Ainger Tomlin
CHARTERED ACCOUNTANTS

Ainger Tomlin Ltd AMI House, Level 1, 116 Riccarton Road, PO Box 8237, Christchurch 8440
p +64 3 343 0046 **f** +64 3 348 9312 **e** email@aingertomlin.co.nz **w** www.aingertomlin.co.nz

Trusts and Trading Trusts

Accountants are not generally involved in the actual drafting of trusts, but it is appropriate that we offer some advice.

Trusts explained

People commonly refer to trusts as if they are separate legal entities, just like companies are separate legal entities. Although this is convenient, it causes confusion because it is incorrect and misleading.

A trust is simply a set of legally enforceable obligations. An essential feature of a trust is that a person, being the trustee, must use their legal entitlement to the trust property for the benefit of another person – the beneficiary.

Why create a trust

Asset management

As an owner of a property, you may:

- Not wish to transfer the whole ownership but would rather divide the ownership among a number of people. Using a trust can facilitate this.
- Consider that absolute control of the property by a person is inappropriate to the way you want it managed. Using a trust means that person can benefit from a share of ownership of the property while ensuring they do not have control of its management.
- Want to transfer the ownership of your property, but not yet know who you want to transfer it to. Through a trust you can delegate the responsibility for choosing who should receive the benefit of this property to the trustee. The trustee may be in a better position to know how the trust property should be distributed either now or at the time at which they can make this decision.

Obtaining government subsidies

Currently, applications for rest-home subsidies from the government are means tested as to income and capital. The allowable asset level is extremely low.

Where there is a large age difference between spouses, there may be spectacular consequences, as the younger spouse will also be means tested and will be expected to contribute disposable capital and income to pay rest-home fees for the older spouse.

The Department of Social Welfare currently looks back 5 years as a matter of course to see whether the rest-home applicant has divested themselves of assets in that time. If they have, the application will probably be declined.

However, if the applicant is a beneficiary under a discretionary trust this need not be disclosed under the current Department of Social Welfare means test. Therefore, if the applicant transfers assets to a trust early enough they may be able to obtain a rest-home subsidy. Note that there is no guarantee that these arrangements will prove effective.

In addition to setting up a trust during your lifetime, you may consider setting up a trust in your will for your surviving spouse. This may at least protect the assets passing under the will should your surviving spouse enter a rest-home.

Should I use a trading trust

A trading trust is any trust in which the trustee carries on business as opposed to passive investment. As is the case with any trust, the trustee will be personally liable for trade debts.

The type of trading trust considered here is where a company is used as the trustee. This approach is often used, and is designed to avoid the liability for trade debts falling on those who would otherwise be trustees.

Liability of trustee

Under this form of trading trust, the trustee company will be fully liable for trade debts. The directors and shareholders of the trustee company will (at least in theory) not be directly liable to creditors for the trade debts.

They may, however, be directly liable if they personally guarantee the trade debts or make a material misrepresentation about them. They may also be liable to the trustee company itself (but not to the creditors directly) if they breach their directors' duties under the Companies Act.

A trading trust will allow distributions to be made at beneficiaries' tax rates rather than the company tax rate. This is because the trustee company will be earning income as trustee of the trading trust rather than on its own behalf.

Distributions of income or capital will also be flexible. This is because income can be allocated to one or more of the beneficiaries of the trading trust rather than shareholders.

Discretionary beneficiaries will also have no assets or liabilities relating to the enterprise. This is because the discretionary beneficiaries will only have a right to be considered for a distribution of the trust assets. This is not a property right.

Discretionary beneficiaries are probably not liable for trustee's liabilities either. Therefore, while the assets remain in the trust they will be preserved during a discretionary beneficiary's bankruptcy.

Insolvency

A trading trust may well protect trust assets on insolvency and liquidation of the trustee company. This is yet to be decided, but is at least theoretically possible. The trustee company will not have full ownership of the trust assets, because it holds them on trust for others. Therefore, at first glance these assets will not fall into the pool of assets available to satisfy creditors' claims.

Under normal trust law, the trustee company will have rights to be indemnified from the trust assets. These rights are important on insolvency because a liquidator can claim under them and obtain access to the trust assets for the benefit of creditors. However, if the trustee company's normal protection against the trust assets are excluded or lost the liquidator cannot reach the trust assets.

Exclusion or loss of these protection rights is a key issue with 'aggressive' trading trusts. It also dramatically affects the solvency of the trustee company and its directors' duties.

Note that the courts are likely to view with suspicion attempts to exclude or limit trustee protection. It is seen as a device to avoid bankruptcy law, which makes exclusion even more difficult.

Even if the trustee company's protection rights are lawfully excluded, the directors' will run the risk of their duties being breached due to insolvent trading.

A trustee is only entitled to recover properly-incurred liabilities. If the liabilities are improperly incurred, there will be no right of recovery by the trustee and thus no right of recovery by a liquidator. For example, if a trading trust deed only allows the trustee company to carry out chicken-farming, any liabilities incurred in cattle-farming will not be recoverable under the indemnity.

However, this type of approach is dangerous. If a trading trust is set up with this intention, the whole scheme will be liable to attack as a sham because the trust deed will not truly reflect the intention of the parties.

When forming a trading trust, there will always be a trade-off between protecting the trust assets and protecting the individuals who will be directors of the trustee company.

If the trust deed claims to exclude or limit the trustee company's indemnity rights against the trust assets, the exclusion or limitation may not be effective. If it is effective, a breach of directors' duties may result. Therefore, much care is required when setting up and running this type of trust.

See Us First

- Talk to us if you are considering establishing a trust. Remember, when the trust is established it must be maintained.
- If you consider that any of the issues contained in this fact sheet may affect you.

Disclaimer