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WHAT IS A TRUST?

Despite the mystery that surrounds trusts, the concept is very simple. One person holds an asset for another person. The first person holds the asset "on trust" for the benefit of the other.

The first person is called the "trustee" who cannot use the asset for their own use, and can only use it for the benefit of the other person, the "beneficiary" (although a trustee may also be a beneficiary).

A trust can arise in many circumstances, and for the purposes of this discussion, it is created by a "trust deed".

The trust is created by the "settlor" who starts or "settles" the trust. Conventionally this is done with a gift of say $10 and the settlor hands the $10 to the trustee(s) and requests that they hold it (on trust) for the beneficiaries. (Usually there is more than one trustee).

The trust is created by a document known as the "trust deed", which names the settlor, the trustees, and the beneficiaries. Often the beneficiaries are named as a "class" group such as "my children".

The trust deed records the rules that the trustees must follow. The trust can last for up to 80 years but can be distributed or wound up at any time before that date. If it is not wound up until expiry, then the assets will "vest" and be distributed to the "final beneficiaries".

WHY FORM A TRUST?

Most trusts are set up for variations of the following benefits:

- Asset protection from creditor attacks
- Asset protection in succession planning
- Eligibility for income/asset tested benefits
- Relationship property protection

Many trusts are set up for asset protection. This can be for a variety of reasons. The obvious reason is to protect someone in business who may be exposed to risk.

A good example is a builder or architect designing homes over the last 15 years of leaky homes. They would have been well advised to hold their homes (at least) in trust so if they are sued for negligence or breach of contract; their homes are safely protected in trust.

This is not a bulletproof guarantee, as the assets cannot be safely transferred after the horse has bolted. It is a conservative process to begin as soon as possible. For example, insolvency law may unwind the transfer of an asset to a trust up to two years back.

In business life it is natural to focus ahead on making money (that's why we're in business) but we would like you to look over your shoulder to see where attack could come from and protect yourself so far as possible from attack. This could be from a creditor, client, or relative.

Often you have to give your personal guarantees to leases and the like, and a trust would "save" the asset from being attacked under a personal guarantee.

Another reason for having a trust is to protect your assets from being used to pay for care if you go into a retirement or rest home. This is complex and we set out the position in more detail below. Someone has to pay the cost, and unless the retiree pays then the burden falls on the rest of the taxpayers. Alternatively, it is argued that you have paid tax all your life and are entitled to state care in retirement.

Aside from the morality/politics, it is useful to have your assets in trust to protect them for the family rather than pay them to the state. This is subject to the claw back rules referred to below.

There was a time when deceased estates were taxed – "death duties" or "inheritance tax". At present, there are no death duties, but it is not difficult to envisage a time when some enlightened political party will seek to redistribute wealth (especially to the state) upon death, with the aging "baby-boomers" holding significant wealth and mortgage-free houses.

Trusts have been used in the past to protect assets against death duties, and what goes around comes around – death duties will no doubt be imposed again sometime in the future.

We live in an age of "blended families" – a recent term referring to the various mixes of families that can range from two partners or spouses, each with children from prior relationships and their own children, to threesomes, and various permutations of children born from donor eggs and sperm, and surrogate mothers.

If you are a member of such a family then a trust may be an ideal way of preserving your assets for your "own" family to ensure that your assets pass on to "your" children rather than pass sideways to other partners and possibly their children. A trust is not bulletproof in such circumstances but goes a long way to ring-fence assets.

The arrangement of choice to protect assets in a relationship is a relationship property agreement, which describes assets held within the relationship, and their shares, and may exclude certain assets from the relationship, defining them as separately owned property.

In some circumstances where a relationship property agreement is not available, or as advance protection, setting up a trust and transferring assets to the trust may be the preferred approach.

A combined "belt and braces" approach of trust and relationship property agreement may be the ideal arrangement.

You may wish to set up a trust for a child so that his/her inheritance can go straight into that trust and protect it as far as possible from being attacked by a partner or spouse.

It would be wise for that child to have a relationship property agreement excluding such assets, but while you may not be in a position to influence that decision, you may be able to exercise some "control" by ensuring at least that their inheritance is protected by their trust (which you could assist him/her in forming). The sooner the better.

Generally, trusts are set up for income earning or at least tax neutral positions. If there are losses being made by an investment then it may be better to hold it personally or by a company that may accumulate its losses to apply against future profits or apply against other income.

There have been times when there has been a tax advantage for trusts taxed at a lower rate than the maximum individual rate, but that tax break has gone.

A trust can distribute income to beneficiaries within 6 months of balance date so the beneficiary may pay tax at his/her own rate, which may be lower than the highest individual tax rate or trust tax rate.

If a trust retains its income and pays tax, it is taxed at 33%. Thus, a trust can pay out income either before or after paying the tax, and can distribute as income or capital

We see very few trusts set up purely for the purpose of tax saving. It would be foolhardy to base setting up a trust on an arbitrary tax rate which could (and does) change without notice.

WHAT OTHER DOCUMENTATION IS REQUIRED WHEN FORMING A TRUST?

We recommend to our clients that they should have Wills, appointing the trustees of their estate and disposing their estate.

If you do not have a Will, then your assets will pass to your family in a predetermined order and amounts. These may not be the people you wish to benefit or the amounts you wish them to receive.

Having a Will also removes any doubt for your family as to who you want looking after your affairs, what you want done with your estate and personal effects, and possibly, how you wish your body to be treated after your death (cremation/burial).

If you have a trust, this may replace or add to your Will to some extent. Certainly if you have a trust your Will must be reviewed.

In your Will you will appoint a replacement trustee (for your trust) to replace you, and you will very likely forgive any balance of debt that your trust may have still owing to you and ungifted.

You may give all or part of your remaining estate to your trust, so that your trustees only then have be concerned with continuing to manage your trust rather than also administering your estate, especially when there are ongoing matters such as a surviving spouse whom you have given the right to enjoy an asset for their life (e.g. a house), or an under age beneficiary.

Your trust will describe some beneficiaries in general terms or class. This is necessary, as it would be difficult and perhaps foolhardy to predict each beneficiary's future needs.

For this reason you will sign a "memorandum of wishes", which enables more specific instructions to the trustees as to how they are to administer the trust and as to who the specific beneficiaries might be from time to time.

For example, the trust deed will show you as a discretionary beneficiary, and probably your children as final beneficiaries.

The memorandum of wishes can be changed whenever you wish, and quite simply, to reflect your changing needs and the changing needs of your beneficiaries. It may give you the right to reside in the house you may have transferred to the trust. While trust deeds can be changed, it is not a simple matter and it is usually preferable to leave them unchanged.

Once the trust is set up, it will acquire assets. Sometimes the trust will be set up for a specific purchase of an asset, say a home. In this case, the person(s) setting up the trust will lend or gift their deposit to the trust, and either they will borrow the balance from their bank and on lend it to the trust, or more likely, the trust will borrow funds from the bank. The trust will then be able to complete the purchase.

Usually the lender will require the personal guarantee of the trustees, so if the trust cannot meet the mortgage obligations, the bank can then look to the guarantors to fulfil the obligations of the mortgage. A professional trustee will limit its exposure to the assets of the trust.

We advise the trustees to record in a memorandum of wishes that the trustees shall have the right to live in the house provided they keep it maintained, pay rates and insurance. It is good practice for the tenants to pay a regular (e.g. monthly) sum to the trust in return for this right of occupancy, and the trust can then use these payments to pay the mortgage, rates, and house insurance.

It is good practice to maintain a separate bank account for the trust to receive and make all payments, so the trust's bank statements provide a full financial picture of the trust's activities and reinforce that the trust is not a sham or alter ego trust in that it manages its own affairs and does not intermingle its income and expenditure with that of the trustees who may be the tenants. This may seem a fiction, but it is essential to maintain the transparency and separate entity of the trust from the financial activities of the trustees and beneficiaries.

You may wish to transfer other assets to your trust. For example, if you are an earthmoving contractor, with expensive plant and equipment, it may be worthwhile transferring those assets to your trust which could lease them back to you at a commercial rental, so that you produce an income stream for the trust, and remove valuable assets from your company where they will be safe from attack by creditors or a liquidator.

Please note that this is an example only of how a trust may be used to protect assets and is not meant to be legal advice. You should check with your lawyer and your accountant as to the wisdom of taking such steps in your position, and the tax efficiency.

You could make your trust the beneficiary of your life insurance. It could own your shares, investments, art works and bach if you are lucky enough to own one!

Trusts can also be beneficiaries, and it may be prudent to advise your parents to change their Wills so that any bequest you may receive goes directly to your trust rather than to you personally and then gifted into your trust.

We strongly advise trustees to maintain good records and not to confuse the trust income and activities with their own. All decisions should be recorded in writing. These are known as resolutions (deciding to do something) and minutes – the notes recording the resolutions and activities of the trust.

TRANSFERRING YOUR HOUSE OR OTHER ASSETS INTO A TRUST

Often a trust is formed after an asset such as a house has been owned for some time. The mechanics of transferring the house to the trust are usually as follows:

We advise the trustees to assess the fair market value of the house to ensure that the house is transferred to the trust at its proper value.

If there has been a recent valuation by a registered valuer, you could ask the valuer to update the valuation for a modest charge. Failing that, QV (Quotable Value, the privatised former Government Valuation Department) can provide a "desktop estimate certificate for a related parties transaction" which is an office-based estimate of value from its database.

This estimate is used to value assets for related party transfers and/or IRD purposes. QV charges approximately $175 for properties valued up to $600,000, and approximately $225 for properties valued up to $900,000.

We prepare an agreement for sale and purchase based on the assessed fair market value, which is signed by the owner(s) as vendors, and the trustees and purchasers for the trust.

If there is a mortgage, we request the bank to agree to the transfer (which it usually does for a fee around $200). Usually there will be bank documentation, involving a release of the mortgage and a registration of a fresh mortgage, and personal guarantees from the trustees.

The transfer is then registered. No money changes hands.

The difference or gap between the mortgage and the registered valuation is your "equity". This is recorded in a deed of debt which may then be gifted to the trust if appropriate.

GIFTING

Until recently there was an annual limit of $27,000 that could be gifted (without incurring a tax called "gift duty"), hence gifting programmes gradually forgave the debt following assets being transferred to a trust. The law has changed and now there is no limit to the amount that can be gifted, as gift duty has been abolished.

Clients with gifting programmes will be considering gifting off unforgiven balances, and completing their gifting programme in one step. Others may wonder whether, for future dispositions of property to a trust, they should gift the whole value, or take a debt back.

This is a personal decision. For greater asset protection, the sooner the debt is completely forgiven the better, but some people will wish to maintain control by retaining a debt, which they can seek repayment of at any time. This final gift should be documented with a deed of gift, which no longer has to be filed with IRD with a Gift Statement.

Some lenders/donors will want to take advantage of this opportunity to place all their assets beyond the reach of creditors. There are powerful creditor protection provisions in the Insolvency Act 2006 and Property Law Act 2007, which can claw back assets/gifts in some circumstances.

The Official Assignee can cancel gifts made within two years before a person is made bankrupt, and within five years if the bankrupt person cannot prove he/she was solvent at the time the gift was made. The Court can set aside gifts where there was an intention to prejudice creditors when the gift was made.

The repeal of gift duty will allow you to place property into trust more easily and quickly to safeguard it from potential future relationship property claims. This is likely to bring closer scrutiny from the courts and the greater exercise of the powers available to the courts where those dispositions have not been made properly.

Because gifting can be viewed as denying creditors access to assets, we recommend that you sign a statement of solvency so there is evidence confirming your solvency at the time of gifting.

We also recommend that you obtain a statement of solvency from your accountant. In the event that an aggrieved creditor or relationship partner later sought to show that you were insolvent, or that you intended to defraud or prejudice them or creditors when you forgave the debt and that you were doing so to obstruct access to your assets in the face of a claim, then this could be disproven by evidence of your solvency.

There has been recent focus on income-splitting trusts by the courts in the Supreme Court decision of Penny v. Hooper, which was a "trading trust" where the income earner was employed by the trust on a salary, and the trust earned the full income. This is now largely of historic interest since the tax regime is now mainly a level playing field and there is little benefit in income- splitting.

There is also increased interest by the courts and litigators to see if trusts can be busted to access assets for aggrieved creditors or relationship partners and spouses. Trusts are also under the focus of the Law Commission.

It is essential to ensure that trusts are properly established, transparent and managed correctly, to reduce the likelihood of successful challenges of the trust being a "sham" or "alter ego" trust.

We encourage the appointment of an independent trustee who is not a beneficiary of the trust. The trustees should meet at least once a year to review the trust's activities, and all activities should be accurately recorded or minuted.

All financial transactions should be through the trust's bank account, which should not be the private “piggy bank” of a trustee/beneficiary.

If the trust makes an income then it should have an annual tax return. Trustees may decide that annual accounts and balance sheet are good practice even if there has been no income or profit.

The trustees' or settlor’s wishes should be recorded and reviewed regularly to ensure that they are current and reflect your wishes.

The trustee's Wills should be reviewed to make sure that each trustee who has a power of appointment appoints his/her replacement trustee in his/her Will.

There will be increased vigilance from the Ministry of Social development to claw back gifts to trusts intended to deprive the state of funding for residential care.

Applicants are means tested, and MSD will look through gifting when assessing residential care subsidies. Some gifting will be brought back into the financial means assessment: those made within the last five years; and those made prior to five years.

MSD will pay close attention to all gifts made within five years that exceed in total $30,000 and to all gifts made more than five years ago even if they were under the gift duty threshold. This area is quite complex and we advise that you discuss this with us in detail.

POTENTIAL PITFALLS

Lawyers are very concerned to make sure that the trusts they set up for their clients are as bulletproof as possible, to prevent the trusts being labelled as “shams” or “alter ego” trusts.

Often we find that a trustee may be the settlor and a beneficiary. It is preferable that these roles are kept separate and we advise to keep some distance between these functions.

We advise you to make sure that at least one of the trustees is not a beneficiary, and often the “independent" trustee is a professional trustee, such as your accountant or lawyer.

Often the professional trustee is a company established specifically for that purpose, which does not trade or have income, existing solely for the purpose of being a professional independent trustee, to avoid as much as possible the accusation that the trust is a “sham” or “alter ego” trust.

A trust must be treated as a separate entity. Its financial affairs must be kept separate and not blurred with the trustee’s or beneficiary’s affairs.
It should record or “minute” all its decisions. It should have its own bank account.

All financial transactions should pass through the trust bank account and not be blurred by transactions through a trustee’s or beneficiary’s personal bank account.

The roles of settlor, trustee, and beneficiary should be kept separate. A recent description referred to who held the key to the “piggy bank”. It should not be a beneficiary, or a trustee who is a beneficiary, holding the key to the piggy bank.

The trustees should meet regularly, to approve review and record trust activities.

The trust deed usually specifies who has the power of “appointment” to hire and fire trustees and add/remove beneficiaries. Again, this power of appointment may be a pointer as to who controls the key to the piggy bank.

The best practice is to keep these functions separate and distinct to avoid any inference that the trust is a sham or alter ego trust. In these litigious times, clever lawyers will waste no time in attempting to “bust” a trust to satisfy an angry creditor or aggrieved spouse.

The new gifting rules place an increased need to ensure that your trust is robust and properly managed. If it is, then it is an excellent rampart to protect assets against aggrieved creditors and relationship spouses/partners.

You should review your trust’s gifting programmes to ensure that all gifting is completed, if that is appropriate.

In summary, we see benefits for client's well-managed trusts, and the increased need to ensure good management, which we are happy to advise on and provide; although there may be limited benefit for alienation of assets to qualify for means tested residential care subsidy.