DISTRIBUTIONS AND LOANS

Chris Kelly, Grey Kelly Law

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Lindsay: I'm pleased to introduce Chris Kelly, a Wellington based lawyer from Greg Kelly Law. Chris has over thirty years' experience providing advice on wills, trusts, estates, and elder law. He's a co-author of two widely used New Zealand trustee books, Garrow & Kelly Law of Trusts and Trustees (7th edition published 2013) and Dobbie's Probate Administration Practice (5th edition) and he regularly presents on the practical management of trusts and estates.

Chris, today we're going to be covering how to best manage trust distributions and loans. What are the important aspects of managing distributions and loans that trustees should think about?

Chris Kelly: Thanks Lindsay. I think a good way to start looking at that question would be to consider it from a beneficiary point of view. I think for many beneficiaries, they would want to know whether they will be getting some money from a trust.

If beneficiaries have that thought uppermost in their mind, trustees need to be thinking about how they manage and set expectations with beneficiaries on what they will be entitled to expect from the trust, how they will get it and when they will get it.

If we were to say the purpose of a trust is usually to distribute money to beneficiaries when they need it or want it, then from a trustee's point of view, it's really important to know as a trustee that you're doing the right thing and that you're not going to get yourself into trouble because you've paid the wrong person, paid money out at the wrong time or you've gone about it the wrong way.

Lindsay: So when you talk about "getting some money from the trust", you're referring to the trustees making distributions of money or assets of the trust or loans, to one or more beneficiaries. What sorts of distributions or loans can trustees make?

Chris: The two main types of distributions from a trust are generally income distributions or capital distributions. An income distribution will be paid in cash whereas a capital distribution may be paid in cash or may involve the transfer of an asset or assets from the trust to a beneficiary. For example, a house may be transferred to a beneficiary as a capital distribution from a trust.

However, where a loan is made from a trust to a beneficiary, the trust still retains the loan as an asset of the trust. Generally, where a loan is made, there will usually be a discussion around the term of the loan, whether it has to be repaid (and if so on what terms), whether it will be

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secured or not, and whether interest will or will not be charged.

Lindsay: So Chris, what sorts of things do trustees need to be thinking about when they're working out whether to make a distribution or a loan, to a beneficiary?

Chris: Trustees need to work out whether they should make an outright distribution to a beneficiary (in which case the beneficiary will own the money or the assets distributed) or whether money should be treated as a loan (in which case the trustees will retain ownership of the money loaned and can ask for it to be repaid on an agreed date, or as they demand it, in the future).

Each situation will be different and trustees need to think about their specific circumstances for their trust if they are ever asked by a beneficiary for financial support. I know some trustees seem to be in a habit of making loans to beneficiaries rather than distributions. I've seen some trusts where there's almost no cash assets left in the trust and the assets of the trust are essentially just a whole lot of loans of money made to the beneficiaries.

An example where a loan could be quite a good idea would be a situation where money is lent jointly to a beneficiary and the beneficiary's spouse or partner (for example, a situation where the trustees are asked to help out with the money for a deposit to buy a house for a beneficiary). If the trustees distribute the deposit money outright to the beneficiary and there was a later split up, the beneficiary's partner may get half of it.

So using that example, the trustees may decide it is better to make a loan from the trust and even consider securing it over the title of the house. The trustees could say something along the lines of "we're happy to help you buy a house, but we want to know we will get the money back if you ever sell the house and so we're going to put something on the title". That way if the beneficiary and their spouse or partner later split up, the trustees can ask for the money to be repaid to the trust.

While there are lots of circumstances where the trustees may want to keep control just in case something goes wrong, you can overdo it. An example where the trustees may make a distribution rather than a loan might be where a child is going to university and the trustees agree to pay university fees and accommodation costs from the trust. In such a situation, the trustees would usually make an outright distribution payment on behalf of the beneficiary direct to the university so there is no requirement for the beneficiary to pay the money back.

There are a lot of cases where trustees are actually better off paying money out as a straight distribution. I've seen trustees get into an

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awful muddle with managing and reconciling beneficiary loan accounts as technically, every time you lend money to a beneficiary, it creates a debt that the beneficiary owes back to the trust. I've even seen situations where in the end, the beneficiary may actually owe more than they personally own so they're technically insolvent.

If the trustees really mean for the beneficiary to keep the money or asset, it may be best for the trustees to make a distribution rather than a loan. Trustees need to weigh up the situation or circumstances for their trust and consider what makes the best sense at the time.

Whatever decision the trustees make to either distribute or loan money, they need to check the trust deed to make sure it allows them to do what they are looking to do.

Lindsay: Chris, if the trustees do decide to make a loan to a beneficiary, what sort of paperwork do you think they should put in place to record the loan?

Chris: I know some trustees are quite formal and prepare a Deed of Acknowledgement of Debt or a document like that. Where interest is not being charged on the loan, often the more common approach seems to be to just keep track of the loan in the annual financial statements for the trust using what is called a Beneficiary Loan Account or Beneficiary Current Account.

So, as money is loaned or distributed to a beneficiary, a record appears in the financial statements of the trust and the trustees can keep precise track of how much a beneficiary has received by way of either loans or distributions.

Lindsay: Chris, the accurate tracking of loans and distributions is really important where the trustees want to equalise what each beneficiary receives at a future date. For example, various amounts may have been distributed over the years to different beneficiaries and then when the trust is wound up, a payment is made to equalise what each beneficiary has received.

Chris: Yes, that's what we call a hotchpot adjustment and there will often be a clause in the trust deed allowing for such an adjustment to be made. So for example, say one beneficiary has received $100,000, one has received $200,000 and one has received $300,000, the trustees may decide to top up the first two beneficiaries so that each beneficiary eventually receives $300,000 from the trust.

That's where having annual financial statements showing the exact loan balances owing, or a record of the distributions made each year is important. It enables trustees to see if one beneficiary is getting more than another and helps in a situation where the trustees do want to

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balance up or equalise what each beneficiary receives from the trust.

In some extreme cases, I've seen where beneficiaries have been charged interest on their loans. Where interest is charged on beneficiary loans, the trustees have to return the interest received as income in the trust tax returns and pay any tax.

Whatever the trustees do decide to do, I think it's important for them to keep careful track of beneficiary loan balances and distributions made to beneficiaries.

Lindsay: Chris, you've mentioned the importance of tracking loans and distributions, are there any other areas that you think trustees need to watch for in making distributions or loans?

Chris: I always think that when trustees are considering making a decision to pay out money, transfer an asset or make a loan, there are two questions they should ask themselves.

The first question is: Can we do this?

A number of times I've seen trustees who have paid money to someone who's not actually a beneficiary or paid money to someone whose not entitled to a share of the income while the trust is running (they're only entitled to a share of what's left at the end of the trust as a final beneficiary or something like that). So, first check the trust deed to see who you can pay and then what you can pay them. Some old trust deeds have limits on what you can pay people each year.

The next question that trustees should ask is: Should we do this?

Even if you can make a payment, is it a good idea? Is it the sensible thing to be doing? Is there enough money in the trust "kitty" to make the payment? When is the right time to make the distribution? Are we doing the right thing? Also at this point, trustees need to talk their accountant to check the tax consequences as making distributions of income or capital can have significant tax consequences.

The basic principle is that if trustees receive income and then pay it straight out to the beneficiary, the beneficiary is taxed at whatever the beneficiary's tax rate is. If the beneficiary was say, a student or someone who's not working, they may be on quite a low tax rate. If the trustee was to hang on to the income instead and pay the tax within the trust, then they would pay thirty three cents in the dollar tax (using current tax rates). So there can be quite a significant difference.

Another trap that trustees need to look for is the timing of their decisions to pay out trust income they are holding as there are certain time periods by which trustees have to do it. A lot of trusts still have a

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clause in the trust deed saying that the trustees have six months after the end of the tax year ending 31st March to make that decision.

The Income Tax Act now allows trustees twelve months to make that decision but a lot of trust deeds haven't been updated and the trustees of those trusts are restricted to the six month period. As a trustee you need to be very careful you know what your trust deed says and whether you have to make your distribution decisions within six months of 31st March or whether you have the full twelve months that the Income Tax Act will allow.

Once you know the timeframe that you have to make a decision to distribute trust income, it's important you have the trustee's resolution signed within the allowed time. Otherwise the trustees will be in a situation where income received and not allocated to beneficiaries by the cut-off date, will be treated as trustee's income (and taxed at 33 cents in the dollar).

Generally, capital distributions of cash have no direct tax consequences. However, where a capital distribution of an asset is made from a trust to the beneficiaries, the tax issues can be more complex or significant. I would recommend trustees getting professional tax advice well before they decide to make a distribution of assets from a trust. I'd also recommend that trustees keep an eye on any future changes to the tax rules (for example, if there was a proposal by the Government to introduce a capital gains tax).

Lindsay: So, if you're making distributions or loans as a trustee, you need to know your authority in the trust deed, you need to consider whether it's a good idea and whether there are tax implications.

Chris: Yes, that's right Lindsay. And on that point about the trust deed, it can sometimes be hard for a non-professional trustee to find the right clauses in a trust deed. That's where you need to get in touch with your accountant or lawyer to hunt out the right clauses and explain them to you.

If you find the trust deed hasn't been updated to cope with that change in the tax law that I mentioned, the trust's lawyer should be suggesting that a deed is prepared to vary the trust deed to give the trustees the full twelve months to make their decision for the distribution of trust income.

Lindsay: So, to finish Chris, you've suggested a number of good practices for trustees with their distributions and loans. Do you have any final comments or suggestions?

Chris: I'd reinforce the importance of what we've already mentioned about keeping very good trust and financial records. I think trustees

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too often forget about keeping the records straight. So that's about good resolutions to record distribution decisions. Trustees don't have to record "why" in the resolution, but as good practice, they should have a written resolution signed by the trustees for each decision they make, and keep those resolutions as part of the trust records.

Preparing good financial statements of account annually for the trust helps trustees to track and be very clear about what money's been treated as loans and what money or assets have been distributed outright to beneficiaries.

Finally, trustees have to know their trust deed, they should go back to it regularly and find out what their authority is to make decisions so they know what they are allowed to do (or not do). Trustees have to understand the trust deed and when they don't, they have to get advice so they can.

Lindsay: Thank you Chris. This is an area of trust management where there are clearly some pitfalls for unwary trustees. You've highlighted some great practices that trustees can easily implement as part of their decision making around distributions and loans.

Chris, you can be contacted through the firm's website www.trustlaw.co.nz. I see you've got a regular newsletter on the website with good information on topical issues for trustees.

Chris: You're most welcome. Good talking to you.