is a sham.

1 *Official Assignee v Wilson* [2007] NZCA 122; [2008] 3 NZLR 45 – case sometimes referred to as *Re Reynolds, Official Assignee v Wilson*.

Protection Given by a Family Trust

For most families, the objective in establishing a family trust is to safeguard your family's assets against business and other risks. The sections below briefly describe some of the most commonly used protections offered by family trusts.

It's important to keep in mind that assets are only protected if they have been completely given away to a trust. If you have retained some assets, or the trust still owes you money, then this will be vulnerable to a variety of claims.

Business owners

Without a family trust, business owners run a considerable risk that their family assets could be vulnerable. A range of situations could bring this about, including:

- Creditors, if there is a business failure
- Compliance issues, resulting in action taken against you or your business under, say, occupational workplace health and safety laws, and/or
- Action taken against directors or senior management of a company.

Trusts are not only for employers. Looking to the future, if you establish your own business or are in a senior position in business, you should also consider some method of protecting your assets as this type of business activity may expose you to legal claims.

Trading and development trusts

Conducting business in New Zealand is carried out on a personal basis as a sole trader, or through a joint venture, partnership, company or trust. When a trust is used as a vehicle to run a business it's commonly called a 'trading trust' or a 'development trust'.

Trading in land and property development

Special rules apply if your business involves trading in land or developing real estate. These activities need to be separated from your other business and personal assets to avoid association for tax purposes.

There are specific tax rules covering land sales and associated persons. If you are a property dealer or developer, anyone you are associated with can also be taxed as a property dealer or developer. This can happen unwittingly. The result can be that a profit may become taxable when the property is sold. If you can avoid being treated as associated, and if you retain the property for at least two years, you may not have to pay income tax on any profit.

The structures that need to be put in place in these circumstances are complex; we would expect both your lawyer and your accountant to be involved in advising about this.

Even if you do separate dealings with land from your personal finances, you can still be caught by the rule that profits made on sale of land within two years are taxable income.

Relationship property claims

Trusts are often used to help avoid claims by a former spouse or partner; for example, a claim against your son or daughter's inheritance.

When a couple separates – whether they were married or in a civil union, de facto or same sex – the basic rule is that they share equally in all 'relationship property'. These are the assets they have built up together during their relationship. There are some exceptions, such as inherited property, and the court has some overriding discretion. In reality, however, it's easy for an inheritance to become relationship property if, for example, you use inherited money to pay off your joint mortgage.

The best advice is usually to sign an agreement contracting out of the Property (Relationships) Act 1986. We can draw this up for you. Another solution is to ensure that any inheritance is kept in a trust, separate from relationship property. Putting your children's inheritance in a trust will help avoid claims from a rogue son-in-law or daughter-in-law.

Before you enter a de facto relationship, marriage or civil union, if you have significant assets you should carefully consider how best to protect your personal assets in case you later separate or one of you dies.

The equal sharing rule does not apply to short duration relationships (usually less than three years). However, transferring your assets to a trust just before the three year period ends is not likely to be effective. Relationship property law has claw-back rules which apply if you have given away assets with the intention of defeating a future claim. The Courts may also compensate a former partner who has contributed to a property, even if it is held in a trust.

If you are going into a second or subsequent relationship, civil union or marriage, and you have children from an existing or from previous partnerships, it's even more important to ensure that your assets are preserved in order to make the division of property fair and just, and to ensure your children's interests are preserved.

The Claymark trust decision: *Clayton v Clayton*[2]

The Claymark trust was set up by Mr Clayton to hold land around his saw milling business. He and his wife and their children were beneficiaries. After the couple split up, Mrs Clayton claimed a share of the trust property. The Family Court, High Court and Court of Appeal all said it was a commercial arrangement, not relationship property. However, the Supreme Court decided it was a 'nuptial trust' and, under s 182 of the Family Proceedings Act 1980, the court decided to split the properties equally between two trusts – one each for Mr and Mrs Clayton.

2 *Clayton v Clayton* [2016] NZSC 30; [2016] NZFLR 189.

Children with special needs

A trust can help to ensure your assets are safeguarded for a child with special needs such as a disability. This protection may be given through the family trust, or by setting up a separate trust for the individual child. However, you need to be aware that trust assets can be treated by the authorities as financial resources that should be used first before asking for government help, such as a benefit.

The trustees can exercise their discretion to make available to the beneficiaries any income and/or capital to help meet their legitimate cash requirements. The trust could also make loans for capital needs such as housing, or even buy a home for occupation by a beneficiary.

Similar protection can be arranged when you have doubts about the ability of a child or other family member to manage their financial affairs.

You may feel the need to protect your children or other family members from their own folly or lifestyle. It can be left up to the trustees to give these children control of some or all of the assets held in trust at a future date and, in the meantime, provide for their reasonable needs.

Education trusts

Sometimes parents or grandparents want to establish a separate trust or trusts to help fund education costs for their children or grandchildren. Often these trusts specify levels of education to be funded, such as high school costs, boarding fees and/or tertiary level expenses.

Claims against estates

Establishing a trust will help protect your estate against family protection and testamentary promise claims.

Family protection

If your Will doesn't provide adequately for your spouse or partner, children, grandchildren or other close family members you may have been significantly financially supporting, claims may be made against your estate after your death, under the Family Protection Act 1955.

The claimant/s must show that you had a moral obligation to provide for them and that your Will did not provide for their adequate maintenance and support. If provision is made under your trust for those for whom you have a moral obligation to provide, claims can usually be avoided. However, your children in particular have a right to be acknowledged as members of the family.

Testamentary promises

A testamentary promise claim can be made against an estate if the deceased promised to reward someone by his or her Will in return for work or services. These claims are made under the Law Reform (Testamentary Promises) Act 1949. To support a claim there must have been something done for you by the claimant, such as looking after you without being paid (for example, housekeepers or companions).

While evidence is needed to prove the claim, often the promise will be implied in the circumstances. Assets held in a trust at your death are not part of your estate and cannot be claimed under the testamentary promises legislation.

Minimising tax liability

Establishing a trust principally to avoid paying tax is not likely to be effective. If there is a tax saving by establishing a trust, it must be seen as an incidental benefit, not the sole or dominant purpose of the trust.

Tax savings can be made if the trustees have flexibility to decide which beneficiaries should receive income each year. Trusts are taxed at the maximum individual rate (currently 33%) but income distributed to beneficiaries is taxed at their own personal rate. Using a trust for tax efficiency requires careful advice.

A decision as to how much income is to be allocated to a beneficiary must be made within 12 months of the balance date for the trust.

The 2011 Supreme Court decision, *Penny & Hooper v Inland Revenue*, emphasises that an artificial arrangement intended mainly to avoid tax can be ignored by the Inland Revenue (IRD) for income tax purposes even if the trust itself is perfectly valid.

Penny & Hooper v Inland Revenue[3]

Two surgeons (Messrs Penny and Hooper) each put their business into a company. Each company was owned by a family trust. In each case the company paid the surgeon a salary far lower than what he was previously earning. Most of their earnings were channelled through their trusts. Because this reduced the amount of tax in each case, the IRD invoked the anti-avoidance rule in the Income Tax Act 2007.

The Supreme Court agreed with the IRD: the trust and company arrangement was legally valid but the surgeons must pay income tax on what they actually earned, not just the notional salary. The surgeons also had to pay $25,000 towards the IRD's legal costs.

3 *Penny & Hooper v Inland Revenue* [2011] NZSC 95; [2012] 1 NZLR 433

A trust or a company?

Other structures such as Look Through Companies (LTCs – previously called Loss Attributing Qualifying Companies), partnerships, and Portfolio Investment Entities (PIEs) may offer tax advantages for individual investors. It's important to remember, however, that these structures do not offer the asset protection available through a trust.

State assistance and benefits

Strict rules apply if you want to apply for a government benefit or assistance such as legal aid, student loans, the unemployment benefit, etc. These rules have been in place for a long time. Assets transferred to a trust can be treated as resources that you should use first before asking for government help.

Even if you have transferred assets to a trust of which you are not a beneficiary, you may still be denied assistance from the state.

The same is true also of using a trust in order to qualify for a rest home subsidy. In that situation, there are strict limits on how much you may put into a trust each year. There's more about this on pages 17–19.

Capital gains or succession tax

Unlike most countries, New Zealand does not currently have any capital gains tax or any inheritance or estate tax. Gift duty (a tax on gifts of large amounts) was abolished in 2011. This means property of substantial value can now be given to a trust immediately. In the past, there have been suggestions New Zealand should adopt a capital gains tax similar to the Australian model. Having family wealth in a trust could help defer such a tax for a generation or more. There are no plans to implement such taxes at present.

Maximum duration of trusts

By law, most trusts cannot last forever. To avoid the uncertainty of the old legal rules, most family trusts now adopt a fixed period of 80 years. Under current law, this is the maximum number of years allowed for trusts other than purely charitable trusts. The New Zealand Law Commission is considering reform of the law but it may be some years before this takes effect.

If your assets are owned by a trust they may be preserved for the next generation. It must be remembered, however, that most trusts will mature after 80 years and the process must then be started again. Many families may not be taking this trust life cycle into account.

Confidentiality

There is currently no requirement for public registration or disclosure for private trusts. A trust's annual accounts and activities are not available to anyone else except the settlor, trustees and the beneficiaries. Court decisions indicate that trustees have a duty to inform beneficiaries.

The basic principle is that trustees are accountable to beneficiaries. Therefore beneficiaries are entitled to sufficient information to be able to hold the trustees to account. The court has a discretionary power to order the trustees to give information to beneficiaries whatever the trust deed may say. The best advice is to keep the beneficiaries informed and work with them. Beneficiaries are usually entitled to see deeds, accounts and the record of decisions of the trustees, but are not entitled to know the reasoning of the trustees when exercising their discretion.

Charitable purposes

Charitable trusts and foundations must be registered in order to obtain their tax-exempt status. Trust information is publicly available on the Charities Register, unless you ask for confidentiality.

Your family trust could include named charities or charitable purposes generally as potential beneficiaries. If charitable purposes or named charities are included the trustees can make charitable payments without the need to register as a charity.

Since 2008 trustees have been entitled to a tax rebate up to 100% of trust income distributed for charitable purposes.

Dealing with changes in the law

There is always the possibility of changes to trust law, or associated laws affecting trusts, which may remove some of the benefits attached to a trust or frustrate some of the original objectives of the trust.

No one knows what future law changes there may be or when they may occur. However, it is comforting to know that the fundamental structure of a trust has stood the test of time over hundreds of years.

If there are changes to the law, modern trust deeds usually provide the trustees with a power to vary some of the terms of the trust, which may ensure the provisions of the deed can be adjusted to comply with law changes. It's important that your trust deed includes wide powers to resettle and to vary the trust.

Changes to trust legislation are likely in the future following recommendations from the Law Commission. It seems unlikely these will have major consequences for your trust, however, do check with us.

Transferring Assets

Any asset can be transferred to your family trust. However, it's generally recommended that you only transfer assets which are likely to increase in value. For most people this usually involves transferring their family home, and perhaps rental property and some investments such as a share portfolio. We can discuss with you which assets should be considered.

If you're considering transferring assets such as rental properties to your trust you should talk with your accountant about the tax implications of such a transfer, including tax on depreciation recovered.

The transferring of assets

When assets are transferred to a trust, they are effectively being given away. The law requires that trust funds must be kept quite separate from your own personal assets, therefore when you put anything into a trust it's treated as a gift.

The law now allows you to give away as much as you like at any time. The previous gift duty or tax no longer applies (it was abolished in 2011). In some circumstances, however, giving assets away can have adverse consequences.

There are three particular situations where it is particularly important to get specific advice about how to go about transferring assets to a trust. These are:

- Where there are potential relationship property claims
- If you are looking for protection against possible future creditors, and
- If you have concern about the cost of rest home care at some future time.

Rest home subsidies

An application for a rest home subsidy is likely to be declined if you have given away substantial amounts, whether to a trust or to anyone else. Under the current rules, you may gift only $27,000 a year (reducing to $6,000 a year during the five years before you apply for a subsidy). If only one spouse or partner is in care, your combined gifting as a couple must be below those limits.

During the five year gifting period, if too much has been given in one year, the gifts can be averaged over the following years to keep within the prescribed limits. Gifting prior to that five year period cannot be averaged out, but it's sometimes possible to reverse the transfer of assets in order to qualify for a subsidy.

The rules are complex and the Ministry of Social Development has a stringent regime of assessing whether or not you may have 'deprived' yourself of assets, or income from assets. If you attempt to qualify for a rest home subsidy by completing a single gift, it's unlikely to be effective.

Gifting programme

In order to keep within the Ministry of Social Development's limits, it's possible to use what is known as a 'gifting programme'. This usually involves:

- Selling assets to the trust at their full market value
- Leaving the amount of the 'sale price' owing as a debt, and
- Reducing that amount by a gift of $27,000 each year (per couple).

Of course these are all paper transactions; no money changes hands apart from legal fees. It's important to keep full records of the sale, acknowledgement of debt and annual gifting. There should also be records to establish the market value of the assets, for example a report from a registered valuer (local council rates assessments may not be a good guide). We can prepare these documents – sale, acknowledgement of debt and annual gifting – for you so that you can be sure they are legally effective.

Claims by a spouse or partner

As mentioned earlier in this booklet, it's possible to transfer an asset to a trust in order to avoid the risk of a claim by a future spouse or partner. The law does, however, allow 'claw-back' of an asset which has already become relationship property or was transferred in order to defeat the rights of your spouse or partner at the time. The court may also compensate a former partner or spouse who has made contributions to a property, even if it is held in a trust.

While a gifting programme, spreading the transfer of the value of the assets over a number of years as above, is sometimes recommended because of concerns about rest home subsidies, using a gifting programme may have adverse results if there is a claim by a spouse.

Widower John

John is a widower in his early 50s. He hopes to remarry eventually, but he also wants to ensure that the property he and his late wife built up together is passed on to their children in due course. He transfers all his property to a trust. As he is not yet in a relationship, he can transfer everything outright. He is not intending to defeat the rights of a spouse or partner – he doesn't have one yet. So the claw-back rules in the Property (Relationships) Act 1976 don't apply. Gifting spread over a longer period would be risky because of the claw-back rules. John is better transferring everything immediately.

Protection against creditors

Trusts are often recommended if you need protection against possible claims from creditors. There's nothing wrong with putting assets in a trust if you don't have any liabilities at the time, or if you retain sufficient assets to meet your potential liability. In this situation it makes sense to put everything into a trust immediately. You may need to talk with your accountant and complete a solvency statement which will show the actions you are taking are not designed to defeat the rights of creditors.

Another option, depending on your circumstances and the advice of your accountant, may be to adopt a variation of the gifting programme. This would involve selling assets at market value to the trust, leaving the purchase price owing, giving away as much as possible of that amount but leaving enough still owing to you from the trust to cover liabilities such as a mortgage.

Jane and her business

Jane's business is going well but she is concerned that if anything did go wrong, she and her husband Tom could lose their family home. Before Jane and Tom transfer their property and their investments to a trust, they are advised to sign a solvency certificate. Their lawyer draws up gifting documents tailored to their circumstances. They 'sell' their property at market value to the trust, treat most of the sale price as a gift and leave some money owing to them by the trust which is sufficient to cover any liabilities such as their mortgage and business borrowings.

Claims against estates

Assets may be transferred to your trust in order to avoid the risk of a claim against your estate under the Family Protection Act 1955, the testamentary promises legislation or other laws. Assets which are held in a trust don't form part of your estate and are not subject to attack under this legislation.

If a gifting programme has been used as part of the arrangements for transfer of assets to a trust, then the amount still owing to you at your death is part of your estate. This can be claimed under the Family Protection Act 1955 and similar legislation. If a gifting programme is used for some other reason, it's important that the amount left owing to you by the trust is completely given away before you die.

Timing is everything

What assets you give to the trust, and how you go about putting those assets into your trust, will depend on your reasons for wanting the trust in the first place. Many people have more than one reason for wanting the trust. In that case it's important to be clear which is the most important because this may help you decide whether you need a gifting programme or not.

Each person's circumstances will be slightly different and it's important you talk this over with us. As time goes by, you will need to make changes and it is important you review the way your trust has been set up to make sure it still meets your needs.

While there can be no hard and fast rules, as a general guideline:

- If your main concern is to ensure there are no claims against your estate after you die, then you need to give as much as possible to a trust during your lifetime
- If your main concern is about a claim by a possible future spouse or partner, then anything which might possibly be treated as relationship property later on needs to be in a trust and completely gifted before the relationship starts. If you are already in a relationship, talk with us about an agreement to contract out of the Property (Relationships) Act 1976
- If your main concern is possible future creditors, then you should gift as much as possible to your trust while still retaining enough in your own name to meet current known liabilities
- If your main concern is rest home costs, then you could consider a gifting programme within the limits set by the Ministry of Social Development.

It's important to remember that these rules can change. By the time you need rest home care, the rules may be totally different. If you've a gifting programme it's important to discuss this with us to check that you're within the current rules before completing each year's gifting.

Decisions to be Made

There are a number of important decisions that must be made when you're considering establishing a family trust. These include deciding when to establish your trust, who should be the trustees, who will be beneficiaries and so on. These are discussed in more detail below.

The trust deed

The trust deed sets out the rules about how your trust is to be managed and who is to benefit. As it can often be difficult to change at a later time, the trust deed needs to be as flexible as possible, while at the same time reflecting your intentions in setting up the trust.

Most modern trust deeds give the trustees power to make changes to the administration clauses. Either the trustees or a named appointer may be given power to add and remove beneficiaries. There is a limit to how far you can go in allowing major changes to a trust. If changes later prove necessary and there is no power to do this under the trust deed, it may be necessary to apply to the High Court which would be very expensive.

Name of the trust

The trust deed will usually give a name for the trust. A distinctive name should be chosen that will help maintain the separation between your own assets and those of the trust. There is no central register of trust names, so any name can be chosen within reason.

The name should be easily recognisable, for instance a name such as the Smith Family Trust may not stand out from the crowd. Many people are creative with the trust name and others prefer simplicity by using the family name such as the Tom & Jane Green Family Trust.

Trustees

Trustees hold the title to trust assets in their own names and have the power, subject to the trust deed, to deal with those assets as they see fit. Trustees must:

- Be over 18 years of age
- Be mentally capable
- Be aware they have a personal liability for any losses that may be incurred by the trust because of their own dishonesty or negligence
- Understand that they are personally liable for taxes and other charges, such as property rates, payable by the trust
- Acknowledge that they may be personally liable for trust debts, or guarantees given by the trustees, although an independent trustee may be able to contract to have their liability limited to the value of the assets held by the trustees, and
- Be trustworthy, as they must manage the trust's affairs in a way that will provide the maximum benefits possible to the beneficiaries.

Settlors can be both trustees *and* beneficiaries of their own trust.

The trust deed should give at least one person the power to appoint additional trustees and to remove any trustee from office. The settlor usually has this power of appointment and removal, and the settlor should be able to pass this power on to others while alive or by his or her Will.

Independent trustee

If you are a trustee of your own trust, it's recommended that an independent trustee is also appointed; this helps to protect the trust from a claim by a former spouse or partner or creditors that the assets are still at the disposal of the settlor.

The independent trustee could be, for example, a trusted friend or a professional advisor. We can advise about setting up a company to act as a trustee. Such a company should not be confused with the five statutorily recognised trustee organisations.

Setting up a company to be the trustee can have some advantages: the company will not retire, die or become mentally incapable. It also allows for a range of people (the directors are normally the partners or directors of the professional firm) to sign documents for the trust management company rather than relying on a single person who may be overseas or otherwise unavailable. However, there can be disadvantages with this arrangement and you need good legal advice before you decide to appoint such a company as trustee. For example, the company may qualify as a 'financial entity' and be required to file additional information because of Foreign Account Tax Compliance laws (FATCA).

Independent trustees should not be able to benefit under the trust, so that they are truly independent.

Trustees have personal liability for any losses the trust may incur. Independent trustees may, by agreement with individual creditors, have their liability limited to the assets of the trust, in order to limit any future claims against them, other than as a result of their own dishonesty or negligence.

Appointer

Most trust deeds say who is to have power to appoint and remove trustees. Often this person is given a formal title such as appointer and is given power to hand on this role to someone else.

Some mechanism for replacement of trustees on death or incapacity is important. You should check what your deed says about the removal of any trustee, including the settlor, who no longer has mental capacity. The appointer may also be given power to appoint and remove beneficiaries.

Protector

Some trust deeds provide for a protector to be appointed. Protectors are not trustees, but their approval is required for a range of important decisions such as capital or income distributions, or variations to the trust deed. Protectors don't need to be involved with the trust on a day-to-day basis or to sign documents such as bank loan and security documents.

This arrangement simplifies the administration of the trust but retains the involvement of an independent person in major trustee decisions.

Advisory trustee

It's also possible to appoint an advisory trustee to work with the trustees. As with the role of protector, this role can be restricted to specific trust assets. The law gives trustees protection if they act in reliance on advice from an advisory trustee.

Appointing an advisory trustee can be a good way to make use of the knowledge or experience of a family member or friend, or to involve someone from the wider family group. Under proposed law changes, an advisory trustee will be called a *special trust adviser.*

Beneficiaries

Anybody can be a beneficiary of a trust. The most common groups of beneficiaries are relatives, close friends, charities and other trusts established for the benefit of these beneficiaries. A charitable trust, a company or another trust can also be a beneficiary.

To meet a family's changing needs, most trust deeds include the power to add more beneficiaries after the trust has been established. Some trust deeds say that this power ceases when one partner dies. This can avoid the surviving partner being seen to favour a new partner or stepchildren. However, it's becoming more common for trust deeds to allow this appointer role to be handed on from settlor to someone else, or to two or three people, when the settlor dies or is no longer mentally competent.

It's important to remember that discretionary beneficiaries don't have an automatic right to receive benefits from the trust; they only have a right to be considered by the trustees when the trustees decide to make benefits available. This means that the group of beneficiaries you choose should be wide enough to include people who you actually want to benefit from the trust but not so wide that the trustees have to consider the needs of a large disparate group. Beneficiaries also have rights to be kept informed.

You will also need to think about who will receive whatever remains of the trust assets when it is wound up. These people are usually called the 'final beneficiaries'.

One or more trusts?

It may be that more than one trust should be established to protect the interests of a single family. This arrangement is particularly suitable where:

- There's a particular need to separate the ownership of a family's business assets from its lifestyle assets, such as the family home or holiday house
- One or both partners have children from previous relationships; setting up a separate trust for each partner ensures that the interests of each partner's own children will be protected, or
- A business activity is being carried on.

How much control is too much?

Setting up a trust involves giving away property to the trust. You can retain some powers but it's important not to go too far. If you retain too much control you may find you do not get all the benefits of a trust.

Clayton v Clayton[4] – Vaughan Road Trust decision

Mr C set up a trust but retained extraordinarily wide powers: he was the only trustee; he had power to appoint and remove trustees; he had power to add and remove beneficiaries; he was allowed to act completely in his own personal interest; he did not need to consider the needs or welfare of any other beneficiary.

The Supreme Court decided he had such wide powers that he could take back any of the trust assets at any time he wanted to. They therefore considered this was relationship property and the trust property should be shared equally with his former wife under the Property (Relationships) Act 1976. The case demonstrates the risks of retaining too much control.

4 *Clayton v Clayton* [2016] NZSC 29; [2016] NZFLR 230


Anpan

Completing Your Estate Plan

Establishing a family trust doesn't stop when the trust deed is signed. There is other important documentation that should be aligned with the family trust deed including:

- A Will dealing with your personal estate
- A Letter of Wishes, and
- Enduring Powers of Attorney (for Property, and for Personal Care and Welfare)

You may also need to have a relationship property agreement if relationship property is being transferred to the trust.

The transfer of a house or land to the trust will also require further legal documents to register the change of ownership; it may also be necessary to prepare and register new mortgage documents. If a sale and gifting programme is needed (see page 18) this will require a number of different documents.

Your Will

Your new Will should include provisions about:

- Specific gifts or items to be left to named people
- Other household and personal items
- Your other remaining assets, usually given to your trust
- The debt owed to you by your trust, if any, which would normally be forgiven
- Transfers of your powers to appoint and remove trustees under the trust deed
- Appointment of guardians if you have young children, and
- Any instructions regarding organ donation, funeral arrangements, cremation or burial.

Letter of Wishes

It's also a good idea to sign a Letter of Wishes when the trust is established. This sets out in detail your actual intentions for the trust and, in particular, it covers things such as:

- How trustees should deal with the trust assets
- When and how you think the beneficiaries should receive distributions, and
- How the trust will operate after your death.

A Letter of Wishes provides useful guidance for the trustees who will operate the trust after your death. However, it's not binding on the trustees. The letter can be updated at any time by you as settlor.

Enduring Powers of Attorney

You should also sign Enduring Powers of Attorney (EPAs) covering both your personal property, and your personal care and welfare. These documents give a named person, the attorney, the power to act on your behalf.

An EPA in relation to Property can cover all of your personal assets which include any land and buildings that you own as well as bank accounts, vehicles and any other form of personal property. You can say when the EPA is to take effect, which could be at any time, or only if you become incapacitated, mentally incapable or if you travel or move overseas.

A property attorney may be a person such as your spouse or partner, friend or your lawyer, or one of the five recognised trustee corporations. You may appoint more than one attorney.

For the EPA in relation to Personal Care and Welfare, you would generally appoint a close family member or a friend as attorney. An organisation cannot be appointed to this position. This type of EPA can only be used if you become mentally incapable of looking after your own personal care and welfare. Your attorney can ensure your welfare, medical and residential needs are taken care of. You may only appoint one person as attorney, but you may also appoint a replacement (in case the first one named is no longer able to act).

Other documents

We may also recommend that you sign a document to delegate your role as trustee (usually called a Deed of Delegation and Power of Attorney). This will state who can sign documents on your behalf if you're overseas or physically incapacitated. It cannot be used in the event of mental incapacity. An EPA cannot be used in respect of a trustee's role.

Family Trust Administration

It's important that your family trust is administered correctly. If you and the trustees fail to treat the trust as a genuine trust, or you can be seen to be in complete control, all of the benefits of having a trust may be lost (see page 27).

Trustees have a number of duties in law. The trust deed may affect how these duties apply. It's also important that trustees remember that they are only allowed to do those things which they have legal power to do. Again, there are some standard powers set out in law, but the trust deed can expand these.

A trustee's duties

In law the standard duties of a trustee are to:

- Know the terms of the trust
- Adhere to the terms of the trust
- Treat the beneficiaries in an even-handed manner

- Act in the beneficiaries' best interests
- Not make any profit from being trustee and to act without being paid (except for refunds of out-of-pocket expenses)
- Invest prudently
- Not delegate any of the trustee's responsibilities, unless permitted to do so
- Take an active part in trust decisions and the exercise of trustee's discretions – trustees must not agree in advance to place a limitation or restriction on the future exercise of any discretion
- Act unanimously
- Pay the correct beneficiaries, and
- Keep proper accounts and give information to beneficiaries as required.

Most of these duties can be modified to some extent by the trust deed. For example, the deed may allow the trustees to receive trust money as beneficiaries or it may authorise payment to them for their work as trustees. However, the deed cannot override all trustee duties. At the very least, the trustees are obliged to act honestly and in good faith for the benefit of the beneficiaries.

Prudent investment

The trust deed may contain specific rules about how the trustees are expected to invest. If not, then the trustees must invest prudently.

Prudent investment is defined in detail in the law. It's not just a matter of trustees doing what they consider to be prudent. Prudent investment by trustees requires them to invest in the way that an ordinary prudent person would do when investing money that is held for the benefit of other people.

Section 13E of the Trustee Act 1956 sets out a number of factors which trustees should take into account, where appropriate, when making investment decisions. These include:

- Desirability of diversifying trust investments
- Nature of existing trust investments
- Need to maintain the real value of the trust
- Risk of capital loss or depreciation
- Potential for capital gain or growth
- Likely income return
- How long the proposed investment is for
- How long the trust is likely to last

- Marketability of the proposed investment, ie: can it be cashed in if need be?
- Total value of the trust fund
- Tax issues, and
- The likely effect of inflation.

Although not all of these matters will necessarily be relevant in all circumstances, they do provide useful guidance for any trustee when making investment decisions.

A passive trustee who merely rubber-stamps the decisions of co-trustees could be exposed to claims by beneficiaries for losses incurred by the trust.

Trustee decision-making

The law presumes that trustees are to agree unanimously on any decisions they take. However, it is possible for the deed to say that a decision of a majority of the trustees will be binding.

If only a majority decision is required all the trustees are still responsible for the decision; some people may not accept appointment as a trustee on those terms.

The trustees may agree that for some activities such as operating a bank account, they will allow one or more trustees to control the account. These arrangements should be recorded in the minutes of a trustees' meeting. The trustees need not record the reasons for their decisions, only the decision itself.

Trustee liability

Trustees are personally liable for all debts incurred by the trust, including income tax and GST liabilities. Where loans are arranged from banks or other lenders, it's customary for the liability of independent trustees to be specifically limited to the net assets of the trust. It's also quite reasonable for independent trustees to request a settlor to personally indemnify the independent trustees against any losses they incur as a result of their trusteeship.

Personal liability can be avoided by having a company act as trustee. This is advisable if the trust is GST-registered, or is a trading or development trust. If your independent trustee is a trust management company, however, a director has further responsibilities and liabilities. There is also a risk the company could qualify as a financial institution (FI) under the laws relating to international exchange of tax information, for example, US legislation such as FATCA. In that case, additional compliance and information filing may be required.

Tax

Each trust is different in terms of its tax liability. Where appropriate, trustees should take specialist accounting advice to ensure the trust complies with its tax obligations.

It should be noted that a trust is a separate taxpayer and it must file a tax return if it receives income.

The trustees need to decide, within 12 months following the end of each financial year, how any income earned by the trust will be treated. This needs to be recorded in a signed resolution or minute. The trust income can be:

- Distributed to all or some of the beneficiaries and taxed at their tax rate (there are limitations for distributions to children under 16), or
- Treated as trust income and taxed at the trustee rate (currently 33%), or
- A mixture of these options.

If a resolution isn't passed within the 12-month timeframe, the income will be treated as trustees' income and taxed at the 33% tax rate. As a result, any potential tax savings will be lost.

You may have seen news reports about 'foreign trusts'. These are typically trusts where neither the settlors nor any of the beneficiaries have lived in New Zealand. Usually the trust assets are all overseas and no tax is payable in New Zealand. This booklet is not intended for such people. Our purpose is to advise ordinary New Zealanders who will meet their legal obligations but want to protect their property from other risks.

Accessing trust income

Under most modern trust deeds, distribution of trust income is totally at the discretion of the trustees. They may do any of the following:

- Accumulate and retain within the trust all or any part of the trust's income
- Make distributions of income to any one or more of the beneficiaries in any proportion, and/or
- Credit income to the current account of any beneficiary within the trust. The income will then be taxed as beneficiaries' income and will be payable to the beneficiary on demand.

Accessing trust capital

During the term of the trust, distributions of capital are usually made at the discretion of the trustees. Some trusts don't allow capital distribution or they may limit the percentage of the capital that can be distributed. Capital can usually be paid to any one or more of the discretionary beneficiaries.

If you are a beneficiary of the trust you can receive distributions of capital if the deed permits and if the trustees decide to make such a payment. Alternatively, if you are owed money by the trust, you may be able to access the trust capital by demanding repayment of all or part of the outstanding loan (subject to the terms of the loan agreement).

Using a house owned by your family trust

If your family trust owns the family home, the trust can make the house available to you and your family to live in, provided that you are beneficiaries of the trust. The trust may allow you to live in the house on the basis that you pay the rates, insurance premiums and other day-to-day outgoings in lieu of rent. This decision of the trustees should be recorded in writing and should be reviewed regularly as part of the trustees' review of the trust's investment policy. There are usually no income tax implications for beneficiaries living in a property owned by the trust.

Trustees should ensure that the insurance policies for the family home, as well as rates demands, are in the name of the trust or trustees. Contents policies should be in the personal name of the settlor, unless there are items which have been transferred to trust ownership, when two contents policies may be necessary.

Trusts carrying on business and investing

Modern trusts usually give the trustees an unrestricted power to act as if the trust were a real person with no limitation on what the trustees can or cannot do. Trusts can therefore conduct a business in the same way as a real person. However, some care needs to be taken where a trust is conducting a business as legal, taxation and risk management issues can arise.

As a risk management tool when carrying on a business, more than one trust is usually recommended in order to divide the ownership of the family home and passive investments from business ownership. Trusts which have a fund manager to manage investments may have additional compliance requirements under international tax information exchange rules, such as FATCA.

Relationship property issues

If you are currently married or in a civil union or de facto relationship of more than three years' duration, then it's likely that all or a significant part of your assets will be relationship property. If you and your partner separate at any point after the three year threshold, that relationship property must, except in certain limited circumstances, be divided equally between both of you. There are some circumstances in which the three year period is reduced significantly, including having a child living with you.

Assets fully transferred to a trust before the start of any relationship will be trust assets, not your own property. So they should not be subject to relationship property claims, although there are claw-back rules in the Act. Any debt not gifted to the trust may be relationship property if it has not been protected as separate property. An agreement to contract out of the Property (Relationships) Act 1976 may be recommended by your lawyer to avoid these complications. Transferring family assets to a family trust therefore has a significant impact on your relationship property rights.

It's particularly important for you to understand the effects of the relationship property legislation and other rules of law on your family trust arrangements as:

- In some cases, transferring assets to a trust will mean you no longer have relationship property rights which you would have had otherwise
- If relationship property is transferred to a family trust, the court has the power to compensate an aggrieved spouse or partner who has been disadvantaged by the trust arrangement
- Under section 182 of the Family Proceedings Act 1980, if a married couple divorces, the court can rewrite a trust they had set up before or during their marriage – this applies also to civil union couples but not to de facto couples, and
- A former spouse or partner may have a claim based on contribution made to a trust property, for example, redecoration, gardening or other improvements, and the courts may award compensation for contributions made.

Ward v Ward
(Section 182, Family Proceedings Act 1980)[5]

This 2009 Supreme Court decision illustrates how section 182 can work.

Mr Ward was part-owner of a family farm. He bought out the other owners shortly after he married Mrs Ward. Some years later the Wards set up a trust and transferred the farm to it. The beneficiaries were Mr & Mrs Ward and their children. Three years later the Wards separated and the relationship between them deteriorated so that they and their independent trustee could not reach unanimous decisions as required by law.

The Family Court resolved the impasse by dividing the property between two trusts; one for Mrs Ward and the children, and one for Mr Ward and the children. Mr Ward appealed but both the Court of Appeal and the Supreme Court agreed with the division into two trusts.

When relationships terminate and a trust owns the assets, the trustees will generally ensure a fair resolution is reached. In most circumstances the trustees would resolve to transfer half the value of a jointly established trust to each of the partners or to a new trust established by each of them. Alternatively one partner could continue with the existing trust and the other partner could establish a new trust and have half the value of the joint trust transferred to it.

Your trust deed can include a clause to say what is to happen to the trust assets if your separate. You should talk about what you envisage in the event of separation.

Life of the trust

The law only permits trusts to last for limited periods. The usual maximum period is 80 years, but a shorter period can be stated in the trust deed. Usually, the trust deed will allow the trustees to distribute the trust assets before the 80 years is up. This greater flexibility allows the trustees to decide the best time to distribute, taking into account family members' needs and abilities, as well as tax considerations and investment opportunities. Proposed law changes would allow a maximum of 12.5 years.

5 *Ward v Ward* [2009] NZSC 125; [2010] 2 NZLR 31

What will a Family Trust Cost?

Establishing a family trust

There are legal and other expenses involved when establishing a family trust. The cost will vary depending on the time spent in helping you reach a decision on what is best for you and the need to develop a tailored structure to meet your family's specific needs.

Generally this cost will include drafting a trust deed, new Wills for you and your partner or spouse, a Letter of Wishes, EPAs and perhaps also a relationship property agreement, or a Deed of Delegation and Power of Attorney.

If you are transferring your family home or other real estate to your trust, there will be costs for preparation and registration of documents to transfer ownership and redocument any mortgages. For those settlors with a mortgage on the property being transferred, there will be costs to rearrange the loan securities.

Annual costs

You should allow for the time and cost involved with meetings of trustees, accounting and administrative requirements, and possibly gifting documents.

If your trust is to receive income and pay expenses, a separate bank account should be opened. Trustees have a duty to keep trust money separate from their own money. Having a trust bank account can make it easier to prepare financial statements and tax returns.

As each trust has different requirements, we can give you a cost estimate to establish your family trust, to transfer the assets to it and for the annual cost to run your trust.

Glossary

Appointer: The person who is given power to appoint and remove trustees and/or beneficiaries. Usually the settlor will have this power initially but may hand it on to someone else (if the trust deed provides for this).

Alter ego trust: A trust which is a 'puppet of the settlor'. This term was first adopted in Australia which has quite different matrimonial laws. The New Zealand courts have ruled that this is simply a form of sham trust; see sham trust on page 43.

Advisory trustee: Usually appointed in the trust deed to provide advice to the trustees, often on specified matters. An advisory trustee is not a legal trustee, but the trustees may rely on this advice. In future, they are likely to be known as a *special trust adviser*.

Beneficiary: A person, company, another trust or other entity that is entitled to receive benefits from a trust

Court: In New Zealand the courts which may deal with trust matters, in ascending order, are the Family/District Court, High Court, Court of Appeal and the Supreme Court.

Deed of Delegation: A type of Power of Attorney for trustees; see Power of Attorney on page 43.

Discretionary beneficiary: A discretionary beneficiary may receive benefits from the trust but only if the trustees decide to provide benefits to the beneficiary. A discretionary beneficiary may also be a final beneficiary.

Distribution: Payment or transfer of an asset from a trust to a beneficiary.

Enduring Power of Attorney (EPA): Under an EPA another person is appointed to act on your behalf. This power can apply to your own property and/or your personal care and welfare. A property EPA can either be effective immediately it is signed or might only become effective if you lose mental competence. It's your decision when this EPA will become effective.

Family Court: Deals mainly with separation, divorce, care of children and relationship property. Sometimes, however, the Family Court becomes involved in trust issues.

FATCA: Foreign Account Tax Compliance Act. This is part of the US tax code but has indirect effect in New Zealand through an agreement signed by the US and NZ governments. Certain financial institutions (including some trustees) may be required to file information with New Zealand authorities.

Final beneficiary: A beneficiary who is entitled to share in the remaining trust assets when the trust comes to an end, usually after 80 years.

Forgiveness of debt: A debt is forgiven when it is acknowledged that all or part of a debt owing to you doesn't need to be repaid. This is a gift that must be recorded in a deed.

Gift: A gift is made when an asset is transferred to another person or organisation and nothing is received in return. Gifts can be made to a trust either by directly transferring assets or by forgiving all or part of a debt the trust owes to you. If you apply for a rest home subsidy from the government, there are strict limits on the amounts of gifts made previously – see page 18.

Gift duty: A form of tax abolished in 2011. The tax was usually avoided by a notional sale to a trust at market value, leaving the sale price owing and then reducing that debt by the maximum allowed ($27,000 per 12 months). This was known as a gifting programme.

Gifting programme: A system of annual gifting in reduction of debt traditionally used to avoid gift duty as above. Now used mainly where there are possible rest home issues – see page 18.

High Court: The main court which has authority in respect of trusts.

Independent trustee: A trustee who is not a beneficiary.

Letter of Wishes: A written summary of goals and objectives for a family trust. It can also be known as a 'Note for Guidance for Trustees' or a 'Memorandum of Wishes'.

Power of Attorney: A document which states who may sign documents or make decisions on your behalf. A simple power of attorney is cancelled if you are no longer mentally competent but an Enduring Power of Attorney (EPA) remains in force even if you become mentally incapacitated.

Primary discretionary beneficiary: Beneficiary given priority ahead of the other beneficiaries. Since the law normally expects all beneficiaries to be treated in an even-handed manner, it's usually wise for the trust deed to make it clear who are to be the main beneficiaries, for example, the settlors during their lifetimes and then their children.

Protector: A person whose approval is required to specified trustee decisions. A protector is appointed by the settlor and is usually the person who has the power to appoint or remove trustees and beneficiaries.

Settlor: A person who creates a trust by transferring assets to trustees subject to the provisions of a trust deed.

Sham trust: A structure which was set up to look like a trust but was never intended to be a trust; the supposed settlors treat the assets as their own. In practice, the court requires considerable proof that the settlor deliberately intended to deceive before it will say a trust is a sham.

Supreme Court: The highest court in New Zealand.

Trust capital: Assets of the trust. These could include real estate, term deposits and share investments, and include the increases in the value of these assets, and gifts made to the trust.

Trust deed: The document that establishes the trust and includes a set of rules for the operation of that trust.

Trust income: The money a trust makes from the investment of its capital. It can include interest, rent and share dividends.

Trustee: A person appointed to hold trust assets for the benefit of beneficiaries. A trustee has legal control of the trust assets.

Will: A legal document which specifies how you want your personal assets to be administered and distributed after your death.

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