THE WIND UP OF A TRUST

Jeff Kenny, Wynn Williams

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Lindsay: I'm pleased to introduce Jeff Kenny a Partner of Christchurch law firm Wynn Williams. One of the areas Jeff specialises in is trust law and trust litigation. He's a regular speaker at trust conferences and a co-convener of the Canterbury Westland Trust Special Interest Group.

Jeff, eventually the time will come when a discretionary trust may need to be wound up. How long do trusts go for and why might the trustees want to look to wind up a trust?

Jeff Kenny: Lindsay, most family trusts in New Zealand are discretionary trusts and, typically, the termination date of a discretionary trust will be 80 years from the date the trust was started. This is because 80 years is the most common maximum length of time (called the perpetuity period) allowed under current New Zealand law (the New Zealand Law Commission has recommended the perpetuity period should be extended to 150 years if their proposal for a new Trusts Act is passed).

The reason that trusts are set for the maximum length of time is that it is a lot easier to wind a trust up early, than it is to extend the termination date. It's relatively common for a trust to be wound up within the 80 year period and there are a number of reasons why trustees might look to do this (for example, the reason for the trust being formed in the first place might have changed).

If we take an example of a trust established for educating children where the children may have finished their education, the main purpose of the trust no longer exists. The trustees might look to end the trust early and distribute the balance of assets held on trust to the children. Typically, if a trust is formed to hold a particular asset such as shares in a private company or something like that, the trust might be wound up early once the purpose of that company has finished.

Another common reason to wind up a family trust would be in a situation where a mother and a father have settled the trust for their own benefit and the benefit of their children. The mother and the father may have died and it might be in the best interests of the children (and it may have been the mother and father's wish) to split up the trust fund and distribute it for the benefit of the children, so they are able to go their separate ways.

Another relatively common reason is where a couple in a relationship decide to separate. They may have formed a trust during the term of their relationship and having separated, a decision is then made by the trustees to wind up the trust because it's in the interests of everyone to

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do that. Alternatively, the trust may be split up into two new trusts or sub-trusts so that the parties can go their own separate ways.

Of course there's another reason and that's where a trust is small and where it may no longer be economic to keep the trust running. So, there are many reasons why trusts are wound up, but these are some of the more common ones.

Lindsay: Jeff, you mentioned trusts can often go for up to 80 years. I'd imagine people would need to think about how the trust may eventually be wound-up as part of setting up a family trust?

Jeff: Yes, that's right. It's very, very important to make sure that the terms of the trust are set up right from the very start. I find that there is a misconception with many people that "all family trusts are equal" from a structure and drafting point of view. They're not. Some trusts are much better than others.

If the terms of the trust in the trust deed are set up correctly from the beginning and are flexible, it will give the trustees various options at the time of wind up to decide on the best way to manage the final distribution for the benefit of the beneficiaries. There can be quite dramatic differences between trust deeds around this point which is one reason why it's so important to set the trust up correctly from the start.

That leads to another area where trustees should take care with as it can have impact on the wind up of the trust and that's asset selection. Some assets can be easily distributed to beneficiaries on a wind up and others may not be able to easily be distributed. Trustees don't want to be acquiring assets where they might get locked in to a situation that they can't easily reverse out of, if there's any real possibility that the trust will be wound up early.

Lindsay: Would you have any examples of such assets or situations?

Jeff: An example might be a minority shareholding in a small company which locks the trustees in for long period of time. The company shares might be effectively unsellable. Trustees need to be very careful around that and make sure there are proper exit arrangements.

Perhaps a more obvious issue would be where trustees acquire assets that attract liability – an example of that might be where a trust buys a piece of land that has some environmental liabilities attached to it. In such a situation, it may be difficult for the trustees to be able to reverse out of that liability when they want to wind the trust up.

Trustees also need to be very aware of tax liability on wind up. Tax

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liability is personal to the trustees so that liability will not end because the trust is being wound up, so trustees may be unable to shake that off as well. Trustees just need to be careful about the sorts of assets that they acquire.

Lindsay: An insurance broker recently gave me an example where that happened. The trustees made a decision to wind up the trust and distribute the remaining assets. Some months later Inland Revenue Department audited the trust and found further tax was owed and asked the trustees to pay it personally.

Jeff: Yes, that's exactly the issue. There can be difficulties around trustee liability following a wind up. Trustees have a right of indemnity against the trust fund, however, once the trust assets are distributed, they are no longer in the trustee's hands and the indemnity is less useful. The trustees can be exposed following a final distribution so it's really important for the trustees to understand and consider their liability position as part of any process to wind up a trust.

It's also important during the course of the trust for the trustees to make good decisions about interim distributions as it can be quite difficult for trustees to smooth out or reverse out of distributions that they've previously made (for example, they may have paid a particular beneficiary too much and might be looking to even things up at the time of wind up).

If there are not sufficient assets left to make an equalising adjustment, then it may actually prove to be very difficult, if not impossible. When that happens, family disharmony can easily result. So, those are some of the things that trustees need to be looking at during the course of the trust.

Lindsay: Jeff, your point about equalising distributions reinforces the need for trustees to keep good records of distributions made to beneficiaries, especially if they do need to make an adjustment when the trust is wound up.

Jeff: Yes, you want good records of distributions, good records of assets held by the trust, and good records of debts which may be owed to or by the trustees. There can often be arguments around those sorts of issues and the problems we typically see, often stem from the trustees not having done those sorts of things as part of their management of their trust.

That brings us on to what I think is one of the most important things for trustees to think about when they're looking at a wind up and that's planning the termination process. While it's essential to have had a good trust deed and for the trustees to have managed the trust well, when it comes to the termination process, it's very, very important to

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plan that process and get good advice about the best way to do it, well before you start the wind up.

Otherwise, trustees may end up being in a rather difficult situation if they don't understand or plan the termination process properly. For example, the trustees may through the termination process, do something which might trigger a new liability such as GST or the like, or by not fully understanding the trust deed or the powers that they're using to terminate a trust, the trustees may get it wrong. A wind up of a trust is a time to get good advice and have a good plan.

There's another common problem that I see and it's one that shouldn't really happen. It's one that goes back to the way a trust was set up in the first place so it could be argued it is the settlor's fault, rather than the trustees. From time to time I see clauses in trust deeds that automatically trigger a termination of a trust following a couple's separation. These clauses are very dangerous because they can cut across all of the planning that trustees might ordinarily be able to do in some situations.

For example, a trust deed may require that if a husband and wife separate, then unless they do something within a certain time period (say three months), the trust will automatically terminate. Of course that situation can create all sorts of problems if within the three month period the husband and wife haven't done whatever they have needed to do.

It's a type of clause that causes problems and it's quite common. This sort of clause can crystallise a tax liability and again, it can be very difficult to reverse out of it. So, automatic termination clauses like what I have described can be ticking time bombs. They need to be looked at carefully and trustees and parties to a relationship need to be very aware of them where they are used in a trust deed.

Lindsay: Jeff, what then would be your recommendations for good practices for trustees on the wind up of a trust?

Jeff: For trustee best practice I would recommend trustees to:

- Know their trust deed
- Be very careful about asset selection
- Take extra care about the control of liabilities and the type of liabilities they take on
- Be very tidy in terms of management and administration during the term of the trust
- Always keep an eye on what might happen in the future and when a wind up might occur

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- Know beneficiaries, understand their position and think about any future adjustments that may need to be made
- Make sure to plan the wind up process and get good legal and tax advice about the best way to do the wind up, well before they start implementing the wind up!

Lindsay: Jeff, thank you for your insights and recommendations for good practices on how to best wind up a trust. For any people who wish to contact you, they can do that through your website www.wynnwilliams.co.nz where I know you have some other resources for trustees.