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Welcome to the 7<sup>th</sup> issue of *Trust eSpeaking*; we hope you find the articles of interest. If you would like to talk further about any of the articles in this newsletter, or about trusts in general, then please do not hesitate to contact us.

### Short Term Saving Does Not Give Long Term Gain

- The value of having a trust when establishing a business

### Helping Children Buy Houses

- How can the trust help?

### Trustees' Role during Separation or Divorce

- The value of an independent trustee

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.

If you consider that your trust needs to distribute income for the 2007-08 taxation year, then please contact us or your accountant as soon as possible.

*If you require any further information on any of the topics covered in Trust eSpeaking, then don't hesitate to contact us.  
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## **Short Term Saving Does Not Give Long Term Gain**

### **- The value of having a trust when establishing a business**

Mr & Mrs B approached their lawyer about purchasing a franchise business. This was a new branch of a franchise which was currently operating a number of outlets throughout New Zealand.

#### **Establishing a business**

Their lawyer looked over all the documentation for the proposed purchase, which included a franchise agreement, a sub-lease of the premises and a number of the other documents the clients had been provided with.

After considering the documents and financial factors, Mr & Mrs B's lawyer had some concerns for their future success in the business, the potential returns and its profitability.

Their lawyer then sent Mr & Mrs B off to see an accountant to review all the financial information and to produce draft cash flow and profit projections. Although these were not particularly promising, Mr & Mrs B wanted to work for themselves, rather than earn the same amounts they were currently being paid in their salaried positions.

A company was incorporated, a franchise agreement and sub-lease signed, and Mr & Mrs B opened their business.

During this process, their lawyer had advised Mr & Mrs B of the advantages of forming a family trust, or trusts, primarily to protect the family home which had considerable cash equity but also to take advantage of the potential for income tax savings through the family trust/s, being a shareholder of the company.

Mr & Mrs B did not adopt their lawyer's recommendations due to cost considerations.

#### **When things go wrong**

About two years later, Mr & Mrs B returned to their lawyer to see what could be done to sort out the financial mess they were now facing. There were extensive rental arrears, numerous unpaid creditors and they wanted to terminate the franchise agreement. Unfortunately there was little their lawyer could do to save the day apart from directing them to a liquidation specialist.

On the surface things looked promising as Mr & Mrs B had not increased their bank debt to try to save the business, and there was still considerable equity in their home.

Unfortunately Mr & Mrs B had signed numerous personal guarantees in respect of the lease, and the payment of franchise fees and suppliers.

The inevitable occurred; the house was sold at a fire sale price, the equity was gobbled up by the personal guarantees and Mr & Mrs B's marriage started to fall apart under the stresses and strains imposed by their financial position.

The costs quoted to Mr & Mrs B to form the family trust/s, transfer the property to the trusts, re-document the mortgages and complete all the associated documentation in respect of forming new trusts, was less than 1% of the equity in the family home.

When establishing a business, it makes good sense to protect your family's assets. Short term saving of the costs to set up a trust or trusts, does not necessarily give long term gain. If you are considering business opportunities, do talk with us in the early stages to ensure your family's assets are protected.

## Helping Children Buy Houses - How can the trust help?

From time to time we receive enquiries from trustees who wish to help a child to purchase a property, often their first home. This type of enquiry is not confined to trustees, however trustees probably have more decisions to make when deciding to help children than individuals due to the nature of trustees' obligations and their inter-relationship with beneficiaries. This article looks at the implications for a trust to support a beneficiary in the purchase of their first home.

### The facts

Lisa is a beneficiary of your family trust, and has a reasonable expectation to receive support from the trust from time to time. She is in a long-term relationship with Johnny (whom you approve of) and your hope is that at some stage they will 'tie the knot'.

Lisa has rung to tell you that she and Johnny have found a property that they wish to buy; the purchase price is about \$500,000. The bank has said that, based upon the property's valuation and their incomes, Lisa and Johnny can probably borrow \$400,000. The hitch is they only have \$20,000 cash between them, and need to obtain a further \$80,000. *Can the trust help?*

The trust does not have the \$80,000 readily available, but you are confident that, with some judicious liquidating of investments, you can come up with the necessary \$80,000. However, what other issues should you consider before giving Lisa the go ahead?

### Trustees' obligations

Trustees have an obligation to consider the interests of all the trust's beneficiaries when making decisions. If Lisa was an only child, and the primary beneficiaries were (say) her and the both of you as her parents, then this would not appear to be an issue. If, however, Lisa had three brothers and sisters, and the trust fund (its assets) only had a value of \$80,000, then the trustees would need to carefully consider whether it would be desirable for the entire trust fund to be used by one beneficiary.

### How to provide the funds?

Assuming that the trust had sufficient funds and/or a small number of beneficiaries, how should the trust funds be made available to Lisa and Johnny? The most likely methods of providing the funds would be by a distribution from either income or capital, or a loan. It could be assumed that, for most trusts, the distribution of \$80,000 is most likely to be a capital distribution, that is, a transfer of a portion of the trust fund from the trust into the hands of a beneficiary.

The downside of such a distribution is that this would be received by Lisa, and would be used to buy a house that she is presumably going to co-own with Johnny. At some stage, depending on the length of their relationship, the conversion of the capital distribution to Lisa into an interest in their home is likely to become relationship property, and therefore be divided between Lisa and Johnny if their relationship was to end.

There are several options available to the trustees to distribute or lend funds to Lisa (and Johnny) to buy their house. The challenge is to ensure those funds remain as trust capital, and this will be covered in a future article. However if you are a trustee wishing to help a beneficiary, then please consult us first!

## Trustees' Role during Separation or Divorce - The value of an independent trustee

A chord was clearly struck by the article in the last edition of *Trust eSpeaking* (March 2008) that recommended keeping trust structures during a separation or divorce. We often see in both separation agreements and court orders a comment along the lines, "We will treat the parties' own assets and those belonging to the family trust as a single pool of relationship property". That often seems to result in the trust structure being ignored and indeed lost in the divorce process, and clearly people are discovering in hindsight that they are worse off because of it.

### Trustees' role

It seems often to be forgotten that the legal owners of property belonging to a family trust are the trustees, not the settlors, nor beneficiaries. That means that it is the trustees who must make the decisions about what happens to the property, not the settlors or beneficiaries.

Of course, often the settlors (usually the couple separating) are both beneficiaries and trustees in their own right. That in itself can lead to confusion in the roles, particularly if they are inexperienced in dealing with trusts.

However, there is often an independent third trustee of a family trust. Quite frequently that trustee's rights and obligations as a trustee are overlooked when decisions are made about trust property during a separation or divorce. It cannot, indeed must not, be assumed that the independent trustee will simply 'go along' with the decisions made by the couple as co-trustees.

Other beneficiaries (such as the couple's children) also have rights in respect of trust property. When trust property is treated effectively as the settlor's relationship property, the rights of those other beneficiaries are ignored.

The trustees have obligations to all the beneficiaries of the trust, not just to the settlors. All the trustees are not entitled, and can be personally liable, if they allow the rights of the other beneficiaries to be trampled on, in favour of the settlors alone.

### A neutral intermediary

An independent trustee can fulfil a very useful role during a separation or divorce. In particular, an independent trustee with professional or business experience can be an effective sounding board for the parties about options and possibilities for disposition or allocation of trust property.

They might also have good insight into the value of property, not just financially, but also emotionally to the family or some of its members. An independent trustee can provide the couples' own lawyers with a calm and dispassionate opinion about the history of the trust, its property and the needs of the various beneficiaries.

### A weak independent trustee

It is difficult when an independent trustee crumbles at the first hint of marital trouble among the settlors or beneficiaries. Such trustees normally ask to retire when called upon to vote against one of the parties or to consult with unhappy beneficiaries.

A strong independent trustee can add value to the family in a time of trouble, whereas a weak trustee can deprive a family of the opportunity for a voice of calm from someone who has no personal or professional involvement with the parties or their situation.

When establishing a trust, settlors should always consider appointing a strong independent trustee. Not only can an independent trustee give some balance to the management of a trust, but they can also provide some impartiality and stability to the beneficiaries if the settlors separate or divorce.