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Welcome to the Spring issue of *Trust e.Speaking*. We hope you find the articles of interest. 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.

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For most trusts (those with a 31 March balance date) 30 September is the final date for trustees to sign minutes distributing income to beneficiaries.

If you consider that your trust needs to distribute income in respect of the 2005-06 taxation year, then please contact us or your accountant as soon as possible.

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Thinking of Emigrating?

- Take care if you have a trust

Trusts formed in New Zealand are usually designed to take advantage of our relatively liberal trust rules. There are few legal obstacles to a person (the 'settlor') putting assets into a trust and that person being trustee, beneficiary and holding the right to 'hire and fire' trustees (a Power of Appointment).

Many countries are not so lenient. Some will 'look through' a trust where a settlor is a beneficiary, or holds a Power of Appointment, on the basis that the person has not really given away control of the assets.

However there are also traps in our rules where trusts that are given flexible and advantageous tax planning opportunities while the settlors remain in New Zealand ('qualifying trusts'), may become subject to higher rates of tax if they become, inadvertently or not, 'non-qualifying trusts'.

A *qualifying trust* can pay tax at the trustees' rate (33%), or pass income to beneficiaries and pay tax at the beneficiaries' rate (as low as 19.5%). By comparison, a non-qualifying trust is taxed on both its income and capital distributions at 45%.

If both settlors of a family trust leave New Zealand to live overseas, the trust is likely to become a *non-qualifying trust* unless:

- The trust derives only New Zealand sourced income; or
- The trust has at least one New Zealand resident settlor in each income year.

The requirement to derive only New Zealand sourced income is relatively simple, particularly if the only trust asset is a home which is rented out while the family is absent. However, where the trust holds investments which earn income overseas, another option is to have a New Zealand resident settlor. This settlor must not be a nominee for any other person, nor can make a settlement of a nominal amount made at the request of any other person. In that case the Income Tax Act provides that the first person shall be deemed to be the settlor.

Rules in Foreign Countries

Care should be taken to check the rules applying to trusts in the country to which the settlors intend to emigrate, even if it is only temporary residence. Australia, for example, deems tax residency for the trust by the residency of any trustee. Even if only one of the trustees lives in Australia, the trust may be subject to Australian tax, including capital gains tax, on its income and assets in New Zealand or elsewhere. And it is not just a case of resigning as a trustee - if a Power of Appointment is retained, the trust is likely to be subject to Australian rules.

Many other countries have similar (or tougher) rules, which can have expensive consequences.

So what should you do?

Before leaving New Zealand you must get professional advice. You will need to plan appropriately to avoid harsh treatment in New Zealand. Take advice about your new country of residence, preferably before you depart from New Zealand.

Actions for you may be as simple as passing annual resolutions to declare income as beneficiary income, or it may require a variation of the trust or the transfer to you by the trust of some or all of the assets before you leave New Zealand.

If you leave New Zealand without considering the consequences for your trust, you will need to pay tax at the rate which applies. There are no second chances. This may mean paying tax as high as 45% in New Zealand, another 45% again on the distribution of that tax paid income as capital to beneficiaries, and then paying tax again in the country where you are living when you receive that money. Even if the best course for you is to transfer the assets out of the trust before you leave, you can retain the trust with no assets, to be used on your return. If you have a trust and are thinking of moving overseas, please talk with us before you leave.



Trust Resettlements

- What are they, when should they occur and what is the process?

Trust resettlements are commonly used, however they have no formal definition. Generally, a resettlement occurs when the trustees of an existing trust use the powers contained in the trust deed to transfer the trust assets and liabilities to the trustees of another trust, which is often (but not always) a new trust.

Why resettle a trust?

The key reason for a resettlement is to ensure the benefits of asset protection built up over the period of the existing trust are retained in certain circumstances.

The most common circumstances under which trustees may choose to resettle a trust are to :

- * Achieve a division of assets held by a trust between beneficiaries and their families, or to
- * Separate relationship/matrimonial assets in the event of a relationship break-up.

Disadvantages of Resettlement

- * A resettlement constitutes a taxable event as it normally involves the transfer of property to a new taxpayer. The usual tax consequences on the transfer of property such as depreciation recovery and forfeiture of tax losses can be costly.
- * There may be gift duty implications when a resettlement is not made in accordance with the express power of resettlement contained in the trust deed or the power of advancement contained in the Trustee Act 1956. Where the resettlement is not validly made or involves a variation of the beneficial ownership then the resettlement is treated as a separate disposition and potentially subject to gift duty.
- * There are costs involved in a resettlement as additional documentation is needed to create a new trust/s, to record the resettlement agreement/s between the trusts, and to transfer the legal ownership of the assets and liabilities to the new trustees.

The Process of Resettling a Trust

When resettling a trust it is essential that the resettlement is effected. It is important that a careful analysis of the trust deed is undertaken to ensure that it contains an express power of resettlement, and does not contain a prohibition or restriction against a resettlement.

If no express power of resettlement exists then other methods of achieving the same objectives may be used. These range from using powers of variation to powers of advancement.

The trustees must then use their discretion and power to carry out a resettlement for the benefit of one or more of the beneficiaries. When exercising this discretion, the trustees must act in good faith, honestly and with impartiality.

Documentation must identify all the assets and liabilities being transferred, together with the terms on which the trustees of the existing trust transfer, and that the trustees of the new trust accept these assets and liabilities. The formal transfer of ownership of the assets and liabilities to the new trustees is required as the legal ownership of these now vests in the new trustees.

Finally, the decisions of the trustees of each trust to resettle must be recorded in resolutions or minutes of each trust with clear and concise reasons as to why the trustees are exercising the power to resettle.

Summary

A resettlement is an effective tool to retain the benefits of asset protection when transferring the assets of a trust.

If you are contemplating resettling the assets of your trust it is essential to communicate with us and your accountant so the process can be managed cost-effectively and efficiently.



Sham Trusts

- Recent High Court case

A 'sham trust' is a trust that has the appearance of being a true trust but, for various factors, is deemed by the courts when examined to not be a trust at all.

Sham trusts can arise in two ways:

1. A sham trust can be created at the outset, usually by documentation which fails to create a valid trust; or
2. A sham trust can emerge over time, usually through poor administration or decision-making.

The recent High Court case of the *Official Assignee v Wilson*¹ was concerned primarily with investigating whether a trust that had been set up some years earlier was a sham. The High Court eventually concluded that the trust was not a sham trust. However, if the decision had gone the other way, the consequences would have been disastrous, particularly for the beneficiaries of the trust, as the assets of the trust would then have been taken by the Official Assignee and used to satisfy the outstanding debts of a bankrupt.

The trust was established by Mr Reynolds (the 'settlor'). Interestingly, and perhaps crucially, he did not appoint himself as a trustee, but appointed his de facto wife's mother and his lawyer.

Over a period of eight years the trust bought and sold a property in Invercargill, and purchased (and subsequently refinanced) a property in Queenstown. The trust eventually accumulated a reasonable trust fund, particularly due to the increase in value of the Queenstown property.

However in 2001, Mr Reynolds was adjudicated bankrupt and, as he did not have sufficient assets to pay his debts, the Official Assignee issued proceedings against the trustees of the GM Reynolds Family Trust claiming that the trust was either a sham trust from its inception, or subsequently became a sham trust when the settlor and the trustees failed to administer the trust properly. Arguments in support of the Official Assignee's claim included the failure by the trustees to sign resolutions or minutes, the failure of them to prepare annual accounts, and the intermingling of finances between the trust, Mr Reynolds, Ms Clyma (Mr Reynold's de facto wife) and other entities.

The Court's decision

The High Court decided that the trust was not in fact a sham trust. Justice Chisholm acknowledged that there had been significant failures in the administration and management of the trust. His determination that the trust was not a sham trust appears to have been heavily reliant upon the fact that the trustees were two independent people, and did not include either Mr Reynolds, or his de facto wife. One suspects that in the event that Mr Reynolds had been a trustee, there would have been a strong possibility that the trust would have been deemed a sham trust, enabling the Official Assignee to seize control of its assets.

Conclusion

In summary, the case was almost exclusively concerned with determining whether a trust that had been established a number of years earlier was a sham trust or not. Despite the fact that there were serious shortfalls in the management and administration of the trust, the Official Assignee's argument that the trust was a sham was not accepted.

The case does, however, emphasise the importance of maintaining accurate resolutions and minutes, keeping trust funds and personal funds separate and the need to adequately manage the trust affairs separately from others. The critical factor in this case was the appointment of two trustees who were viewed by the High Court as being independent. However, as most trusts established nowadays have trustees who are also settlors, we must emphasise the need for effective record-taking, management and control.

¹ High Court, Dunedin. 12 April 2006