SPEAKMAN LAW

The Trusts Act has now passed into law, the Court of Appeal decision in the Mainzeal (Jenny Shipley director's liability case) is now imminent, the Supreme Court has granted leave to appeal for Frucor in its avoidance case and Eric Watson has announced his intention to write a book….just a few of the key points to start off the year. Below is a discussion of tax, trust and company law matters, as usual, which I hope you enjoy.

Increase in Personal Tax Rate

The increase in the personal tax rate to 39% (on income above $180,000 effective from 1 April) prompts restructuring thoughts and the desire to attain a lower tax rate wherever possible. Unsurprisingly, attention focuses on the use of trusts and the 33% tax rate applicable to them.

There are two scenarios here. These are:

a) persons who derive their income personally (sole traders, professional directors and the like) eyeing the opportunity to shift their operations into a trust (or trust owned company) structure.

b) persons who derive their income through a company that is owned in their own names who establish a trust to own shares in the company.

Both scenarios are inevitably motivated by the tax benefit that the rearrangement proffers. This begs the question whether it is permissible to rearrange your business operations by making use of a trust in either of these two scenarios.

For perhaps the first 20 years of my time in legal practice, the answer to this question would have been a resounding yes (reflecting the choice principle derived from the Newtons case and others, for those interested). Since then, and increasingly so, the answer has become a resounding no. If you embark on either of the rearrangements described above solely with the motive of lowering your effective tax rate, the rearrangement amounts to tax avoidance and Inland Revenue will succeed wherever they choose to challenge it.

Aside from that, the rearrangement might not work technically. Regard needs to be had to the personal attribution rules (that did not exist in the first 20 years

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Briefly

- Loss Carry Back Scheme introduced as one of last year's stimulus packages, already scrapped for it's fiscal cost.
- Purchase price allocation rules on business sales to become effective from 1 April; heavily weighted in favour of vendor (see issue 35 of this newsletter dated March 2020).
- Foreign trust disclosure rules revamped.
- Executors of estates now subject to Trust Act disclosure rules immediately upon grant of administration.
- Halfway through Joe Biden's first 100 days and there is ….. quiet. Meanwhile public schools in the US have remained closed for a year.
- NASA building the most powerful rocket in the world while Perseverance roams Mars.
- Tim Bogert (Bassist with supergroup Beck, Bogert and Appice and later Vanilla Fudge) dies at 76.
- It is a NZ v India showdown in the World Test Cricket Championship final in June (now being played at Southampton and not at Lords).

**Want to know more about the new Trusts Act?
We can help**

of my time in practice). These curtail the ability for persons who derive their income personally predominantly from one source to divert their operations and income to a company. The restrictions on being able to do so were emphatically demonstrated by the Penny and Hooper cases, involving two highly successful orthopaedic surgeons who sought to achieve a tax advantage by shifting their surgical practices into a company, then declaring a salary at only a proportion of their total earnings. The surgeons took their cases to the Supreme Court and lost. Though these cases did not concern the personal attribution rules, nonetheless similar principles apply and they are a useful 'go to' in order to establish what you can and can't do in this area.

So, what can you do? There are two things you can do.

First, for those of you who operate through a company you can (and should) utilise all existing imputation credits that your company may have. This will require a dividend to be declared by 31 March 2021 (which will trigger a 5% resident withholding tax impost). For companies that have no cash available to support the dividend they can declare the dividend and leave it unpaid (crediting the shareholder's current account), though the RWT liability cannot be deferred. If the accompanying liability invokes a balance sheet concern, you can achieve the same result by way of declaring a taxable bonus issue. This will preserve the company's cash, not invoke a liability for the company and deliver the intended tax result. Taxable bonus issues are straight forward; they entail the same documentation as a standard issue of shares.

The second thing you can do is to rearrange your business operations in the context of a wider review of your personal affairs. The new Trusts Act (see Issue 35 of this newsletter dated November 2020 and publications on my website) has necessitated that review in any event and in some cases prompted resettlements. Where a rearrangement is genuinely occasioned by these broad trust and estate planning goals, the rearrangements should withstand a tax challenge. The issues around this are intricate as the discussion in this newsletter under the Trusts Wrap Up heading below will reveal this. Moreover, greatly significant to any rearrangement is the new trust disclosure rules, also discussed below.

Trusts Wrap Up

a) Removing Conflicted Trustees

Many family trusts are established with the husband and wife as trustees, often with an independent trustee being either a family friend or professional advisor. Upon a breakdown in the marriage, invariably one or more of the trustees becomes conflicted and there is potential for misconduct in administering the trust. How might you safeguard yourself against that misconduct and is it possible to remove the other as a trustee of your trust?

The Little v Little case in the High Court (2014) serves as a blatant example of a conflicted trustee behaving badly and what can be done about it.

Mr and Mrs Little had established a trust to own their family home and various other assets. They were the sole trustees. Together with their son, they were the sole beneficiaries. They separated after many years and that precipitated misconduct by Mr Little.

The trust deed protected both Mr and Mrs Little by requiring action of the trustees to be exercised unanimously. Despite this, Mr Little arranged the sale of the Trust's shareholding in a US company, without informing his wife, and instructed that the sale proceeds be paid into an overseas bank account, hidden from his wife.

Mrs Little nevertheless learnt of these events and unsurprisingly challenged her ex-husband about them, firstly by seeking his removal as trustee. The Trustee Act 1956 entitled her to pursue that path and her expectation was undoubtedly that upon Mr Little being removed as trustee, she would attain full control of the trust. It didn't work out that way. The Courts unreservedly disapproved of Mr Little's actions and granted the application to remove him as a trustee but recognised that Mrs Little was equally conflicted and in the result the Court appointed an independent trustee to replace them both.

Under the Trusts Act 2019, there are analogous provisions that would lead to the same result. Notably, section 112 empowers a Court to remove a trustee "wherever it is necessary or desirable to remove a trustee and it is difficult or impractical to do so without the assistance of the court". Reliance on this new section is as yet untested but the facility to remove a conflicted trustee in circumstances of misconduct exists.

b) Ensuring Trust Assets pass to Your Children and not to their Ex-Spouse

It is common to include in a trust deed as one of the classes of discretionary beneficiaries " a trust under the terms of which any one or more of the Primary Beneficiaries or his or her children may benefit".

It has generally been thought helpful to extend the class of Discretionary Beneficiaries in this way because it facilitates a distribution being made by the trust to a trust for your adult child in substitution for a distribution to him or her directly and that will be desirable wherever a distribution to your adult child may become embroiled in a relationship property claim brought by his or her partner (or ex-partner).

This is not as simple as it seems. One issue that is triggered by extending the class of beneficiaries to include a trust for your adult child arises from the disclosure to beneficiaries provisions in Section 51 and 52 of the Trusts Act. If the wording of the class of beneficiaries being discussed here is as above, the class of beneficiaries includes a trust under which the grandchildren may benefit. Where that is the case, bear in mind that the grandchildren are likely also to be beneficiaries of a trust established by and ex-spouse/partner of your son or daughter.

This will oblige the trustees of your own trust to disclose trust information to the trustees of the ex-spouse's trust, or to rely on one of the presumptions in section 53 to refrain from making such disclosure. If disclosure is made, there is scope for problems – the ex-spouse might learn of amounts that your son or daughter has received from your trust and work that to the ex-spouse's advantage in settlement of any relationship property dispute. In recognition of that possibility, the trustees may elect upon non disclosure. However, it may be better to avoid this issue at all by limiting the class of beneficiaries so that it does not include a trust in which the grandchildren may benefit.

A related concern is illustrated by the recent 2020 case Miller v Gregten. There, the settlor of the Miller Family Trust of which the Primary Beneficiaries were the husband and wife and their 3 children, created a problem by trying to be too clever in his memorandum of wishes to protect against matrimonial claims affecting any of the 3 children.

The memorandum of wishes included a statement that "if a beneficiary is married, in order to protect the Beneficiary from the possibility of a matrimonial property claim in the event of a breakdown of his or her marriage, you should take into consideration the stability of the marriage and the purpose of which a distribution would be applied in deciding whether to make a distribution."

Problems arose upon 2 of the adult children, then married, resisting intrusion into the state of their respective marriages and insisting on distributions being made to them personally irrespective of the worry of relationship property exposure. The trustee refused to do so and lengthy litigation ensued, the only moral victory for the beneficiaries being a note in the judgment of the court "I do have concern about whether the current trustees have held rather too rigidly to their understanding of [the settlors] wishes regarding the trust". The lesson, is to be very careful and precise with any memorandum of wishes in these respects.

c) Does establishing a trust prior to marriage protect your assets?

A motivation for establishing a trust is often one's impending marriage or de facto status upon a relationship reaching its third anniversary. The hope of course is that putting assets in a trust shields them from relationship property claims in the event of a breakdown in the relationship. Does this work or can the trust be busted open?

It is right to say I think, that the Clayton v Clayton case (discussed in an earlier article; where Mrs Clayton successfully overturned a pre-nup agreement and busted open her ex-husband's trust, delivering her an amount of $14m) has pioneered the pursuit of trust busting.

There is a small number of bases for challenging a trust. Possibly the most common basis is a claim under the Family Proceedings Act (FPA) and a recent example where the FPA was relied on to do that is the (2020) case Preston v Preston.

Mr and Mrs Preston had begun a de facto relationship in 2009, married in 2010 and separated in 2015. Hence, their relationship was relatively short.

Three years before he had met Mrs Preston, Mr Preston had settled a family trust. The beneficiaries were his children from an earlier marriage.

Notwithstanding his marriage to Mrs Preston, his intention remained for the trust assets to go to his children. However, to accommodate distributions to Mrs Preston (recommended to him by his accountant as a tax effective means of rewarding her for her services provided to Mr Preston's business), Mr Preston extended the class to beneficiaries to include "any wife or widow" of himself.

At first glance this looks untoward. The problem was that it gave Mrs Preston the opportunity to argue that she had a claim under the FPA against the assets of the trust. It is evident that Mr Preston had not expected that.

The FPA applies (in the present context) where there has been an ante-nuptial or post-nuptial settlement upon a trust for the benefit of either of the parties to the marriage.

The respective arguments were:

- for Mrs Preston, her inclusion as a beneficiary of the trust (by virtue of extending the class of beneficiaries to include "any wife" of Mr Preston) was made in anticipation of marriage and the FPA entitled her to an award of the trust assets on account of the Prestons treating their life together and financial affairs, as a joint enterprise.

- for Mr Preston, the purpose of admitting Mrs Preston as a beneficiary was limited to the salary substitute referred to above and did not overturn his intention that the trust assets go to his children.

Mr Preston was successful in defeating the FPA claim and the trust assets did not become available to Mrs Preston. Nonetheless the case illustrates the potential for a FPA claim to undermine the intention about your trust. You would be well advised to seek advice about potential FPA application and to tread most carefully before making any changes to your trust that in any way confer rights to the trust assets upon your spouse.

d) The Role and Benefits of a Protector

Settlors who wish to retain control over their trust often do so by appointing themselves as a 'Protector'. A protector, in relation to a trust, is a person who under the terms of the trust deed may give directions to the trustee that the trustee must follow or who has a veto power in relation to significant decisions. Retaining a trusteeship is the most common form of control but there are fiduciary duties attaching to a trusteeship.

A protector on the other hand has no fiduciary duties and may exercise his or her powers freely without any restrictions under trust law. Indeed trust law does not recognise the concept of a protector and no reference to it is contained in the new Trusts Act, nor does earlier trust legislation refer to it.

The ability for a protector to give directions to the trustees free of any restriction under trust law has wide appeal. Nonetheless, the trustees cannot merely follow the directions given by the protector. Instead the trustees must consider whether doing so would place the trustee in breach of trust.

There are three options for a trustee who believes that directions given by a protector, if followed, would be a breach of the trustee's duties. The first option is to resign. Secondly, a trustee may apply to the High Court for directions. Such directions will bind both the trustee and the protector. A third option, facilitated by the new Trusts Act, is to initiate an alternative disputes resolution proceeding, the outcome of which will also bind both the trustee and the protector.

An alternative to appointing a protector is to appoint an advisory trustee. Such a role is expressly accommodated in the new Trusts Act (as a 'Special Trust Advisor') and will often achieve the Settlor's purpose, though a key difference to the powers granted in favour of a protector is that an appointed trustee is not bound to follow the advice of an advisory trustee/special trust advisor.

In summary, a settlor who wishes to retain control of his or her trust has a choice of three means of doing so. Retaining a trusteeship of the trust is by far the most common means of doing so but that path opens the trust to a trust busting challenge unless the trust deed includes appropriate restrictions on self dealing. Appointment of oneself (or a trusted associate) as protector or special trust advisor are the other alternatives. I favour the latter given the express recognition of the status of a trust advisor in the Trusts Act 2019.

New Trust Disclosure Rules

Applicable to all NZ trusts with immediate effect are new disclosure rules. Their scope and the means by which they have been introduced is quite extraordinary. They have been introduced without any public consultation and with retrospective effect – going back to the 2013 – 14 income year. I have never witnessed a piece of legislation introduced with such alarmingly long retroactive effect.

What are they, why do we have them and how might they affect you?

What are they is twofold. First, they impose a requirement for trusts to file an annual return (along with the usual return of income that trusts already provide to Inland Revenue) that contains:

a) a statement of profit or loss and a statement of financial position;

b) the amount, and nature of each settlement made on the trust in the year (other than minor service provided at an undervalue);

c) the name, details, jurisdiction and tax identification number of each settlor who makes a settlement on the trust each year;

d) distributions made by the trust in the year including,

   I. the amount of the distribution; and

   II. details of the beneficiary of the distribution

e) details of each person who holds the power of appointment for trustees or beneficiaries or who has power to amend the trust deed

f) any other information required by Inland Revenue.

Inclusion of 'other information required by Inland Revenue' essentially gives Inland Revenue unfettered rights to seek any information it wants about the trust.

The second part of the disclosure rules is the right for Inland Revenue to seek the same information listed above for all years from the 2013 – 14 income year, to the extent it is in the knowledge, possession or control of the trustee.

Limits on these rules are that they do not apply to non-active trusts, foreign trusts, charitable trusts (that are incorporated) and Maori trusts.

Why have these disclosure rules been introduced? They are intended to buttress the forthcoming 39% personal tax rate, recognising the 6% differential between that rate and the trust tax rate and the motivation for the tax planning that this lack of alignment in rates prompts. They buttress the 39% tax rate by giving Inland Revenue the opportunity to compare the pattern of distributions going forward with the pattern of distributions by the trust historically. Where there is a change in that pattern, either reflecting increased frequency or the addition of new beneficiaries and their new found participation in distributions, Inland Revenue will be on alert for tax motivated structuring and behaviours.

Who might be affected?

Nearly all trusts are affected, including family trusts, standard private trusts that own shares in a company, solicitors trust accounts and trusteeships that arise from a deceased's estate.

The rules are plainly targeted at those with intent to utilise trusts to substitute a 33% tax rate where a 39% tax rate would otherwise apply. Only a small number of trusts likely fit this category yet inevitably, the new disclosure requirements will impose additional costs for thousands upon thousands of trusts founded on estate planning, and not tax planning.

For those searching for the new rules they are contained in sections 59BA and 59BAB of the Tax Administration Act, inserted by the Taxation (Income Tax and other Amendments) Act 2020.

Can a Parent Company be Liable upon a Subsidiary Company's Collapse?

Yes. Having answered this question in the affirmative, I stress that this will be the case only in the minority cases, and the general principle of corporate protection (limited liability) will most often prevail.

The point to this article however, is that there is some exposure in this respect and moreover there are steps that can be taken to limit that exposure.

A parent will face exposure where it takes over the running of a part of a business of the company. This proved problematic for the parent company in the well-publicised James Hardy Industries case following multiple claims for faulty cladding supplied by its subsidiary.

In my view, the greatest level of exposure facing a parent company in these respects lies in the potential for a contribution order to be made against it under Section 271 of the Companies Act. An order may be made against a company under that section upon liquidation of a related company in recognition of the extent to which the parent company took part in the management of the failed company and its conduct towards the creditors of that company.

A case in point is the 2016 decision in Steel Tube Holdings Ltd v Lewis Holdings Ltd. The lessor, Lewis Holdings Ltd, had leased commercial premises to Stube, a wholly owned subsidiary of Steel and Tube Holdings Ltd.

The business carried on by Stube failed after some years into the lease, but with 10 years remaining under its initial term. The parent company paid the expenses on the property, including the rent and rates throughout that remaining 10 year period, and then put Stube into liquidation.

At this time neither Stube or Steel and Tube acted to terminate the lease. It automatically renewed and upon failure to pay the rent, the lessor sued Steel and Tube (and Stube) seeking a contribution order under section 271, for which it was successful. Critical to the outcome was:

a) The absence of management of Stube independent of Steel and Tube; and

b) The parent's conduct in continuing to pay the rent for the 10 year period running on the initial term of the lease following Stube's collapse. This quite naturally induced the lessor to believe that the parent stood behind Stube's obligations.

Essentially the parent treated Stube as a division and not as a stand alone company.

For corporate groups, the key learning is that where a subsidiary is established to operate a part of the group's business, the subsidiary must be resourced with its own management team and then let loose to do so.

Directors Wearing Two Hats

Where a shareholder is also a director and has advanced money to the company, there is a conflict between his or her role as a funder on the one hand and as a director on the other. Is the director forced to place his or her own interests first, or is the director restrained from doing so by duties owed to the company?

A starting point in answering this question is the fact that company law does not preclude conflicts of interest. To do so would be totally impractical. Instead, company law accommodates conflicts of interest by way of an Interests Register and disclosure regime.

More to the point perhaps, in answering this question is the conclusion that a shareholder/director wishing to advance money to the company who is, on account of directors' duties owed to the company, prevented from enforcing repayment (or other terms), the director simply would not advance the funds.

In that event the company would suffer.

For many years this issue has remained a vexed one for company law practitioners.

However, the decision in Hunan Holdings Ltd v Viriony Corporation helpfully resolves the issue for directors managing two hats, in particular the comment from Winkelmann J's judgment:

"I am of the view that the directors who enter into transactions with a company are free to exercise contractual rights under those contracts and, in so doing, prefer their own interests over the Interests of the company".

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