Introduction

What is a trust?

A trust is the legal relationship created when a person (the "settlor") places assets under the control of a person (the "trustee") for the benefit of some other person or people (the "beneficiaries") or for a specified purpose.

The assets transferred to the trustees become their property, but they hold the assets on trust for the beneficiaries. The trustees are therefore the nominal owners of the property, but they have a legal obligation to deal with the property in the manner set out in the trust deed.

Often there is more than one trustee. There may also be more than one settlor of a trust.

"Fixed" and "discretionary" trusts

- **Fixed (or non-discretionary) trusts** - With this type of trust, the number of beneficiaries and their relative shares are fixed at the outset. For example, a trust might be established for a handicapped child to ensure that the child will be properly cared for if the parents or guardians die.
- **Discretionary trusts** - Here, the trust deed gives the trustees a discretion about matters such as who may be a beneficiary and what each beneficiary's share will be. Discretionary trusts are more common than fixed trusts; nowadays, most family trusts are discretionary.

Note that a particular trust deed might create both a fixed trust and a discretionary trust.

Getting proper legal advice

Trusts have become an increasingly popular way of structuring one's affairs. It is important for those intending to use a trust to be clear on the legal relationships and obligations involved.

You should obtain legal advice before setting up a trust. Your lawyer or other trust professional will assist you with, in particular, drawing up the principal document creating the trust, which is called the "trust deed".

The Essential Requirements of a Trust

Introduction

A trust must have the following essential elements:

- a settlor (the person who creates the trust)
- the assets to put into the trust
- a trust deed (the legal document setting up the trust)
- one or more trustees (those in charge of administering the trust)
- beneficiaries

The law requires that the settlor must intend to create a trust in order for a trust to exist. Therefore a valid trust cannot come into being by accident.

The settlor

The settlor creates the trust. The settlor must be an adult (20 or over) and be of sound mind. The settlor may be a company or even another trust.

There can be more than one settlor of a trust.

Anyone who subsequently gives the trust some assets or benefit will also be a settlor for NZ income tax purposes.

Trustees

Any person who can own property may be a trustee. A minor (someone under 20) can be a trustee, but a court would have to appoint someone to act as trustee until the minor turns 20.

Usually an independent trustee is included as one of the trustees, and this will often be the settlor's lawyer or accountant. Having an independent trustee helps avoid any suggestion that the settlor continues to have control of the trust assets, in which case Inland Revenue may argue that the trust is a "sham" and therefore invalid.

Trustees have a duty to acquaint themselves with the terms of the trust deed, and also with who the possible beneficiaries may be and what the assets and liabilities of the trust are.

Trustee decisions must be unanimous, unless the trust deed allows for majority decisions. Trustees must ensure that proper records are kept of their decisions. Trustees may not delegate their duties or powers to others unless the trust deed allows this.

Trustees may be paid for their services only if the trust deed specifically provides for this.

A trustee will not be liable for any losses suffered by the trust if he or she acts prudently and considers the interests of all beneficiaries (discretionary or otherwise). However a trustee can be liable for losses caused by any act of other trustees in relation to trust property, even though they were not aware of that act. This is one reason that many settlors decide to utilise a corporate trustee, which is simply a company whose only purpose is to act as a trustee. Corporate trustee companies are recommended to have a constitution with clauses specific to this role.

For more information about trustees and their duties, see the document “How to be a trustee”.

The beneficiaries

These are the people who benefit under the trust. Under a discretionary family trust, the beneficiaries are usually the immediate and extended family.

If the trustees breach their duties, this is called a "breach of trust". Only the beneficiaries have a right to bring an action in the courts against the trustees for a breach of trust. See How to be a trustee for information on the duties of trustees.

The trust deed: What should be included in it?

The trust deed (the legal document that sets up the trust) should deal with the following matters:

- the nature and purpose of the trust
- identifying the parties involved
- the duties and powers of the trustees
- the requirements for decision-making by the trustees (including any delegation of decisions)
- the trustees' powers to invest trust assets
- how the trust's bank account is to be operated
- the recording of minutes

Reasons for Forming a Trust

Protection from creditors

Transferring your assets to a trust can be a useful way of protecting these assets from creditors - particularly for professional people whose personal and family assets could be placed at risk through professional liability over which they have little or no control.

For example, if you had personally guaranteed a bank loan or the lease of the business premises, a claim could be made against you personally. In that case, all of your personal assets would be available to the person claiming against you. But if your personal assets had been transferred to a trust, these assets may be protected.

But to be protected, the transfer of the assets to the trust must not be seen to have been carried out to defeat creditors. These gifts to the trust can be challenged if they are made within two years of bankruptcy and claimed back by the Official Assignee under the INSOLVENCY ACT 1967.

The PROPERTY LAW ACT 1952 also allows creditors to apply for a transfer of property to be declared invalid if it was transferred with the intention of defrauding creditors. The transfer could certainly be set aside if it could be proved that when you set up the trust you were insolvent or a creditor was pursuing a major claim against you.

Claims by family members or others

If your assets are transferred into a trust during your lifetime, those assets will not be subject to claims after your death from family members or others whom you do not wish to share in those assets.

Claims of this kind can be made under the FAMILY PROTECTION ACT 1955 and the LAW REFORM (TESTAMENTARY PROMISES) ACT 1949: see How to contest a will.

Matrimonial/Relationship property

If you transfer your assets into a family trust when you enter into a marriage or de facto relationship, this may prevent these assets being classified as "relationship property" should you later split up, and therefore from being subject to the equal-sharing rules contained in the Property (Relationships) Act 1976. This Act sets up a presumption that all relationship property will be split equally between you if you split up. If the assets are first transferred to a family trust, then your spouse or partner would not be able to claim a share of those assets.

A different but related situation can occur with your children. If you have gifted assets to a child who later separates from a spouse or partner, half of that child's assets may be taken by the ex-spouse or ex-partner. But if those assets were held by a family trust for the benefit of that child, rather than being held by him or her directly, those assets may be protected.

Income tax

There may be incidental tax advantages in respect of income-earning assets being held by a trust. The income earned by a trust is taxed at 33%. This is the higher than the rate imposed on companies (currently 28%) and the same as the current highest marginal rate for individuals (33%). The trust income can however be allocated to beneficiaries who may earn little or no other income, and may therefore be liable to pay tax at a rate lower than the 33% trust rate.

But if the Commissioner of Inland Revenue believes that the only reason for creating the trust was tax avoidance, then the Commissioner has power under the Income Tax Act 1994 to declare the trust arrangements invalid and levy income tax as if the trust never existed.

Asset-testing by the government

One of the longer term advantages of a trust is that the capital funds of the trust may be exempt from assessments for rest home subsidies or other government benefits:

- **Rest home subsidies ("Residential Care Subsidy")** - Gifting assets to a trust may assist you to qualify for this subsidy. For more information on how gifting to trusts or directly to family members can achieve this, see How to apply for a rest home subsidy (Residential Care Subsidy) and How to set up a family trust.
- **The NZ Superannuation Surcharge** has now been abolished, but some other form of means test may well be applied in the future. Transferring income-earning assets to a trust can reduce your income, and previously this avoided or reduced the surcharge liability. A trust arrangement would almost certainly confer the same benefits if a future means test is imposed. The value of income-earning assets given to the trust would be owed by the trustees to you, the settlor, and that debt could be repaid by the trustees; as repayments, they would be capital and therefore be tax free.

You should be aware, however, that the relevant government agencies are entitled to review gifts or other transactions that were intended to deprive a person of income and assets in order to qualify for a benefit. It's therefore important that the trust be set up for other valid reasons (such as benefiting family members) and that those reasons are documented.

How Settlors Can Maintain Some Control Over Trust Assets

Introduction

Two questions commonly asked by those considering a trust arrangement are:

- Is it possible for the trustees to deal with the trust's assets in a way that I, the settlor, would not have approved of?
- Is it possible for me, the settlor, to lose control of the assets?

The answer to both of these questions is "Yes".

For example, a trust places "fiduciary" obligations on trustees, which means that the trustees have a duty to act in the best interests of the beneficiaries at all times (see How to be a trustee). This could mean that in the future the trustees may find it necessary to make decisions that were different from what you as settlor originally had in mind. But certain conditions may be able to be included in the trust deed to address this problem: see below, "'Protector' clauses".

Much will depend on how well the trust deed is drafted. For this reason you must seek expert legal advice in creating your trust. A proper trust deed should be a lengthy, carefully calculated document containing detailed provisions as to the trustees' powers and responsibilities and also setting up suitable mechanisms to protect the assets from being used inappropriately.

Appointment of the settlor as one of the trustees

One of the most obvious ways for making sure that the trustees operate the trust according to your wishes is to make sure that you, the settlor, are one of the trustees.

"Protector" clauses

Another method is one of a variety of "protector" clauses. These clauses could reserve the right to you and your spouse to hire and fire trustees, or to limit in certain ways what the trustees can do. For example, a protector clause could require the trustees to obtain your approval before dealing with any trust assets worth more than $1,000.

Amending and re-settling the trust

Finally, to allow for changes to the law or for the settlor wanting to create further terms for the trust, most modern trusts now have amendment clauses, which permit limited alterations to the trust deed in some cases, and "re-settlement" clauses, which allow that, if necessary, the trust assets can be re-settled onto a new trust with different provisions or beneficiaries.

Family Trusts

What is a family trust?

A family trust is a specific type of trust, and the same considerations that apply to trusts in general apply to family trusts. The beneficiaries of a family trust are usually spouses, children and grandchildren.

You will need to decide the assets to be put into the trust, and to place a value on them. The ownership of the assets is then transferred to the trust and the trust incurs a debt to you, the settlor. This debt can then later be "forgiven".

For more information, see How to set up a family trust.

How do I set up a family trust?

A family trust arrangement might typically work like this:

- The settlor makes an opening cash gift.
- The settlor sells assets to the trust, with the trust incurring a debt to the settlor for the purchase price.
- The settlor forgives this debt in stages under a "gifting programme".
- The trust assets (for example, the family home) are leased to the settlor, who pays rent for them to the trust.

This process is explained in detail in How to set up a family trust.

Cautionary notes

- It is essential to obtain legal and accounting advice before setting up a trust. Your advisers can tell you whether a trust is the most effective way of structuring your affairs; if it is, they can assist you in creating the trust.
- You should not put forward as reasons for establishing the trust that you wish to defeat tax and estate duties, because the trust could then be set aside by the courts.