TRUST e.SPEAKING

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Welcome to the first issue of *Trust e.Speaking*. This newsletter is designed to inform trustees, beneficiaries and others involved with trusts of current issues, changes to trust legislation or any information that will help in the effective administration of trust/s.

If you would like to talk further about any topic in this newsletter or about trusts in general, then please do not hesitate to contact us.

Independent Trustees

- Are they needed?

Trustees' Duties

- Managing investments

Distribution of Income

- 30 September is a key date

Warning: Trustees' resolutions distributing income earned by trust/s in the 2004-2005 financial year must be signed off no later than **Friday, 30 September 2005**. See our article on page 4 for more information on this.

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Independent Trustees - Are they needed?

Several newspaper articles have recently dealt with the issue of independent trustees and, in particular, whether it is necessary for a family trust to have an independent trustee.

Currently in New Zealand there is no legal requirement for a trust to have, as one of its trustees, an independent trustee. However, while there is no absolute requirement, it is often considered desirable that one be appointed. There are several good reasons why the people holding the power to appoint trustees should consider the appointment of an independent trustee.

Independence

The appointment of an independent trustee who receives no benefit from the trust fund, gives to a trust an element of independence, and can help in establishing that a trust is not a 'sham' or 'alter-ego' trust. These sham trusts arise where trust assets have been used and decisions made about those assets as if the assets were still owned and controlled by an individual or a couple, and not by the trustees on behalf of the beneficiaries.

The consequences of a trust being held to be a sham or an alter-ego trust can be calamitous, as a trust can be set aside and/or trust assets deemed to be owned by individuals rather than by the trust precisely at a time when the trust is being relied upon to protect assets.

Expertise and administration

The appointment of an independent trustee can bring specific expertise and experience to a trust, and can also help in the proper administration of the trust. If the trustees include an independent trustee, then it is more likely that trustees' meetings will be held regularly and decisions properly recorded. Effective administration of a trust is likely to help in dealings with the Official Assignee, the Inland Revenue Department and other potential claimants.

Who to appoint?

Who should be considered for the role of independent trustee? Important qualities are an understanding of their duties and responsibilities, and sufficient knowledge of business and investment dealings. The most likely candidates are a relative, friend or a professional person who has knowledge of the trust's legal and/or financial affairs.

If a relative is appointed, then it is important that he or she is not a beneficiary of the trust. In that instance the relative is not an independent trustee. Furthermore the appointment of a trustee who is also a beneficiary may result in a conflict of interest arising.

If the relative is not a beneficiary, then their appointment can be useful when balancing the interests of beneficiaries. The relative/friend should attend an absolute minimum of one formal meeting each year, together with any meetings where trust major decisions are to be made.

In many instances, however, it is preferable to appoint a professional person or a professional trustee company that is more likely to be aware of the duties of a trustee, and who will be objective in dealing with trust affairs.

Trustees' Duties
- Managing investments

Acting as a trustee imposes certain obligations or duties. One of the major duties involves the management of the trust fund. The trust fund is made up of all the assets owned by a trust. Trustees are expected to maintain the trust fund for the benefit of the beneficiaries which, in most instances, requires appropriate and prudent investment decisions.

Duties

The duties of trustees in relation to trust investments are contained in sections 13A to 13Q of the Trustee Act 1956. Section 13A of the Act stipulates that a trustee may invest the trust fund in any property and may vary such investments from time to time. However, section 13B of the Act requires trustees investing in trust property to 'exercise the care, diligence, and skill that a prudent person of business would exercise in managing the affairs of others'.

Section 13E of the Act expands upon this by requiring trustees to have regard to certain criteria 'so far as they are appropriate to the circumstances of the trust'. These criteria include the diversification and the need to maintain real value of trust assets, risk of capital loss, the likely income return, and the marketability of investments, overall value of the trust fund, and the tax consequences and the effect of inflation on proposed investments.

The need to adequately diversify trust investments is of critical importance. For example, a trust fund that was comprised entirely of residential property investments, or of shares, may not meet the diversification requirements as 'all the eggs are in one basket'.

It is possible to reduce the trustees' obligations concerning investment by a specific instruction in the trust deed. Many trust deeds contain these clauses, but they must be carefully examined to ascertain how trust funds are permitted to be invested.

Case histories

Several cases illustrate the dangers of being a trustee in the event that trust funds were not prudently invested, and in particular were not satisfactorily diversified. In *re Mulligan (deceased)* the trust owned a farm property which was sold in 1965 and the sale proceeds were invested for a considerable number of years in bank term deposits during a period of rampant inflation. The result was that the initial investment sum was maintained, however the value of the investment in real terms diminished significantly. The High Court held that the professional trustee of the trust had breached its duty to invest prudently, and in particular had not adequately diversified the trust funds. The trustee was held to be personally liable and significant damages were awarded.

In *Hansen v Young* a substantial portion of the trust fund comprised shares in technology companies in the United States, which dropped in value significantly when the e-com bubble burst in 2000 and 2001. The trustees were once again held to have breached their duties to invest prudently by failing to diversify and once again damages were awarded against the trustees.

Investment decisions

It is essential, therefore, that trustees are aware of the terms of the trust deed, in particular concerning trust investments and, that to the extent that is necessary, they observe the requirements of sections 13A to 13Q of the Trustee Act 1956 when making investments. It is recommended that professional advice is obtained before investment decisions are made; this advice should come from adequately qualified advisers. Following receipt of the advice, trustees should record in detail the investments to be made, and the reasons for making the investment decision. These decisions should then be reviewed at least annually to ensure that the investments continue to be prudent.

Distribution of Income - 30 September is a key date

The Income Tax Act 2004 has particular requirements concerning the treatment of income earned by trusts. This income can be treated by trustees as being either 'beneficiary income' or 'trustees' income'.

Beneficiary income

Most trust deeds allow trustees to distribute income before tax to beneficiaries in amounts or proportions as the trustees of a trust consider appropriate. Tax is then payable at the rate applicable to each of those beneficiaries. In most instances, if a beneficiary is over the age of 15 and earns less than $38,000 pa in total income, then his or her share of the beneficiary income will be subject to income tax of 19.5%. Total income earned by a beneficiary (including trust distributions and all other income) in excess of $38,000 and less than $60,000 will normally be taxed at 33%, and total income of more than $60,000 at 39%.

Trustee income

Alternatively, some or all of the annual income earned by a trust can be treated as trustees' income. For a New Zealand qualifying trust the income tax payable on trustees' net income is 33%.

If trust income is to be treated as beneficiary income, then it must be 'paid or applied' to the beneficiary *during the financial year, or within six months after the end of a financial year.*

For most trusts with a balance date of 31 March this means that the income must be applied by 30 September for the preceding financial year – in other words by 30 September 2005 for the financial year ended 31 March 2005. The income does not necessarily have to be paid to a beneficiary by that date, but it must at least have been 'applied' to him or her by way of a trustees' resolution **that was signed on or before 30 September 2005**.

Our recommendation

If you consider that any income earned by your trust during the year ended 31 March 2005 should be distributed as beneficiary income, then we strongly recommend that a trustees' resolution authorising the distribution to the beneficiary be prepared and signed by all trustees before Friday, 30 September 2005. It is not possible to 'back-date' resolutions declaring income after that date.

It is preferable that the resolution specifies the amount attributed to each beneficiary. If it is not possible to detail the exact amount payable to each beneficiary by 30 September (if, for example, the trust's financial accounts have not been completed) then it is possible to sign a resolution specifying the share of income to be attributed to each beneficiary that is to receive income – this should however be used as a last resort.

If you have any queries, or require any further information concerning the above please contact us urgently.