

What is a Trust?



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A Trust is created when a person, called the **Settlor** transfers property to people known as **Trustees**. Trustees are obliged by law to use the property for purposes that the Settlor specifies. Usually, one of these purposes is to make payments from the Trust property to people called **Beneficiaries**.

The way the Trust property is to be dealt with and the parties involved are usually set out in a document known as the **Trust Deed**. Trusts can also be created by wills.

Trusts can be set up for charitable purposes such as education or established specifically for the benefit of the members of a particular family. The terms of Trusts can differ markedly depending on the purpose for which a Trust can be established.

This pamphlet deals with one particular type of Trust – **the Family Trust** – but much of the information will also apply to other types of Trust.

Why a Family Trust?

Reasons for establishing a Family Trust include:

- Protection of assets for family members. By using a Trust to rearrange asset ownership a Settlor may be able to undertake a higher risk occupation or venture.
- Provision for the family sharing of assets when one or more members need rest home or hospital care.
- Protection of family members or a family business from possible matrimonial, or family protection (contesting a will) claims.
- Asset management for someone who is unable to manage their affairs, perhaps through age or infirmity.
- Ease of estate administration (and cost savings) by disposal of assets to a Trust before death.
- Setting up a Trust may change tax liability. More or less tax may be payable. Tax liability should be regularly reviewed.

Who is involved?

The main parties to a Trust are as follows:

The Settlor:

This is the person or people who make the initial transfer of property, which may be as little as \$1, to the Trustees of the Trust. Anyone who transfers assets to the Trust is treated as a Settlor for tax purposes.

The Trustees:

A Trust normally has two or more Trustees. These are usually people in whom the Settlor has confidence. A Settlor can be a Trustee of his or her own Trust if he or she chooses. In some circumstances, it is advisable also to have an unrelated Trustee, who might be a family friend, the Settlor's accountant or lawyer for example, or a corporate Trustee. One of the matters to be looked at when choosing Trustees is how the Trust is to be managed. Is the Settlor to do this himself or herself or is a professional Trustee to have a continuing involvement with the management and account-keeping?

Unless the Trust deed provides otherwise, the Trustees are under a duty to act prudently in the management of the assets subject to the Trust.

These are people for whose benefit the Trust has been established. They can be either named individuals or a class, such as "children" or "grandchildren".

There are generally two types of beneficiary:

i) Discretionary Beneficiaries

These Beneficiaries have a right to be considered by the Trustees for payments from the Trust property but they do not have an automatic right to receive payments from the Trust.

The following are usually named as discretionary beneficiaries:

- ✓ The Settlor
- ✓ The Settlor's spouse
- ✓ The Settlor's children and grandchildren
- ✓ Any spouses of the children or grandchildren
- ✓ Any future spouse of the Settlor
- ✓ The Settlor's parents
- ✓ The Settlor's brothers and sisters
- ✓ Any charity

ii) Final or ultimate Beneficiaries

Final or ultimate Beneficiaries have a legal right to the Trust property on the date the Trust finishes. They are often named and are normally the Settlor's children with provision for grandchildren if a child dies before the Trust finishes.

When is the date of distribution?

In simple terms a Trust cannot exist for longer than 80 years and the Trust deed must set a date on which the Trust will have to finish. This is known as the **date of distribution**. Trustees are usually given the power to bring the Trust to an end before the date of distribution.

Who has the power of appointing Trustees?

The Trust deed should give someone the power to appoint new Trustees and sometimes power to remove Trustees. Usually this power is given to the Settlor.

How does a Trust operate?

A Trust can operate in almost exactly the same way as an individual person is able to. A Trust can hold property, raise mortgages, hold bank accounts and generally hold all types of assets and investments as long as it operates according to the powers set out in the Trust deed.

How does a Trust acquire assets?

Assets can be added to a Trust at any time. Usually the Settlor will sell assets to the Trust or the Trust itself will purchase assets from third parties. The Trust may not have any money to pay for an asset, so the Trustees will need to sign a document (acknowledgment of debt) acknowledging that the Trust owes the seller a sum equivalent to the value of the asset purchased.

The sale of assets to the Trust has the effect of immediately limiting the value of the Settlor's estate to the amount of the debt owed by the Trust. That will be regarded as an asset owned by the Settlor but any increase in the value of the asset sold to the Trust belongs to the Trust and not to the Settlor personally. Similarly, any income from the Trust assets will usually be Trust income and not the personal income of the Settlor.

Reduction of the debt owed by the Trust

There are a number of ways that the amount owed by the Trust to a Settlor can be reduced. For example:

- Cancelling (gifting) the debt. The Settlor can cancel the debt in amounts of up to \$27,000 per year without incurring gift duty. Amounts over this sum will incur gift duty which is calculated on a sliding scale.
- The Trust can make payments – out of its income or out of capital – to the Settlor in reduction of the debt.

Parallel / Mirror Trusts

- (a) "Parallel Trusts" and "Mirror Trusts" involve each settlor transferring assets to a different Trust for which each holds certain powers (i.e. powers of appointment of beneficiaries and Trustees), even though each Trust may be established for the benefit of the same family group.
- (b) With Parallel Trusts, the settlor of each Trust is normally also included in the list of beneficiaries, in addition to his or her husband, wife or de facto partner. With Mirror Trusts, the settlor of each Trust is excluded from the list of beneficiaries, with only the settlor of the other Trust (and normally also the children) being beneficiaries of each Trust.
- (c) Mirror Trusts provided a way of avoiding death duty, which was imposed on a person who settled assets on a Trust of which he or she was also a beneficiary. As this aspect of the law has now been abolished in New Zealand, Mirror Trusts are less in favour, with Parallel Trusts providing the preferred model for those who require two Trusts.
- (d) Parallel Trusts also have the advantage of resolving two potential problems with the Mirror Trust model – first, on the death of one settlor in the Mirror Trust scenario, the survivor would be left with an interest in only half of the family assets held by the two Trusts; secondly, if the relationship between the settlors broke down, the potential existed for one settlor to refuse to distribute the Trust assets to the other party, if that settlor was in a position where he or she did not need to receive the assets from the other party's Trust.
- (e) The main advantage of the Parallel Trust structure is that, if it is necessary to provide for two separate groups of beneficiaries at some time in the future, or if estate duty is reintroduced in its previous form, this structure can be more readily adapted to fit changes in circumstances.
- (f) Parallel or Mirror Trusts have the disadvantage of being more expensive structures to operate, i.e. two legal transfers / ownership for asset purchases, three sets of Financial Statements including separate profit and loss and Statement of Financial Position, plus two lots of Trust administration minutes each year.
- (g) Right of Partition: If you own 50% or more of an asset, you can apply to the Court to get an Order of Partition. The Court will order either the split of the asset (if possible) or request that the property be sold. This stops the issue with assets being held in a stalemate in a Single Trust. Trustees must make unanimous decisions. If a unanimous decision cannot be reached, then the status quo remains.
- (h) Parallel or Mirror Trusts have the disadvantage of being slightly more expensive structures to operate, ie. two legal transfers / ownership for asset purchases, three sets of Financial Statements including separate Profit and Loss and Statement of Financial Position, plus two lots of Trust administration Minutes each year. Cost should not be the factor in determining the correct structure for your circumstances.

Getting money out of the Trust

The Trustees decide which payments from income or capital are to be made by the Trust and who among the beneficiaries shall receive them.

In addition, if the document recording the debt allows, the person to whom the Trust owes a debt can demand any part of the debt owed. If the debt for the initial purchase of assets is repayable to the Settlor on demand the Settlor can require payment of all or any part of this debt at any time.

Payments of this kind from the Trust to the Settlor may be free from income tax.

What about Tax?

Income will either be taxed in the hands of the Trustees as Trustee income, or in the hands of the beneficiary if the Trustees decide to pay income to beneficiaries.

If income is paid to a beneficiary then income is taxed at the beneficiary's personal tax rate. Income that is not distributed to the beneficiaries is taxed in the Trust at the rate of 33c in the \$1 from the first dollar earned i.e. there are no low income earner rebates available to Trustees.

Caution!

Trustees are subject to various legal requirements and there are a number of statutory claw-back provisions, which can defeat the purpose for which the Trust was set up in the first place. The structure of a Trust will depend on what the Settlor specifically wants the Trust to do. It is important to note that Trustees, once appointed, cannot do just they want with the Trust property. They have powers which allow them to do certain things, and duties which must be observed.

These have their foundation in:

- The Trust deed – what does the deed allow the Trustees to do?
- Legislation – what does the printed law allow or stop the Trust from doing?
- Case law - what do the cases which have already been decided prohibit or allow the Trustee to do?

If you wish to set up a Trust it is important that you understand your Trust and what Trustees can and cannot do. You should talk to your advisor to ensure that the terms of your Trust fully meet your needs, fulfil the intended purpose and will not be upset by any claw-back provisions.

Finally, you should assess whether a Trust is a suitable vehicle to meet your objectives. You should weigh up the advantages and disadvantages of your various options, including the ongoing management compliance costs of each.

Your advisor will be able to assist in determining what is required to suit your needs.

Investment duties and responsibilities of Trustees

The Trustee Amendment Act 1988 has removed the list of authorised Trustee investments, freeing Trustees to invest in any form of investment. In tandem with this move a prudent person rule is now referred to as a measure of the standard of care which must be exercised by Trustees. Trustees may have a greater freedom to invest, but they also have greater responsibilities.

Guidelines for the standard of care to be exercised by non-professional Trustees are set out in Section 13B of the Amendment Act.

Section 13B reads as follows:

"Duty of Trustee to invest prudently – subject to Sections 13C and 13D of this Act, a Trustee exercising any power of investment shall exercise the care, diligence, and skill that a prudent person of business would exercise in managing the affairs of others."

"A higher standard of care is required for professional Trustees under Section 13C":

“Duty of certain person to exercise special skill – Subject to Section 13D of this Act, where a Trustee’s profession, employment, or business is or includes acting as a Trustee or investing in money on behalf of others, the Trustee, in exercising any power of investment, shall exercise the care, diligence, and skill that a prudent person engaged in that profession, employment, or business would exercise in managing the affairs of others.”

It is important to note that the Act does not tightly define a test for the prudent person’s duty of care, it simply refers to the duty of care as being in the nature of a rule. We think that the standard of care would seem to be assessed with reference not only to investment performance, but also to Trustees’ conduct.

Section 13E of the Act provides a suggested list of considerations that Trustees may take into account when making investment decisions.

The section states:

“Matters to which Trustees have regard in exercising power of investment – Without limiting the matters that a Trustee may take into account, a Trustee exercising any power of investment may have regard to the following matters so far as they are appropriate to the circumstances of the Trust:

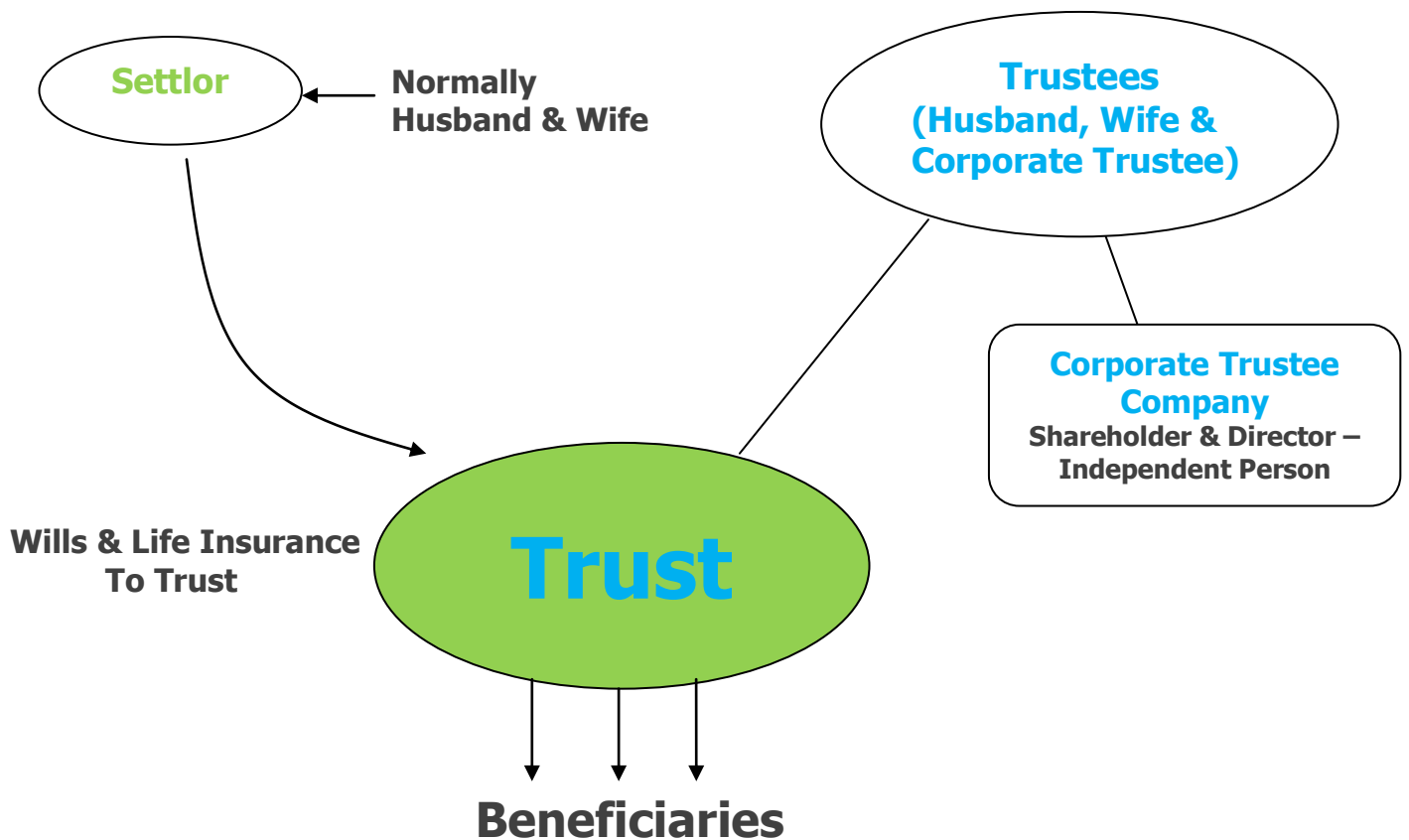
- (a) The desirability of diversifying Trust investments;
- (b) The nature of existing Trust investments and other Trust property;
- (c) The need to maintain the real value of the capital or income of the Trust;
- (d) The risk of capital loss or depreciation;
- (e) The likely income return;
- (f) The length of term of the proposed investment;
- (g) The probable duration of the Trust;
- (h) The marketability of the proposed investment during, and on the determination of, the term of the proposed investment;
- (i) The aggregate value of the Trust Estate;
- (j) The effect of the proposed investment in relation to the tax liability of the Trust;
- (k) The likelihood of inflation affecting the value of the proposed investment or other Trust property.”

There is a need to preserve the respective positions of the beneficiaries and the life tenants. To this end, you require a measured balance of growth and income investments.

Finally, on this point, it is important to remember that prudence is said to be a test of conduct, not an evaluation of results with the 20/20 vision of hindsight. Central to the enquiry undertaken when evaluating whether a Trustee has failed in managing the affairs of others will not be the “bottom line” results, or even the wisdom or otherwise of individual investment decisions. Instead, the Court will be called upon to evaluate the methodology, the process by which Trustees arrived at their investment decisions. In this regard, I suggest that the Court will take into consideration factors such as:

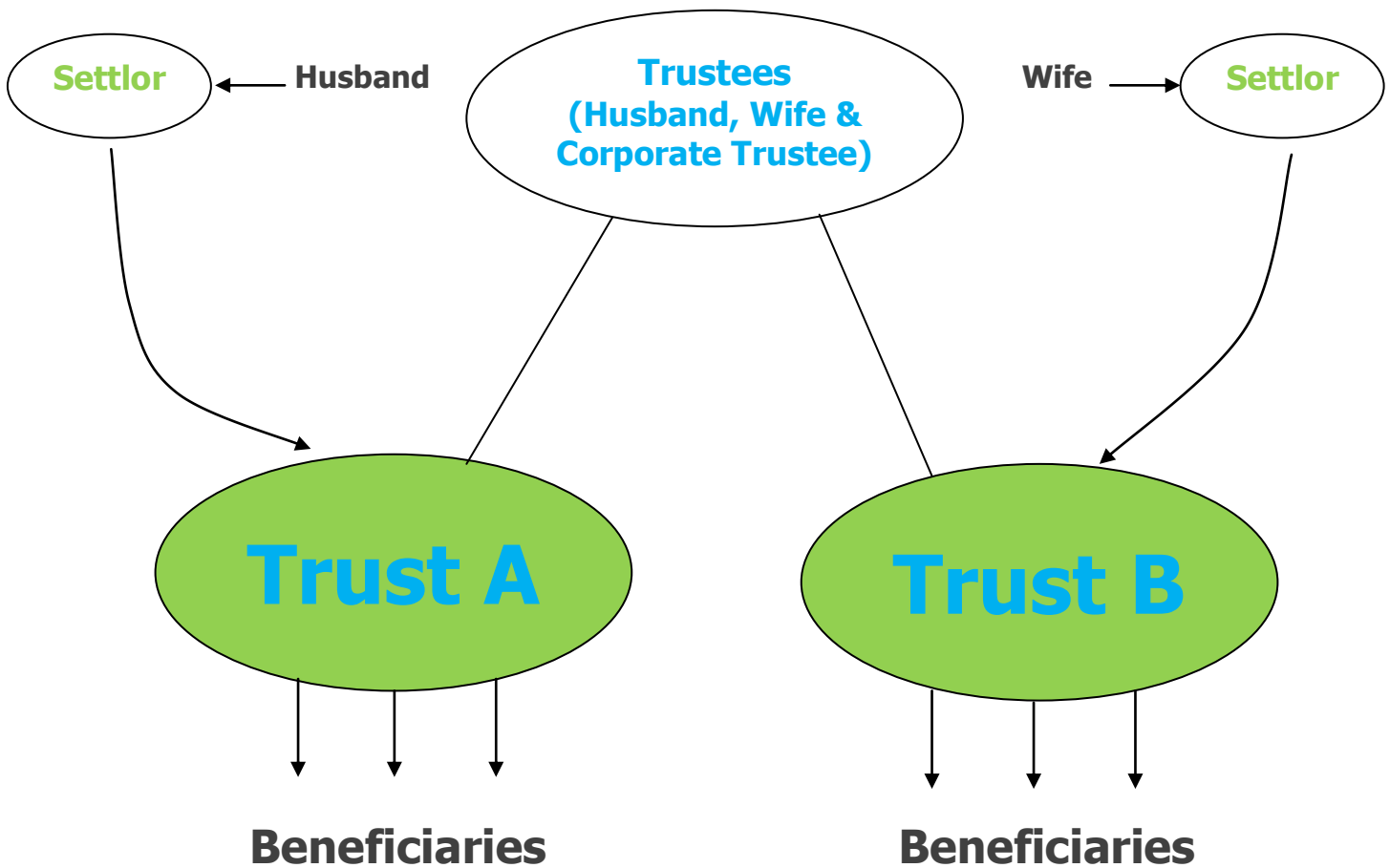
- (a) The establishment of objectives in order to meet the perceived needs of the fund (here the factors set out in Section 13E of the Trustee Act will be relevant, although they may not be the only factors that the Trustees of the particular fund need to take into account).
- (b) The development of an investment strategy in order to meet the perceived needs of the Fund.
- (c) The monitoring of the performance of the particular investments chosen, in order to establish whether the needs of the Fund are being met (and, if necessary, the taking of remedial steps if those needs are not in fact being met, including re-examination of the investment strategy and its implementation).

Example of Single Trust Structure "A"



**** Power to appoint Trustees – Husband and Wife**

Example of Parallel Trust Structure "B"



**** Power to appoint Trustees – Husband and Wife**

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