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CHARTERED ACCOUNTANTS

YOU & YOUR TRUST

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What is a Trust?

In the simplest terms, a Trust is an obligation upon one person to deal with the assets, property or money, of another person.

There is normally a signed document, the Trust Deed, which details the terms and conditions of the Trust, and which indicates how the person who established the Trust (the Settlor) requires the trustees to deal with the property.

Why a Trust?

Trusts were used in England as early as the 13th and 14th centuries, to preserve wealth. In those times a landowner embarking upon a risky venture, would convey his land to a friend for it to be held for the use of his family. If the venture failed at least the land would be safe for the family.

Today, the modern Trust provides for the same wealth and estate preservation, by providing flexibility and options in dealing with the hazards of life and commerce.

If you want to keep your assets a family trust is ESSENTIAL. “Your objective is PERSONAL POVERTY AND A RICH FAMILY TRUST” (Ross Holmes – ‘Using a Trust to Protect Your Assets’).

What is it Used for

The main uses are:

- to provide a flexible, orderly transition of wealth from one generation to the next
- to provide for the management of assets & protection of dependants in times of absence or incapacity
- to protect assets from claims by future and potential creditors
- to protect wealth from spendthrift children or spouses
- to protect assets from undeserving matrimonial claims
- to maintain confidentiality
- to reduce the incidence of taxes imposed by Government.

One of the other purposes is to distinguish family wealth from risk capital – risk capital may be lost if the venture fails, but the balance of the capital is protected.

Who is Involved?

The Settlor

The settlor is the person who establishes the Trust by way of a gift of money or property, which is to be held and used in accordance with the settlor's intentions.

The Trustees

The trustees are the legal representatives of the Trust and have the responsibility of administration, in accordance with the terms of the Trust Deed.

In a conventional family trust structure, there are generally three trustees - these are often the founder of the Trust (the Settlor), the spouse, and the solicitor or the accountant.

Generally trustees must unanimously agree with decisions before they can be effected, but this may be modified by the Trust Deed to permit decisions to be made by a majority of trustees.

The Beneficiaries

These are the people for whose benefit the Trust has been established. They are usually named individually in the Trust Deed, and may also be identified by their class eg children or grandchildren of the settlor.

The benefits that they receive may be the capital or the income of the Trust, or both. The Trust Deed sets out the way in which both capital and income are to be dealt with.

How does a Trust operate?

Generally, the objective is to establish the Trust with the trustees having the same powers to deal with the assets as the settlor would have, if the settlor had remained the owner of the assets. This allows the family's economic and tax circumstances to be met as they change from year to year, with the specific objective often being to achieve a smooth transition of ownership or control between generations, without fragmenting that ownership or control.

- The Trust Deed will be prepared by a lawyer and will generally be established with only a nominal cash gift (which can be as low as \$10). Assets will then be sold to the trustees with the sale price being loaned to the Trust by the Settlor.
- A separate bank account will be operated by the trustees to record all receipts and payments.
- The Trust is a separate taxpayer, which means that assets transferred to the Trust that produce income, will result in that income being earned by the trustees. Trustees then have two alternatives:
 - They can treat the income as "trustees' income" in which case tax will be paid at a flat rate of 33%. If the trustees then wish to distribute the "after tax cash" to beneficiaries they may do so either by making "capital" distributions or, alternatively, they can make partial repayments of loans owing from the initial asset sale. Neither of these payments is taxable.
 - The trustees can treat the income as "beneficiaries' income." It is then taxed in the hands of the beneficiaries at their personal tax rates. However, if the beneficiary is under the age of 16 on the balance date of the Trust, the income will be taxed as trustee income at the trustee tax rate, rather than at the rate of the beneficiary.

Before completion of the annual financial statements, the trustees will determine whether the taxable income for the year is to be applied to the beneficiaries or added to the Trust Capital. In either case, the trustees are responsible for paying the income tax involved. A beneficiary receiving

taxable income from the Trust, will receive a tax credit for the amount of tax paid on their behalf by the trustees.

- Any part of the Capital of the Trust may be paid to the beneficiaries (if this is allowed by the Trust Deed), and the beneficiaries then receive the amount as a tax free capital payment.
- The Trust Deed sets out when the Trust is to be wound up. The law limits this to 80 years making it possible to "skip" a generation, with the settlor's children receiving income and the grandchildren receiving capital. The trustees should have discretion to terminate the Trust at a date earlier than that stated in the Deed. This avoids being locked into a Trust that has ceased to serve its purposes due to changes in family circumstances or in wealth related law.

Other Considerations

Whilst income tax and insolvency provisions continue to be relevant considerations, the abolition of Estate Duty has removed some of the former constraints on trust structures and now:

- a settlor can be a beneficiary and a trustee
- there is less need for an independent trustee
- a settlor retains complete control of the appointment and removal of trustees
- assets can be re-vested in another trust
- only one trust for the benefit of all family members is required.

Trusts may be either:

Discretionary
or Non-Discretionary

A beneficiary of a **discretionary trust** does not have a legal interest in the capital or income of the Trust until the trustees have made a decision to apply funds in favour of that beneficiary.

A settlor may prepare for trustees a "memorandum of wishes" which details the settlor's views on how he/she would wish the discretionary powers to be used in particular circumstances.

A beneficiary of a **non-discretionary trust** has a specific entitlement to the trust funds, on the basis detailed in the Trust Deed.

A Corporate Trustee

Companies as well as individuals can be appointed trustees, (but only companies specifically authorised by Law may act as trustees in deceased estates).

Advantages of a corporate trustee:

- Perpetual succession (it does not die).
- Limited liability for the Trust in the event of an inability to satisfy creditors.
- Secrecy, as the fact that the company is acting as trustee is not normally disclosed.
- Ease of contract administration & signing.

Disadvantages of a corporate trustee:

- Additional cost.
- Compliance with the law to provide additional returns to the Companies Office and the Inland Revenue Department.
- Some apprehension from financiers.

What are the Benefits?

A Flexible & Orderly Transition

The Trust Deed of a discretionary trust gives the trustees the ability to make distribution decisions, and the needs of each beneficiary can therefore be recognised at different times as appropriate.

In a non-discretionary trust the trustees may only make distributions on the basis stated in the Trust Deed, which then achieves the specific orderly transition required by the settlor.

Asset Management

A trust can be used to benefit someone who is unable for some reason, (eg infancy, illness) to manage their own financial affairs.

Creditors Claims

Assets held in trust are not available to creditors in an insolvency where the settlors at the time of transfer of any of their property to the Trust were able to meet their liabilities as they fell due. That liability test must also be satisfied during the three year period following the asset transfer.

Such assets are not removed from any insolvency clawback until any debt resulting from the transfer is repaid or gifted.

A trust may also be designed so that if one of the beneficiaries becomes insolvent, their share of the trust passes to other family members, rather than to the creditors in the insolvency.

Potential Creditors

Assets held in trust are not subject to claims that may arise from personal statutory liabilities. Company directors, managers and corporate decision-makers can be personally liable under several areas of law and severe potential penalties exist. For example:

- The Resource Management Act - fines of up to \$200,000, plus \$10,000 per day for a continuing offence.
- The Health and Safety in Employment Act – fines of up to \$500,000.
- The Building Act – fines of up to \$200,000 and up to \$20,000 per day for a continuing offence.

These three pieces of recent legislation impose strict liability. Intent or knowledge is irrelevant to liability.

Further, liability attaches to a far wider group of people than directors. Anyone in "management" positions can be personally liable, not only for their own acts or omissions but also for those of their agents, contractors or employees.

Civil claims against directors are more likely to increase under the Companies Act 1993 as the legislation now imposes stringent duties of care. Directors and others involved in management or decision-making roles have far greater personal exposure now than ever before.

Under the Income Tax Act personal liability for company tax debts can arise in particular circumstances.

Spendthrifts

Protection of the family wealth is secured. The trustees can use their discretion to recognise varying needs at appropriate times, and must ensure that the Trust's funds are dealt with in a responsible manner.

Relationship Property

Assets held in a trust are generally excluded from the provisions of the Property (Relationship) Act.

Confidentiality

There are no requirements to file documents which publicly disclose the details of the beneficial owners of assets.

The Incidence of Taxes

- ***Income Tax***

Changes in rates and income levels mean that income tax savings are still possible by:

- applying income to taxpayers aged 16 years or older who pay a rate of tax lower than the settlor;
- allocating income in a way which reduces the impact on income tested benefits.

- ***Inheritance Taxes***

Estate duty was abolished in December 1992 and the legislation was repealed in June 1999. It is possible that some type of capital assets transfer or wealth tax will be introduced in the future. The holding of assets in Trusts may provide flexible options in dealing with any such new taxes.

- ***Targeted Thresholds***

The design of the Social Welfare system is based upon the political perception of need. It functions on the basis of providing assistance from Government expenditure, to targeted individuals whose circumstances conform to criteria defined by thresholds. As both Governments and their policies change, so too do the directions, criteria for assistance, and thresholds.

In the current political climate the focus is upon the eligibility for health costs and rest home subsidies. University student allowances are means tested against parental income until the student is aged 25.

The holding of assets and income sources within trusts provides the opportunity, on a flexible basis, to react to this focus and any changes.

- ***Peripheral Taxes & Levies***

Income flowing through trust structures is not subject to miscellaneous taxes and levies eg accident compensation levies or Companies Office filing fees.

When is a Trust used?

Some specific uses are:

- Setting up an educational trust for your family, children or grandchildren.
- Setting aside a bequest now for a spouse, friend, child or grandchild.
- Setting aside funds to cover funeral expenses or to pay to your spouse or children a fixed amount when you die. That may immediately give them financial freedom.
- Benefiting your local church or favourite charity.
- Protecting someone with a special need, handicap or disability.
- Keeping the inheritance of a first family separate when you marry again or enter into a relationship.

- Avoiding challenges to a controversial bequest under your Will.
- Providing for comfort and welfare of a surviving companion.

Three examples illustrate where trusts are sometimes used:

- A businessman with a young family needs to reduce his estate, or arrest its growth, and protect that family wealth. The family are too young to take title in their own names. A trust assists each of these.
- A donor's wife and/or family already have significant assets – perhaps already with a wealth risk of their own. A trust can be used to ensure that at least part of the significant assets is available to grandchildren.
- The family wealth is in one main entity – say, a private company. Direct transfer of shares to several holders might result in divided control. If a trust holds the shares, the trustees can control the company for all beneficiaries.

Each of the above can be assisted by a trust:

- Selected assets are sold to the trustees, who then give a mortgage back to the owner for the full price.
- At that point, the former owner has merely substituted a fixed amount (the mortgage) in his/her estate for a growth item (the assets transferred).
- The settlor will then, as requirements dictate, deal with the mortgage in any combination of three ways.
 - Forgive it by instalments (\$27,000 pa is free of gift duty).
 - Accept tax-free capital repayments from the trustee.
 - Charge the trust interest on the mortgage (taxable in the settlor's hands).

The Trust Deed should give the trustees ample and flexible powers. They might, for instance, be authorised to distribute each year's income in ways as diverse as:

	<u>Tax payable by</u>
Repayments off the vendor's mortgage	Trustees
Other capital purposes of the Trust	“
Accumulation in the Trust Fund	“
Accumulation in the Trust Fund	“
Distribution among beneficiaries (in proportions variable, year to year) ie discretionary	Beneficiaries
Charitable objects	Nil in NZ

This ability to spread income depends upon a proper legal transfer of assets to the trustees, under a Trust Deed.

The income flowing from Trust assets can be retained in the Trust, and taxed at the trustees rate of 33%, where that is appropriate. The cash remaining after tax can be paid to the settlor in reduction of the loans arising from the initial sale of assets. Where these repayments are used for living expenses the settlor's estate is reduced, thereby lowering the exposure to rest home subsidy clawback and means tests. The objective is to minimise personal capital and maximise Trust capital.

Income allocations from the Trust may be planned on the most tax effective basis to minimise the overall amount of tax paid.

At any appropriate time the Trust may sell assets and make capital allocations and payments to the beneficiaries, or buy replacement assets.

Leases for Life

It is possible to reduce the debt levels involved in the sale of family homes to a trust by granting to you, before the sale, a lease for your lifetime over the home. However such leases increase in value as a result of inflation and we recommend that it is preferable to sell the home to the trust without such a lease.

This fixes the value at which the home is removed from your personal estate and provides a fixed base for a gifting programme. Such a lease should only be considered where you are unable, in exceptional circumstances, to reduce your estate fast enough from the normal gifting programme.

Asset Testing for Residential Care

This was a controversial topic in the 1990s with an intention by Government to abolish it being rescinded in September 1998.

However, in 2003 the Government announced the progressive increase in asset testing thresholds for Residential Care Subsidy purposes, effective from July 2005.

The thresholds pre 2005 and post 2005 are:

	Single Person <u>Age 50–64</u>	Single Person <u>Aged 65 +</u>	Married Couple <u>Aged 65 +</u>	
			<u>One in Care</u>	<u>Both in Care</u>
Asset Limits				
<u>Savings Investments</u>				
Pre July 2005	15,000	15,000	30,000	45,000
Post July 2005	Removed	Removed	45,000	Removed
<u>Prepaid Funeral</u>				
Pre July 2005	10,000	10,000	10,000 ea	10,000 ea
Post July 2005	Removed	10,000	10,000 ea	10,000 ea
<u>Total Assets</u>				
Pre July 2005	15,000	15,000	45,000	30,000
Post July 2005	Removed	150,000	Removed	150,000
Average gifts per annum over prior 5 years				
Pre July 2005	5,000	5,000	5,000	5,000
Post July 2005	Removed	5,000	5,000	5,000
Family Home & Car				
Tested				
Pre July 2005	Yes	Yes	No	Yes
Post July 2005	No	Yes	No	Yes
Income Limits				
Partner working/ investment income				
	1,594	1,594	28,972	1,594

The 'total assets' and 'savings investments' thresholds applying from July 2005 increase by \$10,000 per annum from July 2006.

Family attitudes to these provisions range from a comfortable acceptance of allowing the family home to be sold to fund parents care, to a total hostility to such a position. Some aged people have strong views that the home should pass to the next generation even though they may be quite wealthy in their own right.

The Structure of Family Trusts

Whether you have one trust for both husband & wife, or two trusts (Mirror Trusts one for the husband's assets and one for the wife's assets) is dependent upon your assessment of the likelihood of the value of your estates.

The alternative structures are:

One Trust

Trust Name	Family Trust
Settlors	Husband & Wife
Trustees	Husband Wife Lawyer
Primary Beneficiaries	Husband Wife Children Grandchildren
Secondary Beneficiaries	Other Relatives, Charities

Mirror Trusts

Trust Name	Husband Trust	Wife Trust
Settlors	Husband	Wife
Trustees	Husband Wife Lawyer	Husband Wife Lawyer
Primary Beneficiaries	Wife Children Grandchildren	Husband Children Grandchildren
Secondary Beneficiaries	Other Relatives Charities	Other Relatives Charities

Mirror Trusts were used during the life of the now repealed Estate & Gift Duty Act, to ensure that assets sold to a trust of which the vendor was a beneficiary were not included in that vendor's estate at the date of death. There was no effect on the Trust, only on the estate of the vendor.

It is now not necessary to use Mirror Trusts if there is no possibility of future estate duty in your case. You should recognise potential inheritances in assessing your position, and also that the former Estate Duty exemption was \$450,000.

Are there any Traps?

Whether the desired objectives are achieved with the establishment of the Trust depends on the timeliness of the transfer of assets to the Trust. If assets are transferred to a trust in a period of impending insolvency, creditors may be able to upset the transfer in a subsequent bankruptcy, as the law gives creditors certain rights to reclaim assets transferred to defeat their legitimate interest.

This is only fair, as creditors must continue to have access to assets that backed the contracting party at the time credit was given. However, appropriate planning measures taken early, to transfer assets to the Trust can ensure creditors are not misled into believing assets are available at the time credit is given.

Likewise, in the family context, timeliness is important in protecting separate property from relationship property claims which can legitimately arise if separate property is intermingled with relationship property.

Just as in earlier times, the time for planning is prior to embarking on a risky venture. Those who do not must accept the risks.

Comments are sometimes made about trusts which have not worked out well, and these have the unfortunate effect of making some people "*anti trust*" to their own, and their family's, expense. Generally such, problems arise from:

- Insufficient consultation. The settlor, spouse, lawyer and accountant must all be clear about the proposals before anything is signed. The plan must be made to fit the people and their circumstances – not the other way round.
- The Deed being too rigid. So long as a person owns an asset, they can change their mind about how to administer or dispose of it as circumstances change. The trustees to whom it is transferred must be able to do the same.

Reference has been made throughout to trust assets being protected from a variety of risks, and it must be emphasised that such protection is not effective until the debts due to the settlor from the initial sale of assets have either been gifted to the trustees, or repaid by the trustees. IT IS ONLY WHEN THE ASSETS HAVE BEEN FULLY INVESTED IN THE TRUST, AND THERE IS NO DEBT TO ANY SETTLOR, THAT COMPLETE PROTECTION IS OBTAINED.

The Social Security Act 1964 provides that any application for assistance may be refused where the applicant has taken any action to deprive him/her of any income or property in order to qualify for a particular benefit or an increased rate of benefit. It is understood that the present Social Welfare process, in practice, only reviews the past 5 years.

It is therefore crucial that "criteria motivated trust planning" commence at an early enough time for the gifting and repayment process to be completed before the "criteria" microscope is applied. Some forethought should be given to potential questions that are likely to arise within the application process, and the appropriate administrative processes should be put in place.

The time to complete the gifting/repayment programme should always be considered within the basic planning process, and may involve a matrimonial settlement to balance the spouses' estates before selling assets to the trust. As a result of a matrimonial settlement the rate of gifting may be increased to \$54,000 pa presently.

From 20 May 1999 trust distributions may be taxed as trustees income where the recipient is not:

- A natural person for whom the settler can have natural love and affection.
- A charitable organisation whose income is exempt from income tax.

Some care is, therefore, necessary to ensure that distributions are only made to approved tax exempt organisations and the beneficiaries named in the Trust Deed.

And the Benefits Again

The principal benefits are that family wealth is protected against the variety of risks arising from the hazards of life and commerce, and the opportunity to choose options, in relation to differing government policies, is enhanced.

Succession to ownership may be planned ahead through an intermediate structure until the eventual owners take over. That will almost always be cheaper and smoother than holding on, and transferring at a later date.

Development, profit plough-back and inflation all tend, over time, to increase wealth. Thus the earlier the transfer process starts, the greater the savings will be.

There is also an incentive element in a discretionary trust. Beneficiaries, especially family ones, may be much more careful about an unknown future inheritance at an unspecified time, but may perhaps hastily spend an amount received.

Further Considerations

Even if you are not setting up a trust, we think all people in business should seriously consider having a solicitor attend to the following.

Enduring Powers of Attorney

This concept was introduced by the Protection of Property and Personal Rights legislation passed in 1988 and enduring Powers of Attorney are becoming increasingly popular as their importance is appreciated.

The Powers of Attorney can be set up for two purposes:

To cover personal care, and to cover property.

To cover personal care, you usually appoint a member of the family or close friend.

Enduring Powers of Attorney are basically intended to cover a situation where someone may temporarily or permanently lose the capacity to make decisions. Under previous law, if, for instance, somebody was involved in an accident and lost their legal capacity, no person could automatically assume the legal rights without an Order of the Court. With an Enduring Power of Attorney in place, there is now someone who can immediately step in and make decisions in consultation with the family, thus ensuring assets are protected and personal financial affairs can continue to operate without disadvantaging the family.

These Powers of Attorney are not just for elderly people who may be contemplating moving to rest homes. They are now being completed by many younger people who are simply taking prudent steps to protect their families.

You have several options as to the way in which the Enduring Powers of Attorney can be set up. Some come in to force immediately, while others only take effect when you are unable to handle matters yourself.

A Living Will

If you wish, your lawyer can guide you in the preparation of A Living Will which is a declaration of your wishes to apply in the specified circumstances involving long term terminal incapacity.

It records for your family and medical advisers, your wishes in relation to medical treatment, sustenance and the avoidance of pain and distress, in what is often referred to as the "vegetable state."

Wills

Everyone over 18 should have a Will. If you die without making a Will, your estate is arbitrarily divided up by law. That probably will not match your wishes and it could mean delays in dealing with your affairs, possibly causing hardship for your relatives.

Every significant change in family or financial circumstances should prompt a review of the Will. Among such changes would be:

- marriage of the testator, which in general revokes the Will automatically
- dissolution of marriage, which automatically eliminates the former spouse, but otherwise leaves the Will unchanged
- death of a principal beneficiary
- disposal of a major bequeathed asset
- business changes, eg incorporation of a company, formation or dissolution of partnership.

Trustees cannot continue a deceased owner's activities, or achieve that person's objectives, without adequate powers. The Trustee Act gives them only limited scope – for instance, they have no general authority to invest in real estate, or to continue operating a business.

Here are a few of the important matters to cover:

- Do you leave the balance in your Estate to your discretionary Trust?
- Who gets the share of a major beneficiary (say daughter or son) if that beneficiary dies before the testator?
- Are the main benefits inflation adjusted? It is unwise today to provide fixed dollar amounts (income or capital) particularly for dependants.
- Are the trustee's investment powers wide enough?
- Is there authority for carrying on the business?
- Is provision made for the sale of any asset on flexible terms, to a partner, associate, or family member?

Sometimes, one person's estate planning will require another person to make or review their Will. For example:

- Transfer of substantial assets to a spouse or family member – what happens if that family member dies first?
- Life assurance transferred before death to a spouse – will the funds be available on loan to the life assured's estate if required? What happens to the policy if the spouse dies first?

Wills are a specialist area, and clients should consult their solicitor. In many cases, the production of an effective Will requires both legal and accounting skills. We therefore advise clients to consult us also, so that the best long-term arrangements can be developed.

Additional Reading

For a comprehensive explanation, in layman's terms, of relatively complex issues we recommend "Trusts – using a trust to protect your assets" by Ross Holmes LLB (Hons).

Please contact us for your copy of one of our other Business Advisory Publications, or download them free of charge from our website at www.kendons.co.nz.

You and Your Bankers

You and Your Business Plan

You and Your Business Acquisition

You and Your Business Records

You and Your Profitability

You and Your Qualifying Company

You and Your Review of Performance

You and Your Trust

You are Thinking About Going into Business

You and Your Wealth Creation

You and GST on Your Real Estate Transactions