

# FAMILY TRUSTS

## A BRIEF OUTLINE

The following is a brief explanation of family trusts. It is intended as an overview only. Before establishing a trust it is essential to seek appropriate professional advice.

### INTRODUCTION

Family trusts are now reasonably common vehicles used for acquiring and holding assets. Most trusts are now discretionary trusts. This means that the property of the trust is held by the trustees for a group of beneficiaries, but prior to the final termination of the trust the beneficiaries are only entitled to such benefits from the trust as the trustees in their discretion decide to confer (within the terms of the Trust Deed).

A family trust is established by drawing up and executing a Trust Deed. There are three parties involved:

1. A Settlor - that is the person establishing the trust by settling an asset on it.
2. Trustees - the people who hold the ownership of the asset and look after it for the beneficiaries.
3. Beneficiaries - the people who will benefit from the trust. They can benefit by being recipients of payments from the trust during the term of the trust and/or by becoming entitled to the assets of the trust when it terminates.

The following quote is worth remembering –

*“A man cannot eat his cake and have it ... If a man disposes of his property for another’s benefit, certain tax results may follow; but the results cannot be achieved unless the disposition is in the first place effected not as a fiction but as a fact.”*

(Potter and Monroe Tax Planning 1954)

### WHY HAVE A TRUST?

#### Asset Protection

On transfer to the trust the asset is no longer the settlors – it is held by the trustees on behalf of the beneficiaries. Because the beneficiaries of a trust are discretionary beneficiaries they do not have any right 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 does not form part of the estate or assets of any person. This gives protection for the assets.

### ***- Protection from Creditors***

It is therefore very common for business and professional people to have a family trust holding some of their assets, especially their family home. If something goes wrong with their business the assets held in the trust do not form part of the business person's assets to which the business creditors have access.

### ***- Protection from Spouses/Former Spouses***

People who have separated or divorced often use trusts as a means of protecting assets from claims by the former spouse. Also, people can place their assets in trust before marrying so as to protect these assets in the event of a marriage failure.

### ***- Protection from the Government***

Government benefits such as rest home subsidies are asset tested, not just income tested. Many people have used family trusts to reduce personal assets and so continue to get subsidies for rest home care.

To qualify for a rest home subsidy an individual is able to have assets totalling \$15,000 including the family home. The individual is expected to use the proceeds from the sale of their assets before they can get any subsidy from the Government for the cost of rest home care. Not only does this result in a perceived loss of financial independence for the elderly person, but they often wish to have something left to pass on to their children and grandchildren. Disposing of their assets to a family trust can enable them to do this.

Trusts were also often used to enable assets to be passed down to family on death instead of being paid to the Government as estate duty, when there was an estate duty imposed. Estate duty has now been removed from the statute books, but some people believe it may be reimposed and consider a trust for this reason.

### ***- Asset Protection for Future Generations***

Trusts can also allow assets to be passed down from generation to generation, perhaps also allowing for protection against matrimonial claims following the break up of children's marriages. For example, a farmer may sell his farm land to his family trust for the benefit of his child and his child's children. In the event of his child's marriage breaking up the spouse of the child would have no claim to the farm land as it was never matrimonial property.

Parents with spendthrift children may also use trusts so that they can control what is given to the children rather than letting them have the asset ownership outright. A trust could also be used to ensure that an asset is passed down through generations, rather than being sold.

## **Taxation Advantages**

A trust can give tax advantages. However, the tax advantage can never be the reason for forming the trust, or the trust could be attacked by the Commissioner of Inland Revenue under the anti-avoidance provisions of the Income Tax Act. It must also be remembered that tax law is constantly changing and tax benefits which apply now to trusts may not apply after legislative changes.

A trust itself currently suffers tax at 33c on income earned, however a trust can be used as a means of income splitting, to get income earned taxed at the lower marginal tax rate of the beneficiaries.

From the 2002 income year 'minor beneficiary rules' apply to many family trusts. These rules restrict the income splitting benefits where distributions are made to beneficiaries who are under the age of 16 on the balance date of the trust. Where these rules apply, the trustees are required to pay income tax on the beneficiary income of children under the age of 16 at the trustee tax rate of 33%.

### **Example of Tax Benefit**

A family of four's (husband, wife and two children at university (aged 17 and 19)) only source of income is a business producing taxable income of \$150,000 per annum. If the husband owned the whole business he would pay tax on \$150,000, an amount of \$49,770 for the 2002 tax year. If the business was owned by a trust, with the beneficiaries being all of the four family members, and the income was split evenly amongst the family members, the total tax bill for the 2002 year would be \$29,250 – a saving of \$20,520. This is because advantage is taken of the lower marginal tax rates of the spouse and children (as beneficiaries), that is 19.5%, instead of the 33c and 39c marginal tax rates which would apply if the income was all in the husband's name.

However if in this example the children were under 16 at the balance date of the trust and the trust was subject to the minor beneficiary rules, the total tax bill would be \$39,375. In this scenario the trust would be responsible for paying tax on the amount distributed to the children at 33%. This is still a tax saving of \$10,395 compared to the position when the husband earned all of the income.

The tax rates applying in New Zealand for 2002 are –

<b>Income</b>	<b>Rate of Tax</b>
Not exceeding \$38,000	19.5%
Exceeding \$38,000 and not exceeding \$60,000	33.0%
Exceeding \$60,000	39.0%

It should be noted that you need no justification for distributing income to a beneficiary – it is a trustee's decision and providing the distribution is made appropriately from an administration perspective it will be a valid distribution.

However, it must also be remembered that the income is the beneficiary's – it has been given to them. It need not actually be **paid** to the beneficiaries, if they are minors, but is normally credited (less the tax paid) to the child's current account within the trust. This current account accumulates the money owing to the beneficiary. While the beneficiary is a minor (under 20 years old) he or she has no right to the money sitting in the current account. However, when they reach the age of 20, they have the legal right to demand the money be paid to them.

The money in the current account can be used to pay for certain expenses on behalf of the beneficiary (such as holidays, sports equipment, travel costs and so on) – things which benefit the beneficiary – and this then can avoid a large credit building up in the beneficiary's current account.

## **TRANSFER OF ASSETS TO A TRUST**

Gift duty is imposed in New Zealand on any gift made by an individual donor in excess of \$27,000 per annum. Therefore, usually a settlor sells the assets to a trust and takes a loan back of the value of the assets. Instead of owning the asset, the settlor is now owed the equivalent value by way of a loan to the trust. This loan is then forgiven by the settlor, by gifting an amount of \$27,000 per annum over a period of years.

To fully dispose of this asset from the settlor's estate it is therefore necessary for the settlor to act sooner rather than later in setting up the trust.

## **CONCLUSION**

Family trusts are not complicated and do have their place in many cases. However, anybody considering forming a trust needs to carefully consider what they want and why, and discuss the issues in detail with an experienced lawyer and accountant. It is very important, for the trust to be effective, that everything is both set up appropriately and, once set up, administered appropriately.

For further information on the subject of family trusts we recommend Martin Hawes book "Family Trusts A New Zealand Guide" available at most book stores.

If you wish to discuss any issues regarding trusts, please contact any of our partners –

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