

Family Trusts

What is a family trust?

A trust exists when one person (a "trustee") holds and owns property for the benefit of another person (a "beneficiary"). A family trust is a trust set up to benefit members of your family.

The purpose of the family trust is for you to progressively transfer your assets to the trust, so that legally you own no assets yourself, but for you, through the trust, to still have some control over, and get the benefit of, these assets.

You can set up a family trust either while you are still alive (by a declaration of trust contained in a trust deed) or when you die (by the terms of your will). This HowTo sheet is mainly concerned with trusts created while you are alive, and with the benefits that these trusts can provide for you in your lifetime.

What are the key elements of a family trust?

Like any other type of trust, a family trust must have the following elements:

- **The settlor** - This is the person who sets up the trust, and is usually also the person who currently holds the assets that will be transferred to the trust. In other words, this is **you**. There may be more than one settlor: in the case of a family trust, a married couple may both be settlors.
- **The trustees** - The trustees are the people who are responsible for administering the trust. They must make sure that the wishes of the settlor (as set out in the trust deed) are carried out.

You, the settlor, are normally allowed to also be one of the trustees of your trust. Usually the settlor will also appoint an independent trustee, which is often 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.

- **The beneficiaries** - These are the people who may benefit under the trust. With a family trust, the beneficiaries will normally include every member of your family (including possible future family members such as future grandchildren).

These beneficiaries are all "discretionary" beneficiaries, which is a key factor in family trusts. Discretionary beneficiaries (unlike the beneficiaries under a "fixed" trust) have no right to receive any benefit under the trust; instead, the trustees have a power to choose which of these beneficiaries will receive the benefit of any assets. The trustees are free to decide who is the most deserving beneficiary from time to time.

- **The trust deed** - This is the legal document that states the settlor's wishes and sets up the trust. It appoints the trustees and states their powers and duties, states the beneficiaries, and states various rules for the administration and management of the trust. In order for the deed to be clear and to meet certain tax requirements, it must generally be a lengthy and carefully drafted document.

- **The trust's assets** - The trust must have some assets. When the trust is first set up, these assets will usually only be nominal – say \$10. But the eventual aim is for the trust to hold all of your significant assets.

The goal of a family trust: Your "personal poverty"

The goal of setting up a family trust is to transfer your significant assets from personal ownership to ownership by the trust – in other words, to achieve "personal poverty" while becoming a beneficiary of the trust yourself.

By doing this, you may succeed in protecting your assets from threats from various directions, such as claims by business creditors, or claims by ex-spouses or partners under the PROPERTY (RELATIONSHIPS) ACT 1976.

The costs of maintaining a trust

There are likely to be overheads in maintaining a trust. If the trust holds income-earning assets, the trustees must maintain annual accounts and annual tax returns and comply with any other requirements imposed by the Inland Revenue Department. It is therefore important to establish, before you set up a trust, that the benefits of the trust will outweigh the costs.

Transferring Your Assets to the Trust

What assets can or should be transferred to the trust?

Almost any assets can be held by the trust, including real estate, motor vehicles, valuable artwork, household items such as furniture, and company shares.

You should usually consider transferring **appreciating** assets into the trust before **depreciating** assets (such as motor vehicles). But this depends on your age, how you intend the trust to be used, and your personal circumstances. You should get expert advice on this.

The steps for transferring your assets to a family trust

Once the trust has been formed, the steps involved in transferring assets to the trust are as follows.

- **Choose the asset to be transferred to the trust** - This would usually first be the family home. But as explained above, you can also transfer holiday homes, boats, vehicles or paintings – indeed any assets that you personally own.
- **Obtain valid and acceptable valuations for that asset** - Usually you will need to get a market valuation for the house or other asset. In some cases there will be several different methods of determining the market value; it can often be worthwhile to use all the methods available and then take the lowest valuation.

The values should ideally be fixed by an independent valuation - for example, by a Registered Valuer for real estate, by Stock Exchange sale values for equities, and by independent expert valuation of government and other registered stocks and debentures.

- **Transfer the ownership of the assets in exchange for a debt** - Typically you would make an Agreement for Sale and Purchase of the house or other asset to the trust.

The trust must pay you, the seller, the full value of the asset - if the family home is worth \$500,000, the trust must give you a cheque for \$500,000. But usually a family trust will have been set up with only nominal assets (say, \$10), and cannot afford to buy the home. So you the seller will lend the trust \$500,000 as an interest-free loan. This is effectively a paper transaction - the loan and the payment cancel each other out, and so you do not need to borrow any money from your bank.

The debt to you is recorded in, and is secured by, a Deed of Acknowledgement of Debt, made by the trustees.

- **Forgive the debt** - At the end of the previous stage, the asset has passed to the trust, but the trust owes you a debt for an equivalent amount. A debt owed to you by the trust is still a personal asset of yours, so you have not yet succeeded in divesting yourself of significant assets. The solution is to forgive the debt to the trust – this is done in stages over several years, by a "gifting programme", so as not to incur duty on the forgiveness of the debt. Each stage is effected by a Deed of Partial Forgiveness of Debt. This process of forgiving the debt, and why it is necessary to do it by stages, is explained in more detail under the next heading.

Once the debt has been fully forgiven, you have achieved "personal poverty" in relation to that house or other asset. You no longer own it – the trust now owns it. But you can still receive a benefit from it as a beneficiary under the trust.

The "gifting programme": How to forgive the debt to the trust

When you forgive a debt to the trust, this amounts legally to a gift. New Zealand tax laws limit the amount that any one person may gift each year, without incurring gift duty, to \$27,000.

If a married couple transfers assets to a trust, they can each take advantage of the \$27,000 a year limit, and therefore gift a combined \$54,000 a year.

For gifts above \$27,000, gift duty is payable at the following rates:

- \$27,001 to \$36,000 - The gift duty is 5 percent of the excess over \$27,000.
- \$36,001 to \$54,000 - The gift duty is \$450, plus 10 percent of the excess over \$36,000.
- \$54,001 to \$72,000 - The gift duty is \$2,250, plus 20 percent of the excess over \$54,000.
- Over \$72,000 - The gift duty is \$5,850, plus 25 percent of the excess over \$72,000.

If the value of the assets being transferred is more than \$27,000 for each person, the debt incurred by the trust when the assets are transferred to it cannot be forgiven all at once without incurring gift duty. It must therefore instead be forgiven in stages. This process of forgiveness of debt by stages is known as a "gifting programme".

Do I have to notify IRD of any gifts?

Inland Revenue requires you to fill in and send them an IR 196 "Gift Statement" form whenever you make gifts totalling more than \$12,000 in any 12-month period. You will therefore need to send them an IR 196 if you make a Deed of Partial Forgiveness of Debt to a family trust (if the reduction in debt is for more than \$12,000). You should send two copies of the form, along with a copy of the deed of forgiveness. You can get a copy of an IR 196 form from the IRD website at www.ird.govt.nz (under Forms, Books & Newsletters/Duties).

Rest-Home Subsidies & Gifts to Family Trusts

Introduction

People going into long-term rest home care can apply for the Government to pay for their care by way of a Residential Care Subsidy.

The most important requirements for qualifying for this subsidy are that:

- You have no home (unless your spouse or dependent child is still living in your home), and
- You have less than \$150,000 cash in the bank. Current government policy is for this threshold is to be progressively raised to \$200,000 by 2010

The five-year time limit for gifting

When you apply for the Residential Care Subsidy, you must sign a declaration that answers the question, "Have you made any gifts within the previous five years?"

A forgiveness of debt under a family trust arrangement is a gift. This means that the debt owed by the trust must have been completely forgiven more than five years before you apply for the Residential Care Subsidy in order for you to be able to answer "no" to this question.

If you have made any gifts within the previous five years that total more than \$5,000 in any one year, the excess over \$5,000 a year is treated as part of your assets when you apply for the Residential Care Subsidy, even though you no longer in fact have that asset.

You get the benefit of the \$5,000 a year deduction for each year since you made the gift. So if you gifted \$30,000 four years ago, you get the benefit of a \$20,000 deduction (four times \$5,000), so that only \$10,000 of the gift is assessed as part of your current personal assets.

Cautionary notes

It's not enough simply that you form a trust and transfer assets to it. It's essential that the trust is properly administered, that records are kept and that the trust assets are dealt with according to the terms of the trust. Otherwise, the trust could be held to be invalid through investigations by the Inland Revenue Department or some other creditor (including Government departments).

Disclaimer: Information contained in this extract is provided for general guidance only and should not be regarded as professional advice for any specific circumstances.