

# **FAMILY TRUSTS**

**- INFORMATION ON SETTING UP A FAMILY TRUST -**

**WebbFarry** Lawyers

[www.webbfarry.co.nz](http://www.webbfarry.co.nz)

## CONTENTS

1. What is a Trust?
2. How is property transferred into the ownership of a Trust?
3. What can the setting up of a Trust achieve?
4. Are there any disadvantages in setting up a Trust?
5. What is involved in setting up a Trust?
6. What are the ongoing requirements for the operation of a Trust?

**Note:**

All information in this Memorandum is accurate to the best of Webb Farry's knowledge. No liability is assumed however for any losses suffered by any person relying directly or indirectly on this memorandum, which is intended to give information of an introductory and general nature only. It is recommended that you consult a legal representative of Webb Farry before acting upon the information in this memorandum.

## 1 WHAT IS A TRUST?

A Trust is an arrangement in which property ownership is transferred into the care of Trustees who hold the property for the benefit of one or more people.

A Trust is a **separate legal entity** which has a life of its own.

A Trust has three participants:

**The Settlor** - the people or person who initially transfer property into a Trust in order to create the Trust.

**The Trustees** - the Trustees of a Trust hold the property of the Trust and are responsible for dealing with that property in accordance with the Trust Deed. It does not matter legally who the Trustees are, so long as they have the legal capacity to act as Trustees. It is most common however for the Trustees to be the people wishing to set up the Trust quite often together with an independent third party such as a solicitor, accountant or close family member.

**The Beneficiaries** - these are the people who are entitled to receive a benefit under the Trust. The beneficiaries will normally comprise the people establishing the trust as well as their children and other descendants. Depending on circumstances, other family members, relatives, life long friends and charities may also be included. It is important to note that apart from charities you can not provide for non-related or corporate beneficiaries (eg business colleagues or companies) without significant taxation and gift duty consequences.

A Trust of the type being referred to is created by a document called a Trust Deed. The Trust Deed identifies the Settlor, Trustees and Beneficiaries, sets out the powers of the Trustees and generally lays down the ground rules for the Trust. A Trust may well exist for a long period of time and thus it is vital that the Trust Deed is thoroughly prepared, so that it is specific in its provisions yet flexible enough to cover changing situations.

Most Trusts commonly being used today are called **discretionary trusts**. This term is used to describe the Trust because although the Trust Deed will nominate a number of beneficiaries, the Trustees have a discretion as to which of the named beneficiaries will receive a benefit under the Trust. The Trustees not only have a discretion as to which of the named beneficiaries benefit however, but also as to when any distributions are made from the Trust.

The maximum period that a Trust usually exists for is 80 years due to a legal requirement called the Perpetuities Rule.

## 2 HOW IS PROPERTY TRANSFERRED INTO THE OWNERSHIP OF A TRUST?

The execution of a Trust Deed and the resulting creation of a Trust does not achieve anything on its own. To have any impact a Trust has to obtain assets which it then deals with pursuant to the terms of the Trust Deed. A common example of the way this occurs is where a couple form a Family Trust and then transfer to the Trust assets such as their family home, investment property, holiday home, shares or investments.

Overall, because a Trust has no assets or income when it is formed it has to acquire the assets from the people or person who form the Trust. This is normally done by way of a sale and purchase at current market value, which is vital if the people transferring assets to the Trust are to avoid any gift duty assessment. In other words it is not possible to immediately load a Trust up with all of a person's assets without that person incurring very substantial gift

duty. Rather what typically happens is the assets are transferred at current market value but because the Trust has no funds there is a debt left owing by the Trust to the original owners, equivalent to the sale price. That debt is then usually gifted off over a period of time at a rate which avoids any gift duty assessment (currently an individual can gift \$27,000.00 in any 12 month period without incurring gift duty). In that way the individuals over time completely divest themselves of the ownership of the assets, and also the debts, which at the start directly represent the value of the assets transferred.

As noted currently every person can gift up to \$27,000.00 free of gift duty in any 12 month period. A couple can therefore currently gift \$54,000.00 per annum.

### 3 WHAT CAN THE SETTING UP OF A TRUST ACHIEVE?

Under discretionary Trusts the property is legally owned by the Trustees, but because they are Trustees for other beneficiaries, the Trust property does not provide a benefit to the Trustees in their own right. Because the beneficiaries are discretionary beneficiaries, they do not have any rights of ownership in the Trust property prior to the final termination date, except to the extent that it may be specifically vested in them by virtue of decisions made by the Trustees. Therefore the Trust property is held in a state of limbo with the result that it does not form part of the estate or assets of any person.

This means that assets held by a Family Trust will normally be protected from a wide range of risks that an individual faces. Examples of these are as follows:

#### **Creditors**

When people decide to embark on a business venture they normally allocate money towards that venture and in doing so they recognise that there is a calculated risk in that if the venture fails the money that they have put into it is at risk.

Unfortunately sometimes business failures expose other assets to risk which an individual does not wish to have exposed. For example the family home, personal savings, investments and superannuation. By having some or all of these assets held in a Family Trust they will not be lost if a business venture fails or if there is a claim against the individual due to something like a guarantee that an individual has entered into for bank borrowing or the personal guarantee of a lease.

The use of a Trust in these circumstances allows an individual to separate domestic or private assets (that the individual does not want to place at risk), from business assets which an individual will recognise as being part and parcel of the business venture and therefore exposed to risk.

#### **Asset Testing (Rest Home Subsidies)**

A number of people are using Trusts as a defence against asset testing. A government subsidy (Residential Care Subsidy) is available to people over the age of 65 years who require long term Rest Home care. Eligibility for the subsidy is asset tested. Assets held in a Trust which has been set up properly are not currently taken into account when applying for a Residential Care Subsidy, **with one extremely important exception**. Presently any gifts made within five years of a subsidy application (e.g. those reducing debts owed by Family Trusts) can be "CLAWED BACK" into a person's asset pool for the purposes of the asset test. It is for this reason that it is possible to leave the setting up of a Family Trust too late as regards its usefulness for limiting the effect of asset testing.

Obviously with annual Rest Home charges of approximately \$30,000.00 or more it does not take long for a hard earned nest egg to be dissipated. Clearly then a properly set up and well planned family Trust can provide an effective protection for this nest egg.

It must be stressed that there is a high rate of legislative change in this area and it is therefore not possible to guarantee that the use of a Trust is always going to provide effective protection in this area.

### **Income Tax**

In the past marginal tax rates ranged between 15% and 66%. The ability to split income by transferring income producing assets to a Trust was extremely attractive and was a common technique for minimising tax. The incentive to use Trusts in this way reduced when the tax scale was flattened to rates between 24% and 33%. However more recent tax changes which have again widened the scale to rates generally between 21% and 38% mean that there is once more a significant advantage in using a Trust as an income splitting device. This is achieved by the Trust annually distributing the income it receives to various beneficiaries. Those beneficiaries (rather than the Trust) are then liable to pay the tax on the income. Of course the individual beneficiaries may be on a lower tax rate than the original settlor would have been if he/she had received the income him/herself, and thus overall income tax liability on the income is reduced. If income is left in the Trust, it will be taxed at a flat rate of 33%. This in itself is lower than the highest personal tax rate of 38%.

### **Estate Planning**

The use of Trusts for estate planning is probably one of the less obvious but most significant benefits of a Family Trust. People often overlook the fact that when they die a Trust is created. Under a Will property is left to Trustees to distribute to the beneficiaries named in the Will. Use of a Family Trust can bring this process forward so that it occurs during a person's lifetime rather than after their death when, for obvious reasons, they have little control over what is happening.

Use of a Family Trust can ensure that a person is able to see to the orderly transfer of their wealth to the next generation during their lifetime, while at the same time still exercising some control over the asset through the Trust. In this way a person can significantly limit the potential for claims against their estate under the Family Protection Act and Relationship Property Act.

### **Relationship Property**

With the introduction of the Relationship Property Act a Family Trust can provide a vehicle for arranging domestic affairs. Under this legislation rules that previously related to marriages now extend to de facto, including same sex, relationships.

The theory behind using Family Trusts as a way to at least partially solve relationship property issues is based on the premise that the assets owned by the Trust are not personal, and therefore do not form part of relationship property in the event the relationship fails.

For single people, assets that could potentially become relationship property can be transferred into a Trust prior to a relationship. It is important to note that timing is essential. Assets that have been used as part of a relationship that exists for over three years are likely to be split if the relationship ends. Overall this is a complex legal area and specific legal advice regarding your relationship property should always be sought.

## **Superannuation Surcharge**

Although not currently in place, it is possible that some form of asset/income testing for National Superannuation eligibility could be reintroduced at any time. By having assets owned by a family trust (which results in the income off those assets also being paid to the family trust) in advance of any such test being applied, protection is gained against "savings taxes" such as the surcharge. Funds can still be obtained from the Trust however, by way of capital distributions which do not affect any income test.

### **4 ARE THERE ANY DISADVANTAGES IN SETTING UP A TRUST?**

It is important to realise that a Trust is a separate legal entity. Once you transfer property to a Trust it no longer belongs to you. This is the reason that it has the advantages that have already been outlined. Because the property no longer belongs to you there are new and important considerations to take into account when dealing with the property. Although you can be a beneficiary/Trustee and thereby exercise substantial "de facto" control over the assets, you have a "fiduciary duty" to consider the requirements of all the Trust beneficiaries in dealings with the Trust property. Making sure that the duties are met is essential to the Trust being able to stand up to any form of legal challenge.

Obviously there are costs involved with the creation of a Family Trust and the transferring of assets to it. These costs will vary depending on the type and amount of assets being transferred. We are very happy to discuss cost estimates for specific situations but generally it is important to understand that for a Trust to be prepared and set up properly it needs to be done thoroughly. Corners can not be cut for cost reasons.

### **5 WHAT IS INVOLVED IN SETTING UP A TRUST?**

Essentially anyone thinking about setting up a Trust should seek professional advice. Usually these advisors will be a person's solicitor, accountant and where appropriate financial planner. Each of these advisors have special areas of expertise and their involvement will ensure that your objectives are met.

### **6 WHAT ARE THE ONGOING REQUIREMENTS FOR THE OPERATION OF A TRUST?**

Once a Trust is established it must be operated correctly otherwise the benefits could be lost. You cannot simply set up a Trust, transfer some property into it and then forget about it, keep no records and simply treat the property as if it was still your own. Proper records must be kept about all transactions and the administration of the Trust. Remember on all occasions that the Trust is a separate legal entity.

The Trust may require its own IRD number and where appropriate (depending on the level of taxable activity the Trust carries out) a GST number. Decisions made by the Trustees should be properly documented and a minute book maintained. Separate bank accounts may need to be established and a separate set of overall accounting records for the Trust should also be considered.

In most cases where the Trust is used to hold non-trading assets such as property or investments the record keeping will be relatively simple.

## **The Services Webb Farry Offers**

At Webb Farry we have taken care to keep up to date with current practical and legal considerations which need to be taken into account when looking at the possibility of setting up a Family Trust. Because of our experience in setting up Trusts for many different people

in many different situations we are able to make sure all arrangements are tailor made to suit our clients' individual circumstances.

Webb Farry is able to give professional advice in relation to all aspects of Trust administration and asset protection.