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Welcome to the September issue of *Trust eSpeaking*. We hope you find these articles to be both interesting and useful.

If you would like to talk further about any of the articles in this edition of *Trust eSpeaking*, or about trusts in general, please be in touch with us.

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The next issue of Trust eSpeaking *will be published in March 2012.*

Let's Give it all Away

It's not that straightforward

With the abolition of gift duty from 1 October 2011 the first thought for most people who have a family trust would be "let's give it all away". If only life was that straightforward.

Before we consider the implications of giving it all away (see the sub-headings further down the page), there are a few points that you may wish to consider first:

» You may want to think about putting aside a nest egg that is outside your trust. Some settlors are not keen on having to consult with their trustees every time they wish to incur some expenditure.

» If the debt from one party to a single trust was an inheritance which the vendor wishes to protect for their children of another relationship or some other purpose, would you want to give this away?

» If you have advanced funds to your child, or your children's trust, to help them buy a home or other assets, do you want to give this away?

Insolvency and creditor protection

The Official Assignee has claw-back remedies under the Insolvency Act 1976 and Property Law Act 2007. Most settlor's financial positions would not be affected by a gift of $27,000, however, it would be by a gift of $270,000 or $2.7 million. Consideration would need to be given to ss344-350 of the Property Law Act which makes voidable every transfer of property with the intent to defraud creditors.

The Insolvency Act states that the Official Assignee can cancel a gift if that gift was made within two years of bankruptcy. Insolvency is presumed and cannot be rebutted. Gifts made within two to five years of bankruptcy where the bankrupt is unable to pay his/her due debts can also be cancelled. Inability to pay your debts is presumed unless you can prove, immediately after making the gift or at any time after that up to your bankruptcy, you were able to pay your debts without the assets gifted away.

A prudent person would obtain a Solvency Statement after the gift has occurred.

Relationship property claims

If you are separating, or have separated, from your partner, your gifting programme is frequently incomplete and a significant debt is still owed back to one or both of the parties. Most people will want to give this debt away.

Before doing this, talk with us about the impact of s44 of the Property Relationships Act 1976 which gives the court the power to award compensation or set aside the disposition to the trust.

The effectiveness of s44 will depend on how the courts develop the principles set out in Regal Castings v Lightbody[1], *Ryan v Unkovich*[2] and the cases that will surely follow.

Inheritance claims

When you die, if your Will does not provide adequately for your spouse or partner, children, grandchildren or other limited people, a claim under the Family Protection Act 1955 can be made against your estate.

Similarly a testamentary promises claim can be taken against your estate by anyone to whom you have made a promise to provide on your death, but no actual provision was made in your Will.

If you have gifted your potential estate away, claims such as these above would be futile.

Rest home care subsidy

Establishing a trust to dispose of assets in order to qualify for the rest home care subsidy is inadvisable. There is more about this on page 3.

Before making any decision on gifting post-1 October, please contact us so we can discuss your own particular circumstances and the best action to take.

1 Regal Casings v Lightbody [2008] NZSC 87: [209} 2 NZLR 433
2 Ryan v Unkovich [2010] 1NZLR 343; [2009] NZFLR 948

Rest home care

Don't expect government hand-outs just because you've put everything into a trust

After gift duty comes to an end from 1 October, one thing will still be clear: you can't give everything away to a trust and then expect to rely on state assistance because you don't own any assets. Recent publicity about the Petricevic case[3] has highlighted the rules about deliberately depriving yourself of assets or money. Most people, however, will be aware of similar rules about rest home care as these provisions have been well-known for years.

Rod Petricevic is a high-profile former finance company director who is facing serious criminal charges. He was turned down for legal aid, so he appealed to the High Court – and lost. Although Mr Petricevic is not a beneficiary of the trust, the judge was sure that if Mr Petricevic was really stuck, the trustees would find a way to help out with an 'advance' (in other words, a loan). Also Mr Petricevic is a very experienced company director and the court believed that, if necessary, he would cope fairly well without a lawyer.

Help from the state

A number of government agencies apply similar rules. They take into account the 'resources' available to anyone who applies for help from the state. More specific rules apply to rest home care – formally known as the 'long-term residential care' subsidy. These rules will not change when gift duty is abolished.

The Ministry of Social Development (called WINZ in earlier times, and now the MSD) will continue to apply a means test to anyone who applies for a residential care subsidy. It can refuse to pay the subsidy if:

- » You and your spouse or partner have given away more than $6,000 a year over the five years before applying for the subsidy, or
- » You and your spouse or partner gave away more than $27,000 in any year before the start of that five year period.

These limits apply to each application for a subsidy. If only one spouse or partner needs care, these limits will apply to everything given away by both of them. If both apply for a subsidy, each is allowed to have made gifts up to the amounts stated. There is no limit to how far the MSD can look back when applying the $27,000 a year test.

If a possible residential care subsidy is of concern to you, you may be best advised to give away only $27,000 a year – and to reduce to $6,000 a year long before you may need to consider rest home care. This would need to be the total a couple gives away each year, including gifting to a trust and any reduction or forgiveness of debt. Everyone's situation tends to be a little different, so you need to get individual advice.

Setting up a trust

We do not usually recommend setting up a trust just to qualify for the residential care subsidy. Often people have more than one objective when they are considering establishing a family trust. Setting up a trust in a way that appears specifically structured to meet MSD requirements may mean you – or your estate – could be vulnerable to other claims. There is no-one-size-fits-all answer and legal advice is essential.

There are many other good reasons for setting up a trust. Trusts are still a good way to protect your assets, but you need to go about this the right way to achieve your objectives.

3 *Petricevic v Legal Services Agency* HC Auckland CIV 2011-404-2633 Wylie J 3 June 2011; *R v Petricevic HC* Auckland CRI 208-004-029179 Venning J 12 July 2011

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Trustee Liability

As vendor under an Agreement for Sale & Purchase

Trustees are the legal owners of trust property and are personally liable for warranties given under an Agreement for Sale & Purchase. Trustees should be very careful about giving warranties. They should acquaint themselves with trust property and, if in doubt, delete warranties from the Agreement. They should also disclose relevant information to potential purchasers. The dangers of failing to do this were highlighted in the recent case of Ellison v Scott[4].

Ms Scott and her partner purchased a property in 1988. They carried out building works without obtaining building permits or code compliance certificates. Ms Scott's partner did most of the work. In 1997 the property was transferred to Ms Scott. In 2001 she transferred the property to a trust, the trustees being herself and a trustee company. In 2004 Ms Scott sold the property to Ms Ellison. The Agreement described the vendor as 'RM Scott Family Trust (Ms Scott and JSB Trustees Ltd as Trustees)'. Ms Scott signed as vendor.

Ms Ellison later found there were defects in the building works and that no permits had been obtained. She wanted to recover the estimated costs of repairs from Ms Scott, under clause 6.2(5) of the Auckland District Law Society's Agreement for Sale & Purchase 7 ed (2) July 1999 . The clause reads:

6.2 The vendor warrants and undertakes that at the giving and taking of possession:

(5) Where the vendor has done or caused or permitted to be done on the property any works for which a permit or building consent was required by law:

(a) The required permit or consent was obtained; and

(b) The works were completed in compliance with that permit or consent; and

(c) Where appropriate, a code compliance certificate was issued for those works; and

(d) All obligations imposed under the Building Act 1991 were complied with.

In the District Court Ms Ellison's claim failed. The judge decided that the trust was not the owner of the property at the time the defective works were carried out so Ms Scott could not be liable under the warranties given in clause 6.2(5). Ms Ellison appealed to the High Court.

High Court decision

Ms Scott argued that Ms Ellison had contracted with the trust to purchase the property. She contended that clause 6.2(5) only applied to works undertaken by the trust and as the trust was not the owner of the property at the time the non-permitted works were completed, the trust was not liable.

Ms Ellison argued that a trust is not a legal entity. The vendors were Ms Scott and JSB Trustees Limited as trustees and they were personally liable under the Agreement. The fact that Ms Scott held the assets on trust for other beneficiaries did not prevent her from being personally liable. The High Court agreed with Ms Ellison.

Justice Potter said that a trust is not a legal entity. She said that Ms Scott had been the legal owner of the property continuously since 1988, including the time the defective work was done. She (with the trustee company) incorrectly gave warranties under the Agreement that all permits and consents had been obtained for work she had done or caused to have done to the property.

The High Court judge's decision was appealed. The Court of Appeal agreed with Justice Potter's findings that Ms Scott's status as owner of the property had not changed since 1988. The appeal was dismissed. Ms Scott's application to the Supreme Court has also been dismissed.

In summary, trustees need to be careful about giving warranties in relation to property they may not know much about. Trustees should familiarise themselves with the trust's property and the warranties under the Agreement before signing it. Independent trustees should always ensure that their personal liability under any Agreement is limited to the assets of the trust.

4 [2011] NZCA 302

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Trusts and Tax

– The Supreme Court has spoken

Using a trust – or any other structure such as a company – to reduce your income is not straightforward. If you push the boundaries too hard you may end up having to pay a lot more. The latest Supreme Court decision provides a useful warning but, of course, there are other legitimate reasons to have a trust – not just to reduce your income tax.

Penny & Hooper v Inland Revenue[5] involved two surgeons who each decided to run their business through a company. Each company was, in turn, owned by a family trust so that most of the profit from the business would go through the trust and out to other family members at lower tax rates. In each case the company paid the surgeon a salary, which was much less than the income he had been earning previously. The surgeons could not convince the court that there were reasons, apart from reducing tax, for their decision to stop running their business in their own name and start using a company and a trust.

The Supreme Court decided the arrangement had been set up primarily to divert income away from the surgeon into a trust in order to reduce their tax. This arrangement is caught by the anti-avoidance rules in the Income Tax Act 2007 and the surgeons are not allowed to reduce their tax in this way. Not only did the two surgeons lose, but they have to pay $25,000 towards the Inland Revenue's (IRD) costs.

This has been reported in the media as a surprising new development in tax law. In fact, the Supreme Court pointed out there was a very similar case in Australia in 1967[6]. In that case, the doctors had appealed to the Privy Council and lost.

Market salaries

Despite what some commentators have suggested, the case does not say that you are obliged to pay yourself a market rate salary from your business. What the Supreme Court has decided is that any arrangement can be ignored by the IRD if it is artificial, it cannot be explained for other business reasons and one of its main purposes appears to be to reduce income tax. The court agreed that using a trust and a company in this way is entirely legal and the trust remains valid. This decision just means the surgeons must pay tax on their real earnings.

The significant point in this case was the sudden and inexplicable reduction in the income being earned by the two surgeons. Suddenly most of their income was diverted away through a trust. It might have been quite different if they had been starting out in a new business and decided to use this arrangement. The Supreme Court also acknowledged that in many cases there may be legitimate explanations for a reduced salary, such as the need to build up business capital.

Trustees – choose carefully

One important question with any trust is who you should appoint as trustees. Often an independent, impartial trustee will help to demonstrate that a trust is genuine. In this case, the surgeons were not trustees themselves; their lawyers and accountants held this role. As the court said, the surgeons could naturally expect that these trustees would act in the way the surgeons wanted.

It is important to get good advice before deciding what structure to use for your trust or business. If you want to push the boundaries, then you need to be aware of the risks involved. For those who prefer to play it safe, more conventional ways to use trusts and companies can be recommended in order to avoid the risk of challenge by the IRD or anyone else.

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5 Penny & Hooper v Commissioner of Inland Revenue [2011] NZSC 95
6 Peate v Commissioner of Taxation of Commonwealth of Australia (1962 – 1964) 111 CLR 443, affirmed [1967] 1 AC 308 (PC)

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