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## Welcome to the Spring issue of *Trust eSpeaking* and the introduction of our new look newsletter.

### In this issue we have articles on:

#### Bankruptcy and Trusts

What to do about bankrupt settlors and trustees

#### Transfer of Assets to a Trust

A limitation on protection from creditors, the Lightbody case appeal

#### How is a Trust's Income Taxed?

Tax on trustee and beneficiary income

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 for the preceding taxation year.

If you consider that your trust needs to distribute income for the 2008-09 tax year, then please contact us or your accountant as soon as possible.

*If you would like more information on any of the topics covered in this issue of *Trust eSpeaking*, please don't hesitate to contact us. The next issue will be published in March 2010.*

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## Bankruptcy and Trusts

### What to do about bankrupt settlors and trustees

*The present economic downturn has thrown up the problem of what to do when a settlor and/or a trustee becomes bankrupt. This article looks at possible remedies for both situations.*

#### Bankrupt settlor

The last year has seen a number of trust settlors become insolvent. Unfortunately the present economic climate suggests that this trend will continue, at least in the short term. Bankruptcy affects any trust set up by the bankrupt particularly if the trust owes him or her any money.

Any debt owed to the bankrupt is an asset in his or her 'estate'. As a consequence the Official Assignee has the right to take it over and demand repayment. In turn, that could force the trustees to sell trust property in order to produce the cash needed to repay the debt.

It also defeats what was probably at least one of the purposes the trust was set up to achieve, namely, securing the assets for the beneficiaries of the trust.

If you want to make sure your assets are protected against business risk, our advice is it is important to complete any gifting programme promptly, to ensure that any debt owed by the trust is fully written off well before any insolvency issues arise.

#### Transactions intended to defeat creditors

Any gift (or other transfer at less than market value) made with the intention of defeating creditors can be set aside by the court. This is contained in ss344-350 of the Property Law Act 2007.

The court can make an order in favour of the Official Assignee, a liquidator, creditor or other person. The order can be for cash compensation or for the return of the property transferred to a third party, such as a trust. The following article on page 3 (*Transfer of Assets to a Trust*) on the Supreme Court case of *Regal Castings Limited v Lightbody* considers these issues.

What is relevant is the intention of the settlor and trustees at the time the transfer or gift is made. Any file notes, mortgage applications or other evidence of that intention will be sought out by creditors, should the circumstances arise.

As long as the settlor has sufficient other assets to pay their debts at the time a gift is made, then the gift is not likely to be seen as having been made with the intention to defeat creditors. (We would say 'impossible', but you are not going to get a 100% guarantee of any court result from a lawyer!)

#### Bankrupt trustee

Unfortunately, a bankrupt settlor is often also a trustee. Bankruptcy does not necessarily mean that person cannot continue as a trustee, however, it does depend on the terms of the trust deed.

Many deeds specify that a trustee must either resign, or automatically cease, as a trustee if particular events occur, such as mental incapacity or absence for extended periods. Some trust deeds also provide that bankruptcy leads to that same result; but many deeds do not include that provision.

The Trustee Act 1956 does not require automatic resignation or removal of a trustee in the event of bankruptcy. Rather, the court has power under s51 to appoint a new trustee or trustees whenever it is expedient to do so.

Before the court can appoint a new trustee, it must first be found to be inexpedient, difficult or impracticable so to do without the court's assistance. In other words, attempts must be made to remove the trustee, or to get him or her (or them) to resign, before an application is made to the court for such an order.

Moreover, the court would need to be satisfied that it is appropriate to remove the trustee. The mere fact of bankruptcy is unlikely to be sufficient grounds alone to allow the removal of a trustee, otherwise there would be provision in the legislation to do this.

If it sees fit, the court can appoint one or more new trustees, either in substitution for or in addition to any existing trustee or trustees.

#### Summary

The bankruptcy of a settlor or a trustee can have a severe effect on a trust. Obviously the best course of action is to avoid bankruptcy! However, if bankruptcy is a possibility or is unavoidable please contact us for advice on how best to handle this from the trust's perspective.

## Transfer of Assets to a Trust

### A limitation on protection from creditors, the Lightbody case appeal

*The March 2008 issue of Trust eSpeaking contained an article on the transfer of assets to a trust and the protection that this provided from creditors in the event of a business failure. We examined the Court of Appeal case of Regal Castings Limited v Lightbody<sup>1</sup>. Earlier this year the Supreme Court overturned the Court of Appeal's judgment and found in favour of the creditor. This article explores the implications for trusts.*

It will be helpful to briefly revisit the facts of this case:

Mr and Mrs Lightbody (Mr and Mrs L) were directors and shareholders of Capro III Limited (Capro). Regal Castings Limited (Regal) supplied Capro with raw materials. Mr L provided a personal guarantee to Regal in support of the monies owing to Regal by Capro. In 1998, Mr and Mrs L sold their home to their trust for \$230,000. This amount was advanced to the trust and was fully forgiven by Mr and Mrs L by December 2002. In 2003 Capro was placed in voluntary liquidation, and in 2004 Mr L was bankrupted with Capro owing Regal \$160,000. Regal sought to overturn the 1998 transfer by Mr and Mrs L of their home to the trust using s60 of the Property Law Act 1952 (Act); this section permits the setting aside of a transfer of property in circumstances where a transfer is made with the intention to defraud a creditor.

### Supreme Court decision

Finding in favour of Regal, the Supreme Court focused on Mr L's intention when transferring the house to the trust. Important factors considered by the Supreme Court were:

- » At the time of transfer a one-half interest in the house was Mr L's only substantial asset, and Mr and Mrs L continued to occupy the house
- » The transfer was for no effective consideration as the purchase price was to be gifted, and
- » Mr L had provided personal guarantees for his business debts and without the house he had no means to repay these debts, ie: he was effectively insolvent.

Based on these factors, the Supreme Court found that the transfer of the house to the trust was made with the intention to defeat creditors, despite the fact that there was no suggestion that Mr L had a dishonest intention to cause loss to Regal. It was enough that Mr L was aware that the house was placed out of the reach of Regal, and that as he was a trustee, the trust was also aware of this. The transfer of Mr L's half share of the house was set aside for the benefit of Regal.

Interestingly, the Property Law Act 1952 has recently been replaced by the Property Law Act 2007 (New Act). Under the New Act it is now easier to unwind these types of transactions as there is no longer a need to show intent to defeat creditors if consideration equivalent to the value of the assets has not been received.

### Implications for settlors

The decision of the Supreme Court and the provisions in the New Act demonstrate that, in certain circumstances, a trust may not be effective to protect assets even though all the settlor loans have been gifted.

It is still worthwhile establishing a trust as a form of asset protection from creditors. However, the trust should be established before there are any indications of business failure or insolvency on the part of the transferring party, particularly in circumstances where personal guarantees have been given.

Even where personal guarantees have been given, it is still beneficial to transfer assets to a trust as not all creditors are willing, or have the financial resources, to unwind the transaction through the courts.

Before embarking on transferring assets to a trust, we'd recommend you discuss your particular circumstances with us so we can make you aware of any potential implications well beforehand.

<sup>1</sup> Regal Castings Limited v Lightbody (2009) 2 NZLR 443

## How is a Trust's Income Taxed?

### Tax on trustee and beneficiary income

*Income earned by a trust can be either retained by the trust or it can be distributed to the trust's beneficiaries. The following article provides some guidelines on the taxation consequences of these two alternatives.*

#### Tax on trustee income

Trustee income is the income that a trust receives that the trustees decide to retain in the trust. In this instance, tax is payable by the trust, or more accurately, by the trustees. This tax is calculated at the flat rate of 33 cents in the dollar.

The trustees are liable for tax on all income derived from New Zealand, irrespective of where the trustees reside. The trustees must also pay income tax on income derived from outside New Zealand where any settlor is resident in New Zealand at any time during the income year.

If a trust's residual income tax at the end of an income year is \$2,500 or more, the trust will generally have to pay provisional tax on the following year's income.

#### Tax on beneficiary income

For income distributed to a beneficiary there are different taxation consequences. This depends on whether the beneficiary recipient is a New Zealand resident or a non-resident.

A New Zealand resident beneficiary is liable for New Zealand income tax on all beneficiary income from any source in the world. This will be taxable at the beneficiary's normal tax rate, which will vary depending on the total income earned by them.

Again, provisional tax will be payable if the residual income tax earned is \$2,500 or more.

In 2001, the then Minister of Finance Dr Cullen introduced the 'Kiddy Tax' to be effective from 1 April 2001. This deemed distributions of beneficiary income to children who are under 16 years of age (minors) to taxation at a final tax rate of 33% regardless of the tax rate that would otherwise apply. There are some limited exceptions to this, including the payment to a minor of income not exceeding \$1,000 per income year.

#### Overseas beneficiaries

Non-resident beneficiaries only have to pay New Zealand income tax on trust income derived from New Zealand. The trust must deduct non-resident withholding tax from any interest, dividends or royalties before the beneficiary receives them; this is the final tax payable on the income.

#### Timing

Income can be distributed by a trust to beneficiaries at any time. However, and as our warning on page 1 of this newsletter states, most trusts, that is to say trusts with a 31 March balance date, must decide (or 'determine') to allocate income to a beneficiary no later than 30 September for the preceding financial year ending 31 March. This decision is usually formalised by the trustees executing a trustee resolution.

A new bill, The Taxation (International Taxation, Life Insurance and Remedial Matters) Bill, proposes an amendment which will provide more time to allocate beneficiary income from 1 April 2010. It proposes that beneficiary income be allocated by the later of:

1. Six months after a trust's balance date, or
2. The shorter of the time in which the trust tax return is due or the time the trust tax return is filed.

The result of the above changes is that many trusts, at least those using a tax agent, will have up to 12 months from the trust balance date to allocate beneficiary income. This means that trusts will have up to a full year from balance date to determine beneficiary income. This is an excellent result. It is expected that the Bill will be passed shortly.