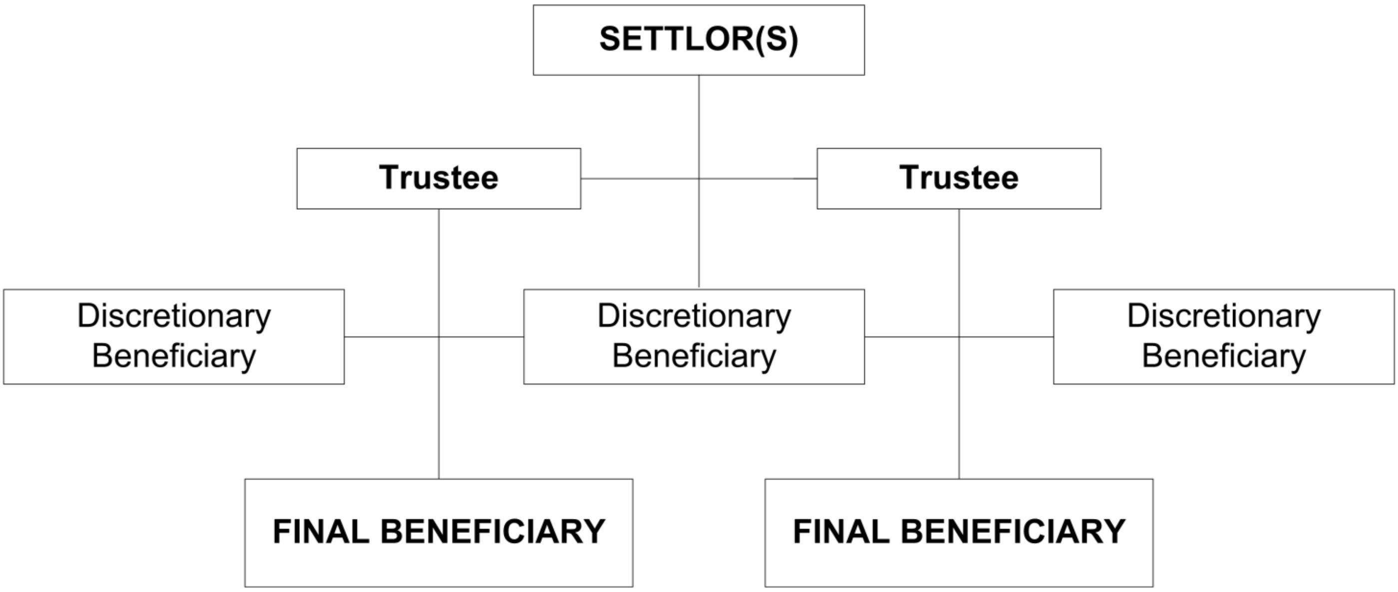
Trusts - Fact Sheet

LAWSON AVERY LTD
CHARTERED ACCOUNTANTS

Setting up a family trust can help protect your assets, as well as securing your children's future…

The way some people put it, trusts sound like the answer to a lot of financial worries. So is a trust a good idea for you? The answer depends on your circumstances. Trusts are generally set up to protect assets and look after dependent people. They can have a valuable role to play, but they are not suitable for everyone.

The Family Trust



What is a trust?

A trust is a legal relationship in which a person (the Trustee) holds an interest in property for the benefit of another person(s) or for a specified object or purpose (the Beneficiary(ies)).

There are 3 categories of persons involved in a trust relationship:

The Settlor(s) The person(s) who creates the Trust by transferring property into trust initially or at later times.

The Trustee(s) The person(s) who becomes the owner of the property transferred to the Trust and whose name(s) appears on the documents of title or ownership.

The Beneficiary(ies)
The person(s) who benefits from the trust relationship by receiving income and or capital during the term of the Trust (the beneficiaries) or upon final distribution of the Trust's assets (the final beneficiaries).

Use of a Trust

There are a number of reasons to form a family trust and potential benefits that arise from doing so. These include:

Asset Protection
Assets in a Trust can be protected from creditors in the event of personal bankruptcy or the insolvency of a company of which a person is a shareholder or director. However, the extent of this protection will depend on matters such as the donor's solvency when gifts are made to a trust and whether dispositions of property were made that have the effect of defeating a creditor's interest.

Continuity
Trusts can continue to operate after the death of the settlor without any immediate need to sell any assets to distribute among beneficiaries. Progressive release of funds to beneficiaries can occur and distribution to vulnerable beneficiaries can be delayed until appropriate. Family heirlooms can also be protected.

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Use of a Trust (continued)

Government Claw-Back or 'Surtax' Type Taxation

Assets in a Trust can give protection when assessing future entitlement to residential care subsidies. However, as there are strict rules regarding means, income and gifting specialist advice is recommended if a residential care subsidy application is contemplated.

Historically Trusts have reduced the impact of additional personal taxation assessed against the elderly on an income/means testing basis such as the surcharge.

Death Duty or Wealth Tax

Assets in a trust can give protection against death duties or inheritance taxes (Note: There are no Death Duties at present. However, these cannot ever be entirely discounted). If a capital gains or capital transfer tax is introduced in the future then, provided such tax is assessed on the profit made on any sale, provided the trust does not dispose of property, such tax could possibly be avoided.

Property (Relationships) Act

Whether or not property transferred to a Trust will be at risk in the event of a marriage, civil union or de facto break up will depend on individual circumstances and whether any disposition to a Trust has the effect of defeating a spouse or partner's interests or expectations.

Family Protection Act

Assets in a trust are generally safe from family protection claims by disgruntled family members who disagree with the provisions of a deceased person's Will.

Protection in Old Age

Trusts can be structured to reduce the risk that an elderly person will lose family assets through an unwise marriage late in life and a subsequent matrimonial settlement. They can also protect against the undue influence of other family members or poor financial decision making.

Irresponsible Children or Their Spouses

Assets can be protected from being wasted by children who are still immature and not financially responsible. Income can be made available but capital retained until children reach a specified age.

Income Spreading

In some circumstances income earned by the Trust can be spread among any one or more of the beneficiaries so as to take advantage of their own lower tax rates, i.e. spouses, partners, children and grandchildren. Note that this is subject to the 'minor beneficiary rule', which provides that distributions to most minors (children under 16 years) must be taxed at the trustee rate.

Cost Effective Estate Administration

The costs of winding up your estate may be substantially reduced or eliminated altogether.

How Does A Trust Work?

Prior to the abolition of gift duty, assets were sold by the settlor at market value into the Trust, which is controlled by the trustees. The trustees have an obligation to deal with this property for the benefit of the beneficiaries. These assets can be, for example, your home, bank investments, shares, chattels or life policies. These can be transferred all at once or progressively as appropriate. Some assets might not be transferred until accrued tax losses are used up.

Now that gift duty has been abolished assets can be transferred directly to a trust by way of gift without gift duty applying. That said, in some circumstances it will still be appropriate to sell assets and to retain a debt back so that the person selling the assets retains some security in respect of the assets sold.

Income generated by the Trust and capital comprising the property owned by the Trust can be distributed to the beneficiaries at the discretion of the trustees. Some trusts provide that capital can only be paid out to discretionary beneficiaries during the lifetime of the settlor(s). The trustees also have the power to make distributions to individual beneficiaries to the exclusion of other beneficiaries. The beneficiaries under a discretionary trust have no power to require the trustees to make any distribution to benefit them, as anything that they may receive is at the trustee's discretion.

Income that is retained in the Trust is taxable to the trustees at a rate of 33%, while income that is distributed to beneficiaries is generally taxable at their personal rates. (However, see also the section headed Income Spreading). This sometimes enables trusts to be used as a tax saving vehicle by distributing income to beneficiaries at the lower tax rates. For elderly beneficiaries, distributions of capital can be made, which if handled correctly, could avoid the imposition of a surcharge if re-introduced.

A trust can be established in such a way that the settlor can still enjoy the benefit of Trust assets. The settlor(s) can reserve the right to appoint and remove the trustees (powers of appointment). The control of trustee appointment desired by settlors after the death of one of them can be specifically designed into the Trust Deed. That said, where settlors who are also trustees and beneficiaries retain too much control, the courts, especially the family courts, will sometimes view the retention of power as property. This is often referred to as the Bundle or Package of Rights. Advice should be taken regarding how to diversify powers of appointment if this is a concern.

Trusts can operate for limited periods, but have a maximum life of 80 years. Most trusts enable the trustees to terminate the trust at any earlier date they so determine.

Different Types of Discretionary Trusts

Mirror Trusts

These comprise two separate trusts. One is created by a husband or partner for the benefit of his wife or partner and children and any others as discretionary beneficiaries. The other is created by the wife or partner for the benefit of her husband or partner and children and others as discretionary beneficiaries. The husband and wife, or partners, transfer their property respectively into the trust in which they are not a beneficiary. This results in the property being owned in equal shares by the two trusts, the income and capital of which can then be distributed to the husband/partner and/or children, or to the wife/partner and/or children, respectively.

This type of trust was used extensively when death duty was in place and is now less frequently used due to the fact that, upon the death of one spouse, the survivor loses access to capital and income of assets in the Trust established by the survivor. This style of trust can be problematic when one spouse or partner dies and should be used with caution.

Sole Settled Trusts

A settlor can create a Trust for the benefit of a range of beneficiaries including himself or herself. In this situation there is an independent trustee(s) and the beneficiaries usually comprise a wide class of persons and/or organisations.

Joint Settled Trusts

Joint settlors such as husband and wife or de facto / civil union partners can create a Trust in which they are trustees jointly with an independent trustee. These trusts best suit people in stable committed relationships of some duration.

Parallel Trusts

Two trusts are created, one by each partner/spouse in the same form as joint settled trusts with the right to appoint and remove trustees being given exclusively to one partner/spouse in one of the trusts. The beneficiaries are the same in each of the trusts and one or both partners/spouse are trustees. This format is particularly suitable for consideration where there are blended families or a desire to keep separation of assets transferred in by each partner/spouse.

Memorandum of Wishes

A settlor can provide a signed letter or note to trustees (to be used in the event of their death) indicating how the trustees should manage assets, for example for the benefit of infant beneficiaries. Such letters are persuasive, but need not be adhered to by the trustees.

Relationship of Will to Trust

In your Will, it may be appropriate to leave personal effects, chattels and cars to your spouse/partner and the rest of your personal estate direct to the trust. This avoids the need for the survivor to subsequently gift into the Trust the assets received as a legacy from the deceased. The same benefit is derived from assigning life policies to the Trust; upon the death of the Life Assured, the insurance moneys go direct to the Trust.

Trustee's Liability

A trustee's role is a serious one. People approached to be an independent trustee should give consideration to their personal liability and take advice. Careful provision should be made to ensure that the trustee's liability to third parties is limited to the assets of the trust. When the trust borrows from say, a bank, then a clause can be inserted in the bank's mortgage recording the fact that the independent trustee's liability is limited to the assets of the trust. Provided regular meetings of the trustees are held, e.g. once every 6 or 12 months and appropriate decisions and resolutions made, all matters affecting the trust are easily monitored and there should be no major concerns regarding liability.

Costs of Forming a Trust

The costs of forming a trust include the initial legal set up costs and modest annual administrative costs usually in relation to annual gifting and a succinct review of personal circumstances and any developments in Trust law and practice. A Trust is issued with an IRD number and files a tax return (even if a nil return). It may need to be GST registered in some situations.

Advice on Formation

Significant legal issues are involved in the formation of a Trust and transfer of assets to it. There is a need to harmonise your property ownership mode, your Wills, the Memorandum of Wishes and the Trust set up; accordingly it is vital to take advice from a practitioner experienced in this area of work.

To achieve your asset protection goals it can also be necessary or desirable to enter into a relationship property agreement to contract out of the Property (Relationships) Act 1976. This allows certainty and clarity regarding the ownership of assets transferred to a trust and to what extent, if any, these comprise relationship property.

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