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Fineprint Special

A brave new world for trusts

ABOLITION OF GIFT DUTY FROM 1 OCTOBER OPENS A WORLD OF POSSIBILITIES – OR DOES IT?

For centuries trusts have been used as a means to protect a family's assets against business risk, relationship breakdowns or other possible events. People also use a trust to ring-fence funds for, say, a grandchild's education, to support a family member with a disability or for other similar positive reasons. For over 100 years the way trusts are set up in New Zealand has been constrained by tax law. Abolition of that tax (gift duty) means a re-think of the role of a trust, how a trust is used and what implications there may be for you, your family and also your trust.

Once gift duty ends from 1 October 2011, it will be possible to give away all your assets at once without having to worry about paying gift duty. It may not be necessary to use the traditional gifting programme – giving only $27,000 a year – as no gift duty is payable. For those of you who already have a trust and are steadily gifting $27,000 annually, the question now is, "Why not do all the gifting at once and get it out of the way?"

Before making a snap decision to give everything to a trust immediately or simply give away cash to, say, family members, it is important to think this through a bit more. There are many different reasons for having a trust and each requires a different approach.

GOVERNMENT ASSISTANCE

Benefits, legal aid, student loans, etc

Strict rules apply if you want to apply for a government benefit or assistance such as legal aid, student loans, the unemployment benefit, etc. These rules have been in place for a long time. Assets transferred to a trust can be treated as resources that you should use first before asking for government help.

As the recent *Petricevic*[1] case emphasises, even if you have transferred assets to a trust of which you are not a beneficiary, you may still be denied assistance from the state.

Rest home subsidies

Although gift duty is ending, the rules about the residential care subsidy and what can be given away will not change significantly in the near future. You may gift only $27,000 a year (reducing to $6,000 a year during the five years before you apply for a subsidy). If only one spouse or partner is in care, your combined gifting as a couple must be below those limits.

During the five year gifting period, if too much has been given in one year, the gifts can be averaged over the following years to keep within the prescribed limits. Gifting prior to that five year period cannot be averaged out, but it is sometimes possible to reverse the transfer of assets in order to qualify for a subsidy.

The rules are complex and the Ministry of Social Development has a stringent regime of assessing whether or not you may have 'deprived' yourself of assets prior to a means assessment or income from assets. However, after 1 October, if you attempt to avoid payment of a rest home subsidy by completing a single gift in close proximity to a claim for a rest home subsidy, it's unlikely to be effective.

These rules don't mean trusts are no longer worthwhile. They simply mean it is unwise to use a trust in order to attempt to qualify for government assistance – as it always has been.

If you want to apply for a rest home subsidy and have a trust, please talk with us first as there may be additional issues that should be considered.

TAX MINIMISATION

One major advantage of having a trust was to minimise tax – this is not so easy now. Trusts are taxed at the maximum individual rate (33%) but income distributed to beneficiaries is taxed at their own personal rate. Using a trust for tax efficiency requires careful advice. For income tax purposes it doesn't matter whether you use a traditional gifting programme or transfer all the assets at once.

Last month's Supreme Court decision, *Penny & Hooper v Inland Revenue*[2] (more on this overleaf), emphasises that an artificial arrangement intended mainly to avoid tax can be ignored by the Inland Revenue (IRD) for income tax purposes even if the trust itself is perfectly valid.

RELATIONSHIP PROPERTY

When a couple separates – whether they were married or civil union, de facto or same sex – the basic rule is that they share equally in all 'relationship property'. These are the assets they have built up together during their relationship. There are some exceptions – such as inherited property – and the court has some overriding discretion. In reality, however, it is easy for an inheritance to become relationship property, for example using inherited money to pay off your joint mortgage.

1 *Petricevic v Legal Services Agency* HC Auckland CIV 2011-404-2633 Wylie J 3 June 2011; *R v Petricevic* HC Auckland CRI 208-004-029179 Venning J 12 July 2011

2 *Penny & Hooper v Commissioner of Inland Revenue* [2011] NZSC 95

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One solution is to ensure that any inheritance is kept in a trust separate from relationship property – put your children's inheritance in a trust to avoid claims from a rogue son-in-law or daughter-in-law.

The equal sharing rule does not apply to short duration relationships (usually less than three years). However, transferring your assets to a trust just *before* the three year period ends is not likely to be effective. The relationship property law has claw-back rules which apply if you have given away assets with the intention of defeating a future claim.

Our advice is that you should transfer into a trust as much as you can before a relationship begins. If you are in a relationship, you should consider a 'contracting out agreement'.

Widower John

John is a widower in his early 50s. He hopes to remarry eventually, but also wants to ensure that the property he and his late wife built up together is passed on to their children in due course. He transfers all his property to a trust. As he is not yet in a relationship, he can transfer everything outright on 1 October 2011. He is not intending to defeat the rights of a spouse or partner – he doesn't have one yet. So the claw-back rules in the Property (Relationships) Act 1976 do not apply. Gifting spread over a longer period would be risky because of the claw-back rules. He is better off transferring everything on 1 October.

PROTECTION AGAINST CREDITORS

If you are in business or a senior company manager, a trust can protect your family's assets against possible future creditors. This is not easy because there are laws which allow assets to be clawed back if, for example, your intention is to defeat your creditors.

There is nothing wrong with putting assets in a trust if you do not have any liabilities at the time, or if you retain sufficient assets to meet your potential liabilities. In this situation, it makes sense to put everything into a trust immediately. We recommend talking with your accountant and completing a Solvency Statement which will show the actions you're taking are not designed to defeat the rights of creditors.

You could gift your assets to your family trust but retain enough to cover your liabilities such as a mortgage.

Jane's business

Jane's business is going well but she is concerned that, if anything did go wrong, she and her husband Tom could lose their family home. Before Jane and Tom transfer their property and investments to a trust, they ask their accountant about signing a Solvency Certificate. Their lawyer draws up gifting documents tailored to their circumstances: they 'sell' their property at market value to the trust, treat most of the sale price as a gift, and retain some money owing to them by the trust which is sufficient to cover any liabilities such as their mortgage and business borrowings.

CLAIMS AGAINST ESTATES

In Charles Dickens' *Bleak House* (1853) one of the characters laments, "It is about a Will, and the trusts under a Will – or it was, once. It's about nothing but Costs, now." Disputes over estates can also cause family animosity. A claim can be made against an estate by a spouse, partner, child or grandchild if they believe they have not been fairly provided for. Also claims can be made by anyone who helped out the deceased in reliance on a promise that they would benefit under the deceased's Will.

To help avoid a claim against your estate one solution is to transfer assets to your trust. Anything that is held in trust does not form part of your estate. Until now, the need for a gifting programme has meant that many people still possessed a substantial amount of property when they died, and this could be subject to a claim.

From 1 October, you can give away all your wealth during your lifetime, leaving no estate to be claimed after your death.

WHAT DOES ALL THIS MEAN FOR YOU?

You may already have a gifting programme in place – giving $27,000 a year to your trust every year. Whether you continue with this programme, or complete all of your gifting in one fell swoop after 1 October, will depend on why you established a trust and your personal (and perhaps business) circumstances.

Matters are further complicated because many people have more than one reason for having a trust. The main reason for establishing a trust could have been, for example, to protect your family's assets against a relationship breakdown in a second marriage/relationship situation, or to help fund your grandchildren's education or to provide protection from business risk. These reasons may also provide incidental benefits such as a protection against asset testing for, say, rest home charges.

A gifting programme structured to meet the requirements of a residential care subsidy may mean your assets are vulnerable to a claim by creditors, or a future spouse or partner.

If you have established a trust and have not yet completed gifting, you need to think carefully about whether or not to transfer all your available assets into your family trust/s in early October.

Do get in touch with us so we can go over why you established a trust in the first place and which concerns are the most important to you. We can then advise you on the best path forward for your particular circumstances. ■

Penny & Hooper v Inland Revenue

Two surgeons (Messrs Penny and Hooper) each put their business into a company. Each company was owned by a family trust. In each case the company paid the surgeon a salary far lower than what he was previously earning. Most of their earnings were channeled through their trust. Because this reduced the amount of tax in each case, the IRD invoked the anti-avoidance rule in the Income Tax Act 2007. The Supreme Court agreed with the IRD – the trust and company arrangement is legally valid but the surgeons must pay income tax on what they actually earned, not just the notional salary. The surgeons also had to pay $25,000 towards the IRD's legal costs.

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