

TRUSTS & HOW THEY WORK

John Brown, Barrister

Notes...

Lindsay: I'm pleased to introduce John Brown, an Auckland Barrister specialising in trusts, asset planning and legal advice on trust issues. John's an external Senior Editor for CCH (the tax and commercial law publishers), and has authored or edited the New Zealand Master Trust Guide, the New Zealand Trusts and Asset Planning Guide and the New Zealand Trust Reports, a law report series which reports on trust related Court cases.

John, I'm often surprised how many people with a family trust don't appear to understand the basics of how trusts came about, what they are and how they work. Can you please give us an overview?

John Brown: Thank you very much Lindsay. I think the concepts are very simple but their practical working can be very complicated. A good place to start is to understand the stream of law from which trusts developed, which is the Courts of Equity. The Courts of Equity were particularly concerned about people's conscience and it's really about focusing on the substance of things rather than the form. That concept of conscience has carried on for almost the last thousand years and is with us today.

What that means for trustees is that where trustees are exercising their trust powers and making decisions, they need to do so for a proper purpose, for example, they can't use their powers to benefit someone who is not a beneficiary of the trust. That's just one small way in which we see the concept of conscience carrying on through to today.

There are three kinds of essential parties to a trust. You have the person who starts it off, the settlor, you have the person or persons who will be holding the assets, that's the trustees, and you have those who will benefit from the trust, the beneficiaries.

With the exception of a charitable trust incorporated under the Charitable Trusts Act 1957, a trust is not a separate legal entity (like a company). A trust is an equitable obligation binding the trustees to deal with the trust property for the benefit of the beneficiaries.

Lindsay: John, can you explain a little more about what you mean by an "equitable obligation"...

John: Sure. What that means is that it's an obligation that can be enforced by the Courts. If you looked at the title deeds or documents of ownership for the assets of a trust, it is the trustees who are shown as the owners, not the trust itself. Because it's the trustees who hold the trust assets in their names, it's really important for settlors to choose

their trustee, or trustees, very carefully.

The trustees are the legal owners but they are not the beneficial owners. It's the beneficiaries of the trust who are the beneficial owners. That means it's the beneficiaries who are entitled to benefit from the trust assets. When a person owns something in their own name entirely, then the legal ownership and beneficial ownership merge. With a trust it's possible to separate the legal ownership (held by the trustees), and the beneficial ownership (held for the beneficiaries).

Lindsay: Thanks John. You identified the three essential parties to a trust – the settlor, the trustees and the beneficiaries. What else is needed to make sure a trust is established validly?

John: To establish a valid trust three certainties have to be present. Firstly, there needs to be certainty that the settlor intended to create a trust. I consider that this area is going to receive more attention in the future if a trust should be challenged. Secondly, there needs to be certainty about what subject matter is to be held on trust, and thirdly, there needs to be certainty of who's going to benefit from the trust.

Now let's focus on the first of these certainties, the intention, because that's important. The person who's setting up the trust actually needs to part or relinquish their beneficial interest in the assets they put into trust. It's really important to understand that a change of beneficial ownership takes place when assets go into trust.

When I look back over the years, I've heard people say "You can form this trust and it's just as if you owned it. You can have complete control". I have to say that I don't believe that is true, because you actually need to part with the beneficial ownership of the trust assets. Yes, you can be a trustee and one of a number of beneficiaries but, the reality is that it is up to the trustees to fairly consider you as a beneficiary along with the other beneficiaries of the trust.

So this element of parting with the beneficial ownership, while it can be fudged, it's important for a person to be very, very clear in their mind what's actually happening when they put assets into a trust.

Lindsay: So in setting up a trust, it's really important for people to be very clear that they're giving something up, they're letting go their rights to the ownership of the assets put in trust in favour of the people who are named in the trust deed as the beneficiaries. Then in any trust three certainties have to be present - the intention to create the trust, the certainty about the property or assets that are to be held on trust, and lastly, certainty of who will benefit from the trust. Is that right?

John: Yes indeed. It is also necessary that the terms of the trust are

established, i.e. on what terms does the trustee hold the assets for the beneficiaries. There are also many different types of trusts that you can have. In New Zealand the more common ones would be either, for example, a trust created by Will or a discretionary trust.

With a trust created by Will, income may be left to a spouse for that spouse's lifetime, and then the capital of the estate would go to the children. In this case, the beneficiaries have what are called fixed interests in that the spouse has a right to the income stream from the trust assets for his or her life and then the children have an interest in the capital of the trust estate on the spouse's death.

In this type of trust the certainty of beneficiary is necessary when the trust commences (once probate of the Will is granted) following the death of the Will maker. With that type of trust the trustee needs to be able to say at the start of the trust, who will get the income (and for how long) and who will get the capital (and when).

Another type of trust is one that is formed in a person's lifetime and commonly in New Zealand they are discretionary and referred to as a family trust. With this type of trust, the beneficiaries are those named or described in the trust deed that may benefit at the discretion of the trustees. They commonly include the person or persons starting up the trust (the settlors) and their children and possibly grandchildren. The trust deed might also provide for new beneficiaries to be added or for beneficiaries to be removed.

I mentioned that the beneficiaries may have a discretionary interest. This means they don't actually have a fixed interest in the trust assets (unlike the example of the trust created under a Will).

Discretionary beneficiaries have merely a right to be considered. So like Oliver Twist, all they can do is come along to the trustees and say "Please can I have some". Now, the certainty of beneficiary is somewhat different for this sort of trust as the certainty must be there at the point at which the trustees exercise their discretion. At that point they must be able to know who is in the class of beneficiaries entitled to benefit from the trust.

Lindsay: So beneficiaries of a discretionary family trust merely have the right to be considered...

John: Yes. The obligation on the trustees in a discretionary trust, commonly referred to as a family trust, is that the beneficiaries are entitled to be fairly and reasonably considered by the trustees in the exercise of their discretion. Whereas in the fixed trust arising under a will that I talked about earlier, there were two different classes of beneficiaries with fixed interests in the trust; the spouse who gets the income and the children who get the capital.

Where there are different classes of beneficiaries, the trustees need to balance the interests of each class when they are making trust decisions. For example, when the trustees make investment decisions, they need to be impartial in the way they do things and balance the interest of current beneficiaries like the spouse who receives income during his or her lifetime, and the interests of the children who receive the capital when the spouse has died, unless of course the trust document provides otherwise.

When it comes to discretionary beneficiaries, the trustees should be neutral between beneficiaries. All the discretionary beneficiary has got is a right to be considered or a right to put their case to the trustees that they may benefit from the trust. When a discretionary beneficiary does this, he or she has a right to be fairly and reasonably considered by the trustees.

Lindsay: John, so clearly it's a balancing act for anyone acting as a trustee when it comes to considering the various interests of beneficiaries. What are the main reasons people set up trusts?

John: The common reasons might include where you could have disadvantaged beneficiaries or beneficiaries with disabilities. In other words, if you left your significant assets direct to your children, could there be some way in which they would be disadvantaged? Examples may be where a child may have a disability or special needs or could be the sort of person that when money hits their pocket, it burns a hole right through.

There may be a dominating or controlling spouse who would want to get their hands on the money. The beneficiary may have gambling or personal problems. Other reasons for establishing a trust include where someone is in an occupation where they're at risk of being sued, professional liability in some shape or form. Other reasons could include possible property relationship claims, or a situation where you considered your Will may be challenged on your death or if there were future creditors that could possibly attack those assets.

Lindsay: We've covered the reasons for setting up a trust. I guess everyone's situation will be different and it's important to get good advice where you're thinking about setting up a trust?

John: Yes. It's not like forming a company and getting one off the shelf and it's not just a matter of churning out a trust. I think you'd want to take proper advice preferably from a firm or a lawyer who specialises in trusts. I think that it's worth putting the time in at the beginning to understand what you're trying to do and the advantages and disadvantages of a trust.

You also need to think about the fact that laws may change and even disadvantage you in having a trust. The changes to rest home subsidies would be a good example of that. Many trusts were formed for people in the 1990s so that in the event of them going into a rest home care, they would not be disadvantaged and could possibly claim a rest home subsidy. Those regulations were changed in July 2005 and so now it is even possible to be disadvantaged by having your home in a trust. The laws are always evolving and you need to take specific advice for your own circumstances.

Lindsay: What would be good practice for trustees in understanding trusts and how they work?

John: I'd try to stay informed. You can get books which can introduce you to the concept of trusts at a bookshop or your library which can give an understanding of the basics. I think it is good practice for trustees to increase their knowledge and skills over time.

There are other books available that can help them do that - there's my own book NZ Master Trusts Guide. Andrew Butler's book on Equity and Trusts in NZ and also Garrow and Kelly on Law of Trusts and Trustees are in my view excellent books that will give you an increasingly better understanding about trusts. They are serious reading, but I believe the more trustees know and understand about the area of law they have taken on, the better.

I should add to that and say that the law does not expect trustees to know everything, but they are required to take advice about the things they don't know or don't understand so they may make informed decisions. As one court case said "experts advise, but trustees decide".

Lindsay: Thanks for that overview John and for your recommendations for trustees to stay informed, grow their knowledge and take advice. Trusts are continuing to evolve, they're just not static. John, I know if someone wants to contact you, they can do that through your website www.jbtrusts.co.nz.

John: Thank you too.