Advisors and Accountants

THE RATIONALE & MECHANISM FOR ESTABLISHING AND OPERATING A FAMILY TRUST

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PART I

What is a Trust and How Does it Operate?

What is a Trust?

In its simplest terms, a Trust is an obligation under which a person having the control of property, (who is called a Trustee) is bound to deal with that property, (called the Trust Property) for the benefit of defined persons or objects (the Beneficiaries).

Trusts may be created by will, or during an individual's lifetime. The latter is called an Inter Vivos Trust. The person creating an Inter Vivos Trust is called the "Settlor". Any person who later contributes funds to an existing Trust is also a Settlor. The Inter Vivos Trust is a popular and useful entity for estate and income tax planning. It also enables other objectives to be achieved.

The entitlements of the Beneficiaries may be fixed or (more usually) the Trustees may have a discretion to allocate income and/or capital during the period of the Trust. These so called Discretionary Trusts give greater flexibility for tax and estate planning.

Why have a Trust?

Assets held by an individual can be attacked in many varied circumstances. If those assets are held in Trust, they can be protected to a substantial degree but still be available in large measure for the individual's use and benefit.

Trusts are an invaluable tool in financial planning, as they enable assets to be spread effectively amongst other family members, without allowing those family members' complete control or access to those assets. Successive generations can enjoy the benefit of the assets, which are protected from a variety of claimants.

How is a Trust Fund Set Up?

A Deed of Trust creates the Trust, which is a separate legal entity and able to own the assets to be acquired. The Trustees then become the legal owners (but not the beneficial owners) and are obliged to act within the limits of the Deed. A will may be changed at any time during the life of a person who has made it, but a Trust Deed can usually only be altered with High Court sanction. Accordingly, it has to be drawn up with care. This does not detract from the tact that the Trust provides a very flexible structure. The Trust obtains its own IRD number and is an independent taxpayer.

It is usual to select assets which are surplus to one's personal needs, or which one wishes to protect from claimants, or which are likely to grow in value through development, or inflation, for injection into Trust. The process involves selling the assets to the Trust at an agreed market value, with that value left owing as a debt from the Trust to the individual. In this way, the individual substitutes an asset for a debt of equal value, the difference being that the debt will not appreciate in value, whereas the expectation is that the asset will. That appreciation will accrue to the trust rather than to the individual. Subsequent gifts of the indebtedness can further the transfer process.

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Who is Involved?

There has to be a Trustee, who may be one or more persons, or a Trustee corporation. In the absence of a provision in the Deed, decisions of Trustees must be unanimous. The Trustees are answerable to the Beneficiaries, not to the person who established the Trust ("the Settlor"). The Settlor may be a Trustee but desirably should not be the sole Trustee.

The recipients of capital and income need not always be the same, nor do the proportions have to be fixed at the beginning. Thus, the allocation or retention of income may be changed from year to year, or the capital may be shared out on a basis to be decided in the future. Flexibility is necessary because what is fair and appropriate today may not be some years hence.

How does a Trust Operate?

The objective is to establish a Trust with the Trustees having powers wide enough to deal with its assets and income, just as the Settlor(s) could do, had the Settlor(s) remained the owner(s). Income distributed is taxed at each Beneficiary's individual tax rate. If that rate is lower than the Settlor's, the spreading process saves tax.

N.B. Distributions to an infant beneficiary (under 16) are taxed at a minimum rate of 33%.

Alternatively, income may be retained in Trust for investment or debt reduction. Trust income is taxed at a flat rate of 33%. Income taxed to the Trustees (i.e. income not distributed within 12 months of balance date) is not taxed again to the Beneficiary, when distributed.

Whether the Trust owns land, other investments, or a share in a business, the general principles are the same. The specific objectives are usually the protection of the assets and the smooth transition of ownership or control between generations.

What Happens to the Capital?

The Trustees should have power to make capital payments to some or all of the Beneficiaries at an appropriate age, or as needs arise. Such payments may be by distribution or loan. In the case of a loan, the term would be set in the exercise of the Trustee's discretion. Interest can be charged but need not be.

Most people wish to treat their family equally. There are often cases where this is not practical (e.g. where it would divide control of a business or farm). When a Trust is set up, it may not be clear what the eventual division will be. The trustees must be free to vary the amount and timing of capital payments or transfers – even if equality prevails in the end.

The law puts a limit of 80 years on the life of most Trusts. It is thus possible to "skip" a generation (for example with the Settlor's children taking income and their children the capital).

The children can, of course, have use of the capital "on loan". The final distribution may be at a specified day (e.g. the date of death of the Settlor, or the Settlor's surviving spouse), or when Beneficiaries reach a stated age).

It is wise to give Trustees the discretion to terminate the Trust at an earlier date. This avoids being locked into a Trust which has ceased to serve its purpose, due to such things as changes in family circumstances or changes in Trust and Taxation laws.

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Are There any Traps?

Transfers specifically to defeat creditors can be set aside.

A Settlor could be assessed personally for income tax on Trust income, if it is established that the arrangement is for the purpose of tax avoidance or that it involves the short term assignment of income to the Trust. Any Trust plan must be carefully formulated and must be the subject of specific legal advice and "good housekeeping".

Trustees are also personally liable to IRD for any unpaid Income Tax or GST owing by the Trust.

A Settlor must look to his/her own future as well as that of his family and business. Some individuals are reluctant to strip themselves of assets, as they feel they will lose their financial independence, or will be inhibited in their individual ability to maintain a comfortable satisfying standard of living. However, in practice, this is not a significant concern, if the Trust is properly structured, because the Settlor will have effective recourse to the Trust assets.

A Trust Deed which is too rigid can be the cause of great difficulty. Trustees must have the discretion to make decisions with the same freedom as the former owner/Settlor.

Beneficiaries do have certain rights under the Trust. Some Settlors may not be comfortable in providing information to beneficiaries. One such right which Settlors may not be comfortable with is the right of all adult beneficiaries to receive a copy of the Trust's financial statements.

What are the Benefits?

A Trust enables planned succession to ownership of assets by subsequent generations. This procedure will almost always be cheaper and more effectively managed, whether on death or otherwise, than holding on to assets and transferring them in total at a later stage.

Development, profit retention, and inflation all tend to increase values over time, and hence, transfer costs. The earlier the transfer process starts, the greater the savings may be.

Protection against creditors' claims and claims under the Matrimonial Property Act in this or subsequent generations, the protection of businesses against fragmentation, and the protection of Beneficiaries with special needs, are examples of other benefits.

Matters to be Considered

1. What are your current assets? (Both lifestyle and investment assets.)
2. What do you expect your assets to comprise in 5 – 10 years time? (Allow for capital growth, income surpluses, inheritances etc.)
3. Your present living and future retirement requirements.
4. Your intentions regarding eventual distribution of assets.
5. Your succession plans, if you are in business.
6. Any special needs within your family for capital and/or income.

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Beneficiaries' Rights under a Discretionary Trust

Beneficiaries legal rights are complex but may be summarised as follows:

- every Beneficiary has a right to be considered by the Trustees, when their discretion either to act, or not to act, is being exercised. Beneficiaries also have a right to seek the Court's intervention, where they believe the Trustees have acted improperly. However, where the Trustees have properly considered all beneficiaries, the Court will generally not interfere. If the Trustees have refused to consider the exercise of a power, or have exercised it in a capricious or clearly wrongful or fraudulent manner, the court will set it aside. The court may remove the Trustees or replace them with others.

- Generally, where the Trustees have given due consideration to the powers and duties imposed upon them and have given reasonable consideration to the circumstances of the Beneficiaries, their powers and discretions can be exercised without fear of attack.

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PART II

Summary of a Trust Strategy

The basic premise behind the establishing a Family Trust is:

"that there are advantages in having few assets"

One cannot afford to be asset-less, so some means has to be found to make provision for an individual reduced to that position, while at the same time still enjoying the security that the ownership of assets provides.

A strategy to achieve these objectives can be summarised as follows:

1. A Family Trust is settled.

2. All assets presently held by the individual (or individuals, in the case of a couple acting jointly) are then sold, or in the case of cash, lent, to the Trustees, in exchange for Acknowledgements of Debt of equal value. It is in order to use lowest credible market values.

3. Over time, the debt, which becomes the individual's only asset, can be forgiven to the Trustees, thus achieving a total divestment of assets, in favour of the Trust.

   There are now no restrictions on the amount that can be gifted to a Trust without paying gift duty. However any gifts in excess of $6,000 per annum, per person, may be taken into account when assessing a person's eligibility for a retirement home subsidy.

4. If the individual's will is changed, so that the Trust becomes the individual's major Beneficiary, then upon death, the whole value of the individual's estate at that time will be divested to the Trust. Gifts by Will are not liable to Gift Duty.

5. Once the Trust is the owner of all of the assets (even though they have not been paid for), increases in value will accrue to the Trust Fund. All income previously derived by the individual, from investments, will be derived by the Trustees in the first instance and can be dealt with in a variety of tax-effective ways.

The Trust Deed

It is important that the Trust Deed is carefully drawn to provide:

i. That the individuals who have divested their assets to the Trust retain a significant degree of control over those assets.

ii. That as a Discretionary Beneficiary, the individual has the prospect of deriving benefits from the assets. This includes access to income and capital where necessary. While the individual is a creditor of the Trust, that individual has recourse to the Trust's Assets, which is quite distinct from the individual's entitlements, as a Beneficiary.

iii. If two or more individuals are divesting assets into a single Trust, then the Trust might need to be structured in such a way which leaves each individual comfortable that the objectives and Beneficiaries of the Trust will be significantly changed after an individual's death. For married couples who are prepared to leave their whole estates to each other and let the future take care of itself, this is not a major concern.

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General Observations

1. The decision to establish and transfer assets into a Trust is not an “all or nothing” exercise, and individuals can decide to divest certain assets to the protective umbrella of a Trust and retain other assets for individual management and control (eg it is usual to retain family chattels and some “petty cash” outside a Trust). However, it is worth considering transferring the majority of your business and investment assets into Trust. Most contrary advice has its origins in ignorance, experience of Trusts whose structure did not allow sufficient flexibility, or mal-administration.

   Lifestyle assets eg a boat, are probably best not owned by a Trust.

2. If an individual still expects to receive inheritances, it makes sense to have those Testators substitute the Trust as their Beneficiary, in place of the individual. Otherwise property, once received, has to be divested, which can be a slow process. Further, those assets have never been owned by the individual and it could not be claimed that the individual has voluntarily deprived himself or herself of the assets.

3. Take the simple case where a couple have both died. Their children who might have inherited under the will of the last to die are, instead, Beneficiaries of a Trust, which holds all of the subject assets. Each of the children can make individual choices as to whether or not they take their “inheritance” (in whole or in part) out of the Trust. It would be quite common to re-settle their respective interests on separate Trusts, so they would retain the protection of not owning the assets but not be involved in each others affairs on an on-going basis.

4. Inherited property under the Matrimonial Property Act is separate property and it does not fall for division, in the event of a marriage breakdown. Separate property can, during the course of a marriage, be converted into matrimonial property, depending upon the way in which it is managed. Once it has been converted, it falls for division. It can impose stress upon a marriage relationship, if one manages property so that it does preserve its separate property character.

   Property held under a Trust, in which the married individual has an interest only as a Discretionary Beneficiary, does not generally fall within the scope of the Matrimonial Property Act. If, for example, inherited property was used to upgrade the family home, then in due, course, one half of the amount so used could be lost to the individual. If contrariwise, the Trustees lent the couple the amount required to upgrade the family home, then that would be a loan, which was at all times repayable (even if not interest bearing) and accordingly, “whole” dollars would come back into the Trust fund for the benefit of the married individual who was a Beneficiary.

5. The question is often asked “What happens to the married couple who have divested their entire assets into a Family Trust, whose marriage then fails?” It is presumed that each of the parties will have an equal interest in dividing the Trust Fund, just as they would have done under the Matrimonial Property Act, so no greater difficulty should be experienced in reaching an agreement than would be experienced under the provisions of the Act. It has to be said that the Act provides a strict code, whereas distributing the Trust Fund is a matter of discretion and negotiation. If a Trustee endeavoured to lock up the Trust fund by being “a dog in the manger”, then there would be no significantly greater difficulty in dealing with a recalcitrant party under the Matrimonial Property act, where agreement as to division has proved impossible to reach, and resort to litigation was required. It is true that the outcome might not be so predictable.

   N.B. The courts now have greater power to look through trusts where assets have been deliberately put in a trust to avoid a matrimonial claim.

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6. The benefits of the arrangements described above flow from generation to generation. There will be an ultimate saving in estate administration costs.

   Where there are non-income earners in the trust, (spouses, children or other Discretionary Beneficiaries) and investment income is being derived, advantage can be taken of the lower tax rates applying to those Beneficiaries, whose other incomes do not exceed $48,000. Charitable Beneficiaries can receive tax-free income.

7. It has to be borne in mind, in dealing with specific assets, that particular considerations can arise depending upon an individual's circumstances. For example, there might be GST consequences to be taken into account; there might be consequences under the Income Tax Act (eg an individual might have the freedom to deal with land, which had been owned for 10 years, which would not be enjoyed by Trustees, who had recently acquired the land; there might be significant depreciation to write back; or the deductibility of certain interest payments might be lost or have to be carefully preserved. Private company shares might have to be dealt with carefully to preserve the availability of tax losses and/or imputation credits.

Setting up a Trust – information required

If you would like to further investigate this issue with your Solicitor then initially you will need to prepare the following information:

i) A comprehensive statement of assets and liabilities, identifying in each case the owner (ie individual or joint).

ii) A decision as to whether you want an independent trustee. (Given the unlimited liability to the IRD finding an independent trustee may not be easy).

iii) The names of the persons who will be the Executors of your wills.

iv) Full names, occupations, and addresses, of all persons involved as Settlor, Trustee and Executor.

v) Who are intended to be the ultimate recipients of the Trust Fund and who would be substituted if, contrary to expectations, those Beneficiaries did not survive to the distribution date.

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Day to Day Administration of a Trust

A Trust is a separate taxpayer for tax purposes. If the Trust is in receipt of the income, it must have its own IRD number. It is necessary to complete an application for an IRD number and file this with the Inland Revenue Department.

The Trust will need to open a separate Trust bank account. The bank will wish to see the Trust Deed. It is important that, in the first instance, monies due to the Trust are paid into this account, and not the personal accounts of the Settlors or the Beneficiaries. Subsequently, the Trust can draw cheques on its own account to pay distributions, make investments etc.

Whilst the Trust is a separate taxpayer, it can only act and contract through its Trustee(s) and, therefore, in legal documents or other formal documents, the Trust will normally be identified by naming its Trustees. Under contracts, the Trustees will incur unlimited personal liability, unless liability, limited to the Trust's assets, is negotiated and recorded.

An annual tax return must be filed for the Trust. If the investment earnings are reasonably straightforward and the Settlor(s) currently complete their personal tax returns, it should not be too difficult for them to complete the Trust tax return. If an Accountant is already involved, a small amount of extra work will be required.

Trust Income

The following notes apply to Complying Trusts only. A Complying Trust is a Trust which has had a NZ resident settlor, for at least some period of time, and which has always met its NZ tax obligations.

1. A Trust is an independent taxpayer; it has its own IRD number and has to file and annual tax return.

2. **Trustees Income**

    2.1 ***Retained*** income is income kept by the Trustees and not distributed to Beneficiaries, within 12 months of balance date. It is taxed at a flat rate of 33%. (c.f. for individual (non-corporate) taxpayers the first $48,000 of income is taxed at the rate of 17.5%).

    2.2 ***Tax Paid*** income (ie the remaining 67%) becomes capital, which increases the Trust Fund if retained or is available for tax-free (ie tax paid) distribution if desired.

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3. **Beneficiaries Income**

3.1 ***Distributed*** income is all income which is not retained by the Trustees, but is paid to, or applied for, the benefit of Beneficiaries within 12 months of balance date (provided Trust Deed does not specify 6 months).

3.2 The Trustees pay no tax in respect of distributed income unless they elect to. Distributed income is taxed in the Beneficiaries hands at their marginal tax rates (except minor beneficiaries – taxed at 33%). Charities pay no tax.

Note: If the beneficiary does not pay tax on any beneficiary income the trustee is liable for the unpaid tax.

3.3 There is a cost of 15.5 cents per dollar of retained income, if the Beneficiaries rate is 17.5%, but there can be reasons, and other advantages, which make retention desirable.

3.4 If the marginal tax rate for all Beneficiaries is 33%, then the tax position is neutral whether the income is retained or distributed.

4. **A Beneficiary can receive "income" in several ways**

4.1 By direct distribution – taxable at their marginal tax rate (except minors).

4.2 By distribution out of tax-paid income – a non-taxable capital receipt.

4.3 By distribution of capital (eg part of the original Trust Fund, gains from the sale of assets, retained tax paid income). In every case, a non-taxable capital receipt.

4.4 If the Beneficiary is also a creditor (eg owed monies lent to the Trust or for the unpaid price of assets sold to the Trust), a debt reduction payment (capital) or an interest payment (income) can be made to the Beneficiary.

5. **Discretionary or non-discretionary capital distributions** can be made to Beneficiaries – these are non-taxable receipts for the Beneficiary.

6. A mixture of the above kinds of payments/distributions can be made.

7. A Settlor, who is not a Beneficiary, might be in a position to receive payments as a creditor.

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Summary of Benefits of Trusts

The structure provides:

1. Possible tax savings on Beneficiaries' income.

2. Creditor protection.

3. Rest Home Subsidy protection, although this is now severely restricted.

4. Protection against future means tests, Capital Transfer Tax, Capital Gains Tax or Wealth Tax.

5. Ease of administration of a deceased's estate (and hence cost saving) because of disposal of assets to the Trust. Ultimately, Probate may not be required.

6. The flexibility to cater for different Beneficiaries' needs at different times.

7. A means by which capital can be withheld from irresponsible children/grandchildren.

8. Benefits which can also be taken by children and subsequent generations.

9. Protection for children and subsequent generations against matrimonial claims or creditors' claims.

10. For the Trust to be a final Beneficiary under a will, to achieve tax planning/matrimonial protection/creditor protection.

11. A means by which Family Protection Act claims can be avoided.

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