ARE Trusts STILL RELEVANT FOR PROPERTY INVESTORS?

Does the original purpose still hold true?

By Deeanah Winders*

Trusts have been used as a property ownership vehicle since the days of the Crusades. Over the centuries, the legal relationship in which a property owner (settlor) transfers their property (trust assets) to a trust person (trustee) to hold on trust for the benefit of certain people or purposes (beneficiaries) has remained relatively unchanged.

In modern times, trusts have been a popular choice of ownership vehicle for hundreds of thousands of New Zealanders. We rank as one of the highest users of trusts in the world.

A trust's popularity lies in its unique ability to provide settlors with:

- Flexible succession-planning solutions
- Protection against creditor and relationship property attack
- Tax-planning efficacy.

Together with business owners, mums and dads, and those on subsequent relationships, property investors have joined the vast number of New Zealanders in settling trusts to protect their assets and property investments.

Despite their popularity and widespread use, trusts are generally poorly understood. As a consequence, the trust could fail or come under attack. Many settlors fail to appreciate that once a trust is set up they can no longer treat trust assets as if they were the owner. To do so could undermine the integrity of the trust structure, rendering the trust void.

"Trust busting" is a strategy used by claimants attempting to make a claim on assets held in trust. This term was coined in reference to successful attacks made on a trust that had not been well set up and managed.

As a result of the associated trust problems, they have come under attack for their "overuse" and perceived "abuse". These concerns culminated in a review of the law of trusts in New Zealand by the Law Commission. It was recommended that the law of trusts in New Zealand be clarified and that the outdated Trustee Act be reviewed and replaced with a new Trusts Act that sets out the obligations of trustees and the rights of beneficiaries and third parties to trusts.

On 1 August 2017 Amy Adams introduced into Parliament the "Trusts Bill", which aims to:

- Provide a description of the key features of a trust to help people understand their rights and obligations
- List the mandatory and default duties of a trustee (based on established legal principles) to help trustees understand the obligations owed to beneficiaries

- Detail the requirements for managing trust information and disclosing it to beneficiaries (where appropriate) so they are aware of their position
- Provide flexible trustee powers, allowing trustees to manage and invest trust property in the most appropriate way
- Include provisions to support cost-effective establishment and administration of trusts (such as clear rules on the variation and termination of trusts)
- Include options for removing and appointing trustees without having to go to court to do so
- Provide alternative and more cost-effective solutions to resolve disputes.

Trustees are facing a significant amount of change, not just with trust laws, but in relation to taxation of trusts, compliance obligations and the moving goal posts relating to eligibility for Residential Care Subsidies. It is timely for property investors to consider whether the original purpose for which the trust was set up still exists and, if not, what the consequences will be if the trustees take steps to wind up the trust.

It is important to understand that tax losses made by a trust are caught in the trust and, if not utilised before the trust is wound up, will be lost.

Tax benefits obtained through a trust have over recent years become increasingly limited. The “minor beneficiary rule” ended the trustees' ability to stream income to beneficiaries aged 16 and under in order to access lower tax rates. Most recently, the Inland Revenue Department introduced the “bright-line” test, which taxes the profits made by an individual, entity or trust on the sale of residential properties bought and sold within a two-year period. The impact of this tax on long-term, buy-and-hold property investors – who are not in the business of trading or in “flipping” their investments – will be minimal, if not non-existent.

An unexpected tax consequence faced by New Zealand trusts and trustees can arise when settlors and trustees are no longer residing in, nor are a tax resident of, New Zealand. The consequences may include trust distributions being taxed in New Zealand at a rate of 45%, or finding that the sale of a trust property in New Zealand has become subject to Capital Gains Tax in Australia.

Why are compliance obligations and costs increasing?

Since the 9/11 terrorist attack in New York and the global financial crisis, New Zealand has been hit with the introduction of a number of new laws and compliance obligations to provide overseas governments with greater transparency of their citizens' tax and financial arrangements.

FATCA (Foreign Account Tax Compliance Act), CRS (Common Reporting Standards), BEPS (Base Erosion Profit Shifting) and AML/CFT (Anti-Money Laundering and Countering Financing of Terrorism) are some of the laws under which disclosure of information must be made. As a result of the compliance obligations, the costs associated with holding and administering investment properties are increasing.

What about the Residential Care Subsidy (RCS)?

Given the low asset threshold and constantly changing rules surrounding the eligibility criteria for RCS, trusts are no longer the useful tool they once were. Statistics show that only 6% of New Zealanders over the age of 65 require rest home care.

Before making hasty decisions regarding retaining or winding up the trust based on the changes to RCS, first consider the trust’s specific financial position and the existence of any degenerative disease in the settlor’s genetic make up. Although it is becoming increasingly difficult to obtain a subsidy, it is not impossible.

Do you still need a trust?

The purposes for which property investors set up the trust will impact on whether the trust is still relevant. The settlors should meet with the trustees, who should all take into account a variety of considerations, including obtaining legal and accounting advice, before going ahead with winding up the trust if it is deemed to be no longer relevant or beneficial.

For example:

- The original value of the investment and the capital gain earned, if any
- The return on investment
- The trustee’s ability to meet the rising compliance and administration costs to retain a trust
- Gifting position and the tax consequences resulting from winding up the trust
- Whether there is an alternative property ownership structure that provides greater flexibility, less compliance obligations and costs, and tax planning benefits.

Property investors whose purposes may have changed since the trust was initially set up may find a trust to be irrelevant and no longer useful. But for those who have a need to protect the trust assets against attack from creditors, spouses or family members, and who understand the obligations of trustees, the rights and the needs of beneficiaries and are willing to meet the associated costs of governing a well-managed trust, then trusts will still be relevant.

Trusts have been around for centuries and despite the bad press, onerous compliance obligations and reduced tax and government subsidy benefits, they remain a useful property ownership vehicle for those who have a real need for asset protection or succession planning. Provided that the trust is managed effectively, it will continue to be relevant.

***DEEANAH WINDERS**
is a Solicitor and Trust Manager at Harris Tate Ltd.
P +64 07 578 0059 **E** deeanah@harristate.co.nz
W www.harristate.co.nz

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