

# ASSET PLANNING AND TRUST STRUCTURING

“FORGET THE THEORY - JUST TELL ME WHAT TO DO”

*Simon Weil, Partner, Morrison Kent, 2006*

## Introduction

Asset planning and trust structuring is an art and not a science – it is not something that can be learnt overnight but rather, is a skill that develops with practice, time and experience.

Having said that, many practitioners find themselves involved in the practice of trust law to some extent. Some involvement may only be on a ‘time to time basis’ (for example when a client is buying a significant asset such as a home or an interest in a business) while other practitioners may be involved on a more regular basis.

Preparing a trust for a particular transaction is one thing but proactively developing an asset plan for a client is another exercise altogether. While some practitioners will know what to do, the aim of this paper is to explain why certain things are done – or should be done – and to provide a practical guide to the asset planning process.

There is however no right or wrong way to implement an asset plan – indeed, there are likely to be as many methods for implementing a trust structure as there are trust deeds.

Accordingly, this paper does not attempt to cover every contingency that should be taken into account when embarking on an asset planning exercise. Instead, it aims to provide an indication of some of the issues that may need to be considered and some options for dealing with them. Like a schedule to a trust deed setting out trustees’ powers, the examples given in this paper are indicative rather than exhaustive.

In light of those caveats, it would seem that the fundamental issues for embarking on an asset plan must surely be determining whether the client has a need for any such planning and if so, whether they will receive any benefit from the plan that is designed for them. To reach that determination, it would seem there is a process that comprises 4 main steps:

- Knowing your client;
- Identifying the assets;
- Planning considerations;
- The documents.

### 1. **Knowing Your Client**

As trust practitioners, our practice in the field is subject to the fundamental precept that a transfer of assets to a trust with the intention to defeat creditors can be avoided. In order therefore to establish a robust structure that will serve the client’s best interests of withstanding challenge and scrutiny, knowing your client is a critical part of the asset planning process. It is important for 2 reasons.

- Initially, if you don’t know your client’s goals and objectives, you can not begin to design a structure to meet their needs.
- Secondly, it is important for the advisor to protect their position. Given that some international jurisdictions have moved to impose a liability on advisors who assist with the transfer of assets to trusts in less than genuine situations, it is not unforeseeable that similar liability may at some stage hover over practitioners in New Zealand.

It is important therefore to extract from the client as much information as possible including full details of their personal and business lives, their background and their goals and objectives. Initially, that means identifying with the client their motivation for establishing a trust structure, reasons for which may include any one or more of the following primary objectives:

- protecting their assets from the potential of creditor attack
- isolating their core family assets from the potential of business risks
- Protecting core assets against potential claims from future spouses or partners under the Property (Relationships) Act
- planning for retirement
- making long-term provision for their children
- preserving residual assets for the benefit of their children
- protecting any inheritance their children may receive against claims from their potential creditors including estranged partners or spouses.

It is also prudent to remind clients that while additional benefits may sometimes be derived from a trust in relation to means testing for rest home subsidies as well as taxation advantages in circumstances where the trust owns income-producing assets, those benefits must merely be incidental to the primary commercial and family objectives for a trust.

When seeking the information from clients, it needs to be recognised that like computers, an advisor will only be as good as the information received from the client. The challenge therefore to the practitioner is to ask the right questions of the client. Sometimes, that means asking the difficult questions, in particular in respect of the nature and extent of a personal relationship. This is because the nature of the (trust) structure put in place for a client will often depend upon whether the client is:

- Single;
- Single but with a companion (although not a de facto partner);
- In a stable relationship with a de facto partner;
- In an unstable relationship with a de facto partner;
- Married with a stable relationship;
- Married but in an unstable relationship; or
- In a second or subsequent relationship.

The structure to be put in place may also depend upon whether the client:

- Has children of their own from a prior relationship;
- Has children with their current partner; or
- Has a partner who has children from a prior relationship.

Depending on the client's status in respect of those matters, it may be that the (trust) structure proposed for the client may comprise a single trust, a single joint trust or perhaps even a dual trust structure. This will however depend largely upon the clients concerns and objectives.

Because each client will be different, it is necessary to understand and recognise that no one size fits all when implementing an asset plan. Also, the way in which individual circumstances are identified for an existing client will differ from the way in which the information is compiled for a new client.

While getting to know the client is important from the practitioner's perspective, part of the exercise should also include educating the clients in respect of the asset planning process and in particular the claw-back and timing issues that can affect the success of a trust. For example:

- Initially, clients need to be made aware that if there is a transfer of assets out of their name (whether to a trust, a spouse or partner, children, parents, other family members or the like) with the intention of trying to save the asset from a known creditor, it is likely that the transfer will be void and of no effect on the basis that it was transferred with the intention to defeat creditors.
- Indeed, the effect of section 60 of the Property Law Act 1952 is that any transfer of land with the intention to defraud creditors can be set aside by the person prejudiced by the transfer.
- Similarly, section 47 of the Property (Relationships) Act provides that any transfer of relationship property between spouses/partners (apart from usual seasonal gifts) which has the effect of defeating creditors (whether intentionally or not) can be set aside by the Official Assignee up to 2 years after the transfer was made.
- Section 56 of the Insolvency Act 1967 provides that any transfer of property within 2 years of being adjudged bankrupt can be set aside by the Official Assignee.

In light of the foregoing, it is important to establish with the clients that when they transfer assets to a trust, there are;

- no claims, threats or demands against them or any company or business in which they are involved (other than as an employee) of which they are aware or ought to be aware; and
- if they are in a relationship of at least 3 years duration to which the Property (Relationships) Act applies, that the assets they intend transferring to the trust (of which the partner is not on an equal footing), are not relationship property.

Ideally, those matters will be recorded in writing and signed-off by the client. Not only will that serve to establish a strong foundation on which to build the trust but it will also help to protect the practitioner if ever there were any assertions that the practitioner assisted a client to shelter assets.

Perhaps the final aspect of knowing your client that will influence the nature of the structure to be designed for them, is recognising their level of understanding in respect of the asset planning arrangements. The most cleverly designed structure comprising a network of companies and trusts will be to no avail if it is too complicated for the clients to work with. Accordingly, the asset planning structure needs to be simple yet effective in achieving the client's goals and objectives.

## **2. Identifying the Assets**

Having established the client's background, goals and objectives, the next part of the process is to identify the assets to be involved in the asset plan. For the purpose of this paper and indeed any asset planning exercise, the assets to be considered will ideally be assets that appreciate in value rather than assets that will depreciate in value (e.g. chattels).

For the asset planning exercise, assets are probably best categorised as either passive assets (i.e. non-income producing assets) or investment assets (i.e. income producing assets). From there, the assets can be further classified as either risk or non-risk assets. Risk assets can then be further classified in terms of whether the risk exposure is to known or unknown creditors.

Take for example the family home, subject to a home loan secured by mortgage. This is a passive asset subject to a known and manageable risk (i.e. the bank).

Compare that to the same home but where the mortgage secures an unlimited guarantee for a business of which the client is only a 50% shareholder. Although the home is again a passive asset, in this context, the risk exposure is higher than in the first example. Not only is that risk unmanageable in that it is an unlimited liability but also, although the bank is a known creditor, the demands upon the business that may result in the bank calling on the guarantee are unknown.

As another example of asset and risk identification, consider investment assets, for example shares in a family owned business. On general principles, the risk attaching to those shares would be limited as the shareholder trustees would at worst only be required to meet the uncalled capital on the shares. Provided the uncalled capital on the shares is not a significant amount, that exposure is an entirely manageable risk. That position (of limited liability) would not however be the same if the trustees were required to give a shareholder's guarantee.

Consider now the example of an investment rental property. In many cases, these investments are subject to significant debt and are reliant upon a regular rental income to meet the mortgage obligations. While fully tenanted, the risk attaching to that asset is generally manageable in that the risk is limited to any top-up payments required as a result of the negative gearing. But what if the tenant leaves; for how long can the investment be sustained without a tenant before the situation becomes financially risky . . . and what if unbudgeted repairs are required before re-tenanting? Clearly, there is an element of risk.

### **Selecting the assets**

So if the main or one of the main reasons for the asset planning structure is asset protection, then that rationale also needs to be carried through to the selection of assets to be held in trust.

Given the risks to which different assets can be subject, advisors need to be aware that the mingling of passive assets (e.g. such as the family home or bach) with investment assets (such as a rental property or shares in the client's business) can sometimes thwart the asset planning intentions if there is a risk attaching to the assets.

Identifying whether the mingling of passive and investment assets is appropriate or whether it is preferable to hold the assets in separate trusts will depend on the nature and extent of any risks or liabilities attaching to the assets.

For example, in relation to the scenarios described above, it is unlikely there would be any adverse impact from holding a family home subject only to a mortgage securing a home loan in the same trust as a family bach. Indeed, shares in the family owned business could probably also be held in that same trust without compromising the asset protection afforded by the trust.

If however the mortgage over the family home secured an unlimited guarantee for a business, the risk to the home is higher. If that business also has other co-owners, the risk increases even further to the extent that it become unwise to mingle the assets in the same trust. In that case, the family home (subject to the mortgage securing the unlimited guarantee) should ideally be held in one trust while the bach is held in another entirely separate trust.

When it comes to the shares in the family business or perhaps even an investment portfolio, there is the clear expectation that dividend or interest income will be received. That being the case, it will be necessary to obtain an IRD number for the trust and to file annual tax returns for the trust.

There is however a measure of concern from holding such income producing assets in the same trust as passive assets. The potential risk is that if any tax liability is not met, all assets held by the trust - including passive assets such as the family home - could be vulnerable to recourse by the IRD.

It may be recalled that not too long ago, there was a wave of concern as a result of IRD suggestions that a failure to satisfy fully a tax obligation could result in a trust falling outside of the qualifying trust regime. The effect of that could have been exposure to penalty tax at the rate of

45%. While that issue was satisfactorily resolved, it highlights the possible concern of mingling investment assets with passive assets and the potential exposure of passive assets to the IRD.

It demonstrates also the importance of identifying the possible areas of risk to which the assets or the trustees could be exposed. Looking more closely at those possible risks, they would generally include the following:

- Creditors – If the trustees are involved in business, for example as a landlord or if the trustees are party to a contract with a third party e.g. a bank as mortgagee.
- Lenders – If the asset to be transferred to the trust is already subject to a mortgage or other security obligation, then on the transfer of the assets to the trustees, they will likely become subject to that liability. In that case, the lender becomes a potential creditor of the trustees.
  - As part of that loan re-documentation process, consideration should be given as to whether that liability can be restructured to make it more efficient (as addressed later in this paper) and also, whether the liability poses an unacceptable risk to other assets held in trust.
- Product Liability – Provided the trustees have not actively accepted a liability for the products of a business, this should not generally be a concern for trustees.
- Services – Similarly to product liability, on the premise that the trustees do not actively provide services and on the condition that the trustees only exposure is as a shareholder (as opposed to partner) in a business which provides services, then liability for services rendered should generally not be an issue for trustees.
- Employees – The error, omission or malfeasance of an employee should not have direct impact on trustees (apart possible from possibly the return on investment) provided the trustees are not actively involved in business.
- Co-owners – Similarly, the error, omission or malfeasance of a co-owner in a business (e.g. co-shareholder) should not have direct impact on trustees (apart possible from possibly the return on investment) provided the trustees are not actively involved in business.
- Government – if the trustees hold income producing assets, there will always be an exposure to the Inland Revenue Department. The issue is whether to subject non-income producing assets to the vulnerability of potential recourse from the Department. This would be of particular concern if for example an incorrect assessment was levied by the Department.
- Local authorities - upon recording the change of ownership of a property into a trust, it is usual that the local authorities record ownership only in the trustees names. The risk in particular to independent trustees is that the local authorities do not recognise a limitation of liability. While the payment of rates and other such charges is generally a manageable and known risk, the concern to the independent trustee is if any activity is carried out to the property e.g. building activities, that may result in breaches of the Resource Management Act. In such a situation, the local authority would regard each trustee as jointly and severally liable.
- Property (Relationships) Act - The newest and possibly most significant risk to trust assets arises under the Act. The exposure may be as a result of
  - the transfer to a trust of assets which may have been relationship property;
  - the contribution to a trust of relationship property (e.g. the servicing of a mortgage from relationship property i.e. income); or
  - constructive trust issues under the Lankow –v- Rose principles.

- Business activities – depending upon the nature and extent of the clients business activities (e.g. if a builder/developer), there might be tax implications to take into account including:
  - Associated persons – i.e. is there a possibility that because of the relationship between the client and the trust at the time the trustees acquired an asset from the client that the 2 will be treated as associated persons under the Income tax Act?
  - The attribution rules – is there a risk that income derived by the trustees may be subject to the attribution rules?

### 3. Planning Considerations

Having assessed the client's circumstances and having determined that the client's interests would be enhanced by the implementation of an asset plan, the next phase of the asset planning process is to determine the appropriate ownership structure for the assets.

As with most aspects of the asset planning process, this facet of the exercise has different categories – one relating to businesses/investment assets; the other relating to passive assets.

#### **Businesses/Investment Assets**

For most people starting out in business, there is seldom good reason for a person to commence that business, by choice, as a sole trader. Generally, a client's best interests would be served by having their business owned either by a company, a trust, a trading trust or a company/trust combination.

For some businesses, it may be appropriate for the business to be owned by a dual trust structure which sees the business held and operated by a trading trust but with a separate discretionary trust as a beneficiary of the trading trust. That is distinct from the structure of the business being run through a company with the shares held in a trust. While the trading trust option offers perhaps a more immediate access to income and use of marginal tax rates, caution needs to be exercised when considering this option given that trading trusts are not universally well received in all quarters.

That is particularly so in situations of restructuring existing businesses. In that case, care needs to be taken to ensure that compelling commercial or family reasons exist that would justify a restructure of the business.

In respect of investment assets, sometimes the need for tax efficiency outweighs the need for asset protection. A rental property is a good example. In some cases, clients rely on the immediate use of tax losses suffered in respect of the investment property. In that case, an LAQC would likely be more appropriate for the client than a trust. That is because losses incurred by a trust can only be offset against income derived by a trust. Accordingly, if a trust has no income against which to offset the losses, the losses can only be carried forward until there is income against which to apply the losses. In other words, the tax loss is deferred.

If however cashflow is not a critical issue for the client in that they will not be adversely affected by the benefit of any tax losses being deferred, then their best interests, from an asset protection point of view, would be for the property to be held in a trust from the outset.

#### **Other considerations**

Additional factors affecting the asset plan to be designed for a client can include:

- Property subdivision - Is the property or part of the property to be transferred to the trust subject to a proposal for subdivision. If so, the acquisition by the trustees, the completion of the subdivision and then disposal by the trustees of part of the subdivided property could give rise to tax implications.

- Loan structuring - Are the loans structured in the best way e.g. is the business debt-free while the family home is subject to a mortgage? In certain circumstances, loans can be restructured to the effect that some or all of the loans are used for the purposes of acquiring business/investment assets. In that case, the interest payable on the business loan will generally be tax deductible.
  - The benefits to the client of this loan restructuring (if available) should not be underestimated. Not only can it confer tax deductibility but it can also be the impetus that a client requires to commence or promote an investment plan to provide for their future.
- Property (Relationships) Act – the implications of this Act can not be underestimated. It permeates many aspects of the asset planning and trust structuring practice. It is crucial therefore that practitioners develop a sound working knowledge of the Act in order to identify issues, risks and pitfalls.
  - Ideally, if there are potential implications under the Act, the establishment of a trust and the transfer of assets to it will be accompanied by an agreement contracting out of the Act.
- Depreciation Recovery – where consideration is being given to the transfer to a trust of an investment property, it first needs to be identified whether the transfer will trigger a depreciation recovered payment. If cash flow is an issue to the client, the need to write out a cheque to the IRD may not be well received, if it is not planned for.
- Imputation credits/losses - Will the transfer to a trust of shares in a company affect imputation credits or losses?
  - in respect of both depreciation recovery and imputation credits and losses, it is advisable to work with the client's account to get input in respect of those issues as well as ensuring that the plan designed for the client will not cut across or compromise any plans the account has for the client.
- Gift Duty - Are there gifting implications – i.e. does the settlor's age preclude them from receiving any substantial benefit from the trust given the extent of their gifting programme to be completed?
- Life Interests - would a life interest be appropriate? Because we have the benefit of recent articles on this topic, it is not necessary to cover it in depth here. It should be recognized though that the life interest regime has limited application in limited circumstances. For the right client, it can be particularly beneficial but for others, it can do more harm than good. It is not an asset planning tool that suits all people and should therefore only be implemented after careful consideration of the clients circumstances.
- Legal Transfer –v- Equitable Transfer – sometimes, it may be necessary to consider whether it is appropriate to proceed with and register a legal transfer of the property to the trust or whether it is appropriate to proceed with an equitable transfer and to defer registration of the legal transfer to the trust. Circumstances giving rise to the equitable transfer option can include:
  - That clients are intending or in the process of subdividing land they have owned for some time with the intention that part of it will be sold off. In that case, if all of the land is transferred to the trust, the subdivision is completed and a portion of the land is sold, the risk is that the sale proceeds may be subject to tax. In that situation, it is preferable that the client's transfer only the residential portion of the land to the trust and that the proceeds of sale of the land sold following completion of the subdivision be transferred to the trustees subsequently. In that case, the legal transfer of the residential part of the land would not be registered until after the subdivision has been completed.

- In some situations, it may be preferable for the legal transfer of ownership of shares in a company to be deferred and for legal title to the shares to remain in the client's name but subject to a declaration of trust – whether oral or written.
- In some situations where a property is subject to a fixed interest rate mortgage, it may be appropriate to defer registration of the legal transfer of title and re-documentation of the mortgage into the trustees' names until the fixed interest rate expires. This was especially so when lenders were less familiar with the concepts and looked to charge penalty fees for transferring the property to a trust during the fixed interest rate period.

#### 4. The Documents

Assume for the purposes of this paper that it has been determined that the (new) client's circumstances warrant and justify the establishment of a trust and that the assets to be transferred to the trust have been identified (the family home [subject to a mortgage] and the shares in a debt free business wholly owned by the family).

It remains then to document the transfer, a process that is anticipated would include the following documents:

- Client identification and bona fides – while this will generally not be a major issue in relation to an existing client, it should be a matter of focus particularly for a new client.
  - For the new client, obtain a copy of their current drivers licence and 2 accounts addressed to them at their place of residence; and
  - A signed statement from the new client of their assets and liabilities and, if appropriate, the source of any unaccounted for funds. From a practical perspective, this statement could also be combined with terms of trade and an estimate of fees – in effect a retainer contract.
- Waivers of independent advice – where acting for more than one party. In this case, the advisor would be acting for multiple parties.
- The trust deed – it is neither intended nor necessary in this paper to address the requirements and/or drafting techniques for a trust deed. That is a topic which commands its own paper.
- Trustees' Resolution - authorising the intended purchase and loan transactions;
- Company minutes - in respect of the share transfer to the trustees;
- Conveyancing documents in respect of the family home
  - agreement for sale and purchase. The agreement should include:
    - + that the trustees of the xyz trust are the purchaser
    - + the consideration (i.e. current market value)
    - + how the purchase price will be paid
    - + limitation of liability for independent trustee
    - + sliding value clause
    - + mortgagee's consent
    - + declaration of trust if transfer of legal title may be deferred

- + encumbrances (if any) to which the transfer is subject
- memorandum of transfer – recording the names of the trustees as the transferee
- notices of change of ownership - recording the trustees of the xyz trust as the new proprietors
- replacement loan and mortgage documents – ideally in the trustees names; including limitation of liability clause for independent trustee and otherwise in accordance with the lenders instructions.
- Debt documents – this presumes that the purchase price payable by the trustees for the assets will be left as a debt owing by the trustees to the client vendor. Again, there is no intention or requirement in this paper to address the requirements and/or drafting techniques for the debt documents;
- Gift documents – on the basis that the purchase price payable by the trustees for the assets will be left as a debt owing by the trustees to the client vendor, from an asset protection point of view, the client should commence a gifting programme. Again, there is no intention or requirement in this paper to address the requirements and/or drafting techniques for the gift documents;
- Trustees' further Resolution – authorising use by the beneficiaries of the family home now held by the trustees.

In addition to the foregoing transactional documents, the asset plan implemented for the client should include:

- Enduring powers of attorney
  - Enduring powers of attorney, once seen as a requirement for only elderly clients, now seem to be equally as important for younger clients as well. Current examples of younger clients suffering physical accidents or mental breakdowns that render them incapable of managing either property affairs or making decisions about their personal will being, warrant the inclusion of enduring powers of attorney when implementing an asset plan.
  - If a considerable gifting programme lies ahead of a client, it is desirable to craft the enduring power of attorney as to property to include express authority to continue a gifting programme.
- Memorandum of wishes – like trust deeds, the memorandum of wishes is a topic which commands its own paper. Accordingly, there is again no intention or requirement in this paper to address the requirements and/or drafting techniques for a memorandum of wishes;
- A Funnel Will – being a Will which provides for the testator's residual estate to pass to the trust (i.e. all assets not held in trust will be funnelled by the Will through to the Trust).
  - The rationale for the Funnel Will is straightforward – if a testator has gone to the trouble of establishing the trust which will provide for a surviving spouse or partner and thereafter children and grandchildren, it makes little sense in having some assets owned by the trust but other significant assets owned by an estate.
  - On the basis that the surviving spouse/partner or children as the case may be are beneficiaries of the trust, in most cases, their best interests will be served by their inheritance being funnelled through to and being held in trust rather than being received personally under the Will and possibly vulnerable to recourse by business and /or relationship creditors.

- The Funnel Will should make express provision as to how any residual debt owing to the testator by a trust should be dealt with. In most cases, a clause will be included which provides to the effect that the residual debt will be extinguished or forgiven. In some cases though, the residual debt may be used as a mechanism to effect payments to a party who is not a beneficiary of the trust.
- Depending upon the terms of the trust deed, the Funnel Will may also include nominations of successor trustees and successor appointors (being the person who has the power to appoint and remove trustees).
- If there are minor children, the nomination of testamentary guardians can also be helpful. Think of it this way, if your client can't decide who they want to be guardian for their children, what chance does a Court have?

### **Closing Remarks**

As indicated at the outset, this paper is intended to serve as a guide to some of the practical issues involved in relation to the design and implementation of an asset plan. It does not address any matters of a technical nature. While every effort has been made to provide guidance to the asset planning process, the paper is indicative only and should not be relied upon as legal advice.