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Review of Trust Law in New Zealand: Second Issues Paper

The New Zealand Law Society (Law Society) welcomes the opportunity to respond to the questions posed in *Some Issues with the Law of Trusts in New Zealand: Review of the Law of Trusts Second Issues Paper*, December 2010 (Issues Paper). This submission has been prepared with assistance from the Trust Law Review Working Group, formed by the Law Society's Property and Family Law Sections.

Q1: In your experience, what are the reasons that people set up trusts?

People set up trusts in New Zealand for the same mix of reasons that have motivated them to do so for the last four hundred years.

(i) To regulate the orderly transmission of private wealth

The most important reason many people establish trusts is to provide for the orderly control and transmission of their wealth, during their lives and following their deaths.

With its flexible and discretionary elements, the trust is arguably the best form of legal instrument or vehicle for regulating the destiny and transmission of property in the future, in a world where lives and circumstances (both private and business) change over time.

In New Zealand (and in other countries) the State has recognised and supported this orderly regulation of wealth transfer, within the boundaries of established doctrines such as the rules applying to accumulations and perpetuities. This is why trust companies, like the Public Trust, were originally established by the New Zealand Government and continue to operate in the trust market today.

Trust relationships, other than charitable trusts that benefit the public, are inherently established as *private* arrangements, specifically designed to enable tax-paid and other private property to be dealt with both presently and in the future in accordance with the intentions and wishes of the original owners (settlers) of that property. In this latter regard, it seems to be often forgotten that trusts and trust practice were and still are a foundation mechanism in the New Zealand legal system, in its jurisprudence and in the work of its legal practitioners.

The thousands of trusts that own and regulate the operation of farms and other key businesses in New Zealand today were neither intended to be, nor are they mechanisms for trying to cheat “the system” in some way. On the contrary, years of New Zealand and international precedent and trust practice have supported and encouraged the use of trusts for legitimate private and business ends. There is judicial authority supporting the underlying integrity of trust relationships in this context: see for example *Coles v Coles* (1987) 3 FRNZ (CA) and *Kain v Hutton* [2008] NZSC 61.

(ii) *Trusts as business vehicles*

The trust has been used in New Zealand as a legitimate business vehicle in a wide variety of commercial contexts. Trusts have been employed as business entities for the same reasons as limited liability companies and, in other contexts, partnerships.

The use of trusts as business vehicles has been endorsed by both Parliament and the courts (e.g. see discussion of Supreme Court in *Ben Nevis Forestry Ventures Ltd v C of IR* [2008] NZSC 115). Given the small number of structural and commercial options available to people as separate legal vehicles, it is unsurprising that trusts are used so often in business practice.

The modern business trust is not just the discretionary farming trust that passively owns land and leases it to another operational vehicle (like a company or partnership), but includes trading trusts, unit trusts, managed funds, superannuation schemes and pension trusts many of which are of a very substantial kind.

Indeed, international commercial and trust literature would support the proposition that it is the trust (in its various forms) that is now the most important form of investment and operational business vehicle in the world.

(iii) *Asset- and creditor-protection purposes*

Many trusts have been set up in New Zealand for asset and creditor protection purposes.

The law is clear that a trust that is established in solvent times by a person (X) operates lawfully and effectively against the future claims of creditors of X if its assets are not tainted by dishonest conduct.

A trust that is established when X's solvency is in doubt (or that involves transactions between X and the trust at a time of insolvency) will not be upheld by the law. The relevant statutory and other legal rules operating in this context are premised on the fact that trusts (and transactions with trusts) established and operating in solvent times, and when no person's interest is being compromised, are beyond legal and moral criticism and any reproach from the law.

These principles have been recently endorsed by both the High Court and the Court of Appeal in cases like *Jordan v Ikuia & Apa & Ors* [2010] NZCA 509 and also by reforms to the insolvency rules and s60 of the Property Law Act 2007. Those reforms reasserted the legal boundaries within which trusts (and their transactions) should not be open to legal challenge.

(iv) *Obtaining rest home subsidies*

In the early 1990s thousands of trusts (many probably inappropriately) were established with the purpose of securing rest home subsidies and avoiding negative surcharges. Many of these trusts have simply one asset (the family home).

While the establishment of these single-asset trusts cannot be criticised *per se*, it seems likely that many of them would never have achieved the purpose for which they were established (either by falling foul of anti-avoidance rules in the Social Security Act 1964 or by being struck down as shams). Most trust practitioners would now generally not support the establishment of single-asset trusts for such limited purposes and it is likely that the number of trusts being established currently for such purposes is not that significant.

Trust formations of this type are unlikely to be repeated in New Zealand's trust practice in the future, so some of the general criticisms about the inappropriate use of trusts are now no longer relevant.

(v) *Trusts to mitigate taxation*

The minimisation of income tax and estate and gift duties has always been a principal reason for the establishment of trusts in New Zealand and around the world. In the past, when significant differences in progressive income tax rates were in place and estate and gift duties were also in place, this may have been the sole or primary reason why trusts were established.

Again, in New Zealand's trust practice today the use of discretionary and other trusts to obtain significant taxation advantages has increasingly diminished through a variety of legislative reforms and judicial interventions. With the continued flattening of progressive income tax rates, the income tax advantages in this context are now often more apparent than real. Estate duties were abolished in the mid-1990s and gift duty is proposed to be abolished from 1 October 2011.

In the context of goods and services tax, trusts have always fallen squarely within the GST tax-base and their use in this context has never assisted with the avoidance of GST.

The courts have also shown their increasing willingness to challenge and strike down trust arrangements whose tax avoidance purpose is more than an incidental one and the *Penny & Hooper*¹ litigation currently before the courts is a good example of this.

In saying this, the New Zealand Parliament has been happy to continue to adopt the basic conduit nature of a trust for taxation purposes, and the income tax rules regulating trusts have been stable over a long period of time, as has Inland Revenue's approach to them.

Many of the trust law reforms in the past have been designed to assist those who have established trusts to avoid punitive taxation consequences. For example, the United Kingdom's Variation of Trusts Act 1958, and the variation of trust rules in New Zealand's Trustee Act 1956, were a deliberate legislative attempt to enable people to break away from older-style restrictive trusts without incurring substantial taxation costs. The development of the modern discretionary trust was equally designed (and endorsed by the courts) as a vehicle for enabling modifications to trusts without significant taxation costs.

¹ *Commissioner of Inland Revenue v Penny and Hooper* [2010] NZCA 231.

(vi) *Avoiding property relationship claims*

Former relationship partners have also used trusts as mechanisms to avoid claims. It is in this environment that many of the major trust disputes have found their way into the courts in recent times.

Trusts are likely to continue to be used for this purpose, and it cannot be regarded as an inappropriate use, provided that it does not offend any of the specific anti-avoidance or former-partner-creditor rules which are designed to ensure that relationship property cannot be divested from a rightful owner.

Again, in this context, a few minor and targeted amendments to the Property (Relationships) Act 1976 rules would be sufficient to set out a clear framework within which trusts established principally or solely to defeat the claims of a legitimate former partner are void and unenforceable. The courts have shown a real willingness to provide just solutions when confronted with “problem” trusts.

As with the position around trusts established to obtain rest home subsidies, the concerns in this context are in many respects now more apparent than real, and the problems that exist are due to technical uncertainties in the law and judicial decisions that could be easily rectified.

Q2: Do you think there are any purposes for which Trusts should not be used? If so, what are these and why?

The Law Society agrees with the statement at paragraph 2.30 of the Issues Paper, to the effect that a trust may be created for any purpose which is not illegal, which is not against public policy, and which it is possible to achieve.

As is evident from other sections in this response, there is a perception, and at times a reality, that trusts are set up which allow some people to avoid legal obligations, such as debts, relationship property entitlements, and family protection/testamentary promises entitlements.

There may well be appropriate policy reasons, within each of the statutes or legal provisions regulating these areas, that would justify the courts in considering and perhaps addressing patent unfairness which may result from the use of a trust to defeat the objectives of the particular legal provisions. However, it would be appropriate to consider amending the

particular statutes involved, rather than attempting to deal with perceived problems by reforming the law of trusts.

A related issue is the amendment to the Estate and Gift Duties Act 1968 that will have the effect of abolishing gift duty as from 1 October 2011. It is relevant here because it is likely to lead to an increase in the use of trusts. The Law Society submitted in relation to this proposal as follows:²

“Family lawyers are acutely aware of the detrimental effect that trusts in particular have on the social aims of the PRA [Property (Relationships) Act 1976] and the Family Protection Act. The repeal of estate duty in 1993 resulted in a sharp rise in the number of trusts. The repeal of gift duty is likely to increase the number of trusts even more. The Society is aware of the Law Commission’s Review of the Law of Trusts. While some of the issues raised [in this submission] may be addressed as part of this review, the concern of the Society is not only with trusts, but with the likely increase in voluntary alienations in general to the detriment of the social aims of the PRA, the Family Protection Act and the Law Reform (Testamentary Promises) Act 1949. Reform of trust law alone will not redress this detrimental effect. Gifts to companies or third parties are likely to arise as well.”

The Law Society recommended that the Select Committee consider what legislative amendment to *those* Acts might be required to afford adequate protection to prevent or remedy the disposal of relationship property to a trust or company that has the effect of defeating a partner/spouse’s rights and/or interests.

In short, then, the distortions just referred to do not lead to the conclusion that trusts for certain purposes should not be used; rather that the remedies lie in other areas.

Q3: *Should trusts be available to be used to achieve any objective or should there be limits placed on the ways in which trusts may be used?*

Trusts are used for a wide variety of purposes, and so long as no trust activity involves criminal activity there should be no limit on the way in which trusts can be used. The Law Society would support legislation being implemented so as to prevent trusts being used to further any illegal or criminal activity (although note also comments made in response to Question 7).

Trustees' duties are becoming increasingly onerous. This provides some practical assistance in limiting more questionable activities that trusts may be involved in, due to trustees' personal liability.

Q4: Is the extent of the control that a settlor may retain a cause for concern? If so, how might the matter be addressed?

The retention of a degree of control by a settlor is not in and of itself a cause of concern. It is important to distinguish between what one would regard as "appropriate" degrees of control by a settlor (for example, retaining the power of appointment and removal of trustees) and what might be regarded as "inappropriate" degrees of control. The Law Society believes that the matters that cause concern are settlor behaviours rather than legal elements of control.

For example, the sorts of behaviour identified by the Commission at paragraph 5.47 (settlor intermingling his property with trust property, settlor treating trust property as his or her own, etc) are elements of settlor behaviour rather than settlor control.

In practice, the ability of the settlor to exercise some control over the affairs of the trust is an important part of many trust arrangements. After all, the settlor decides the objects and purposes of the trust in the first instance. It may therefore be appropriate that the settlor retains some control to ensure that his or her intentions regarding the trust property are being carried out.

Many of the perceived "settlor control" concerns are in fact "settlor behaviour" concerns, which are dealt with in the Law Society's answers to questions 9 and 10 below.

Q5: New Zealand appears to have a significantly higher proportion of trusts per head of population than comparable jurisdictions. Why is this? Is it:

- *Concern about existing or possible future government policies?*
- *Prompted by a desire to protect assets from business risk?*
- *To control the use or destination of assets to avoid obligations to third parties?*
- *To avoid claims by spouses or partners of children to inherited assets?*
- *To access state-provided assistance?*
- *Any other reason?*

² New Zealand Law Society submission to the Finance and Expenditure Select Committee on clause 110 of the Taxation (Tax Administration and Remedial Matters) Bill, 16 February 2011, at paragraph 14. Available at http://www.lawsociety.org.nz/__data/assets/pdf_file/0006/34449/taxation-bill-abolition-of-gift-duty.pdf

The Law Society's practical observation is that the popular reasons for establishing trusts vary over time and reflect to some extent the economic and social environment of the time. For example, as pointed out in the response to question 1, many thousands of single asset trusts were established in the early 1990s as a response to the introduction of asset testing for rest home subsidies. Although those trusts may well not have achieved the purpose for which they were established, the change in asset-testing thresholds means that the motivation for the establishment of those trusts has decreased significantly.

An example of an increasing motivation for the use of trusts is the protection of inherited assets from relationship property claims, particularly since the extension in 2002 of the former matrimonial property regime to de facto couples.

As the Commission has noted, it is difficult to be precise about the number of trusts in existence in New Zealand. The statistics would seem to indicate that a large number of trusts in New Zealand do not derive income and are likely to be single asset (usually family home) trusts. The establishment of single asset trusts became extremely popular in the early 1990s as a result of asset-testing regimes being introduced, with the result that the establishment of such trusts became commoditised. Trust advisers (and lawyers in particular) competed with each other to provide "cut price" trust establishment services. The Law Society suggests that the average cost of establishing a trust in New Zealand is significantly lower than in, for example, the United Kingdom.

Q6: Are the existing legislative mechanisms for addressing the impact of Trusts adequate? If not, can they be made more effective and how? Is the solution to strengthen the current provisions or is a stronger, more uniform solution called for? If you think there should be a single provision in Trust legislation, what factors should be included in this provision?

The Issues Paper discusses some legislative provisions relating to bodies of law including relationship property law, insolvency law, tax law, and social benefits.

Trust law is mainly aimed at protecting beneficiaries. When trust law interfaces with other bodies of law there can be conflicts. For example, relationship property law often clashes with trust law. Relationship property law is aimed at protecting the parties to a relationship. It is not aimed at protecting beneficiaries as trust law does.

Insolvency law often conflicts with trust law as well. Insolvency law is aimed at protecting creditors. It is not aimed at protecting beneficiaries as trust law does.

Tax law is aimed at the State collecting a fair share of taxpayers' property as tax. Social benefit law is aimed at the State delivering a fair share of benefits to the public. Unlike trust law, neither tax law nor social benefit law is aimed at protecting beneficiaries.

Therefore it is no surprise that there are problems where these bodies of law apply and trusts are involved because the applicable laws are aimed at different objects.

Do you think there should be a single provision in trust legislation?

When considering the interface between trust law and each of the other bodies of law it is necessary to consider the different objects and, having regard to them, to make law which is substantively fair. This requires a fair balancing of peoples' interests.

Because of the different objects that the various bodies of law seek to achieve, the Law Society does not think it is viable to make a provision of general application.

Are the existing legislative mechanisms adequate and if not how can they be improved?

(i) Sections 344 to 350 Property Law Act 2007

These provisions are of general application (so they do not just apply to disposals to trustees of trusts) and are aimed at disposals of property that prejudice creditors.

The provisions are in a new form as they replace s60 of the Property Law Act 1952, and appear to strengthen creditors' claims to set aside disposals to trusts.

Under the provisions, where a settlor makes a gift to trustees (or enters into another transaction with them) the position is tested at the time of the gift.

So long as the settlor is solvent (although about to engage in business with insufficient resources or incur debts beyond his or her means), the settlor can legitimately organise his or her affairs to reduce the risk of assets being subject to claims by creditors.

The Companies Act 1993 and Limited Partnerships Act 2007 allow creditor protection in other ways and previous legislation has allowed it for a very long time. The Law Society does not believe it can be said that a person organising his or her affairs with creditor

protection in mind is substantively unfair, so long as it is carried out within appropriate limits.

As the Commission notes in the Issues Paper at paragraph 3.9, the *Regal Castings*³ decision is important because it indicates a shift in approach in favour of creditors, whereas previously it was relatively easy for a debtor to avoid his liabilities by disposing of property. However, there is no reported case law on the new provisions, as they may affect a purchaser for value and good faith without knowledge of the fact there had been a prejudicial disposition. At this stage the Law Society does not consider that the provisions of the Property Law Act need strengthening or are inadequate.

The Law Society does not believe that any "trust busting" provisions are required because a settlor has some legitimate control over a trust or has some legitimate interest in it. If that were so, then it could be argued that the assets of the shareholders of an insolvent company should, in the ordinary course, be subject to creditor claims as well (which would be unacceptable in our social and economic environment).

(ii) *Sections 204 and 205 (voidable gifts) and 211 and 212 (transactions at undervalue)*
Insolvency Act 2006

These provisions are of general application (so they do not just apply to disposals to trustees of trusts) and are aimed at disposals of property that prejudice creditors.

However, unlike the provisions of the Property Law Act, the Insolvency Act provisions only apply to bankrupts, so there are some differences when compared with the Property Law Act provisions. Those differences reflect bankruptcy policy and the attempt, in recent years, to harmonise the provisions in the Insolvency Act with the liquidation provisions of the Companies Act 1993 where it is feasible to do so.

With the abolition of gift duty, more focus will fall on these provisions and, in particular, the onus of proving that the donor of a gift (the settlor) remained solvent when the gift was made.

For similar reasons discussed in relation to the Property Law Act provisions, the Law Society does not think the provisions of the Insolvency Act are inadequate or ought to be amended in relation to gifts or transactions between settlors and trustees.

³ *Regal Castings Ltd v Lightbody* [2009] 2 NZLR 433

The Law Society does believe, however, that the provisions need examining (along with the liquidation provisions under the Companies Act 1993) in relation to transactions leading up to the insolvency of trusts (and the liquidation of trustees and bankruptcy of trustees for trust debts). The issue of whether there ought to be specific legislation to deal with insolvent trusts ought to be examined and it may be appropriate to deal with that as part of the Commission's examination of trading trusts.

As a result of the Court of Appeal's decision in *Official Assignee v Wilson* [2008] 3 NZLR 45 in relation to the Official Assignee's standing (referred to in paragraph 4.16 of the Commission's paper), remedial legislation is desirable to strengthen the Official Assignee's standing to make claims as assignee of a bankrupt settlor. This issue is developed more fully in our response to question 9 below.

(iii) *Property (Relationships) Act 1976*

The Issues Paper in paragraphs 3.23 to 3.31 and 4.26 to 4.57 highlights a number of issues with this legislation. The Law Society believes the key issue is whether the equal sharing concept ought to be paramount where property, which would otherwise be relationship property, is held on trust. Either way, the current provisions are not adequate and have led to unsatisfactory results. This is a result of provisions which sometimes allow a trust to be "busted" and sometimes not. This has led to judicial responses, such as recourse to the bundle of rights doctrine, or to consideration of the difficult concepts of sham and/or alter ego, which many trust lawyers see as distortions of trust law. This in turn leads to uncertainty and concern about trust law in New Zealand.

A clear decision needs to be made about whether the equal sharing concept should be paramount. If it is to be paramount, the legislation should clearly say so and contain wider discretions giving the courts freedom to make appropriate orders in relation to trust assets that would otherwise have been relationship property or separate property subject to a court order. Such legislation would also require the courts to have regard to the other beneficiaries of the trust when making orders. It could contain a simple and expedient "caveat" procedure under which the exercise of a party's powers under a trust could be temporarily suspended and then supervised by the courts – rather than the more clumsy expedient of an application under s51 of the Trustee Act.

The Law Society believes that this approach warrants careful consideration, due to the large number of domestic trusts in New Zealand holding family residences.

The legislation should also contain clear provisions allowing the parties to 'contract out' of the equal sharing regime in relation to trusts. This would encourage parties to deal with each other in an upfront and clear way, which is desirable in this area.

If the equal sharing concept is not to be paramount, then (unless the Supreme Court sooner clarifies the issues satisfactorily) the legislation should be amended to clarify when the courts may intervene and to clarify whether interests (of various kinds) under trusts can be relationship property or separate property for the purposes of the legislation.

(iv) Family Proceedings Act

Section 182 of the Family Proceedings Act contains a separate regime for trusts to that contained in the Property (Relationships) Act 1976. Whilst we understand the historical reasons for this, and that s182 rests on different principles, we believe the interrelationship between the Property (Relationships) Act 1976 provisions and s182 ought to be considered.

For instance, if the Property (Relationships) Act 1976 provisions apply to beneficiaries who are de facto couples, then why should not s182 also apply to them? And if the principle of equal sharing is to be paramount, then why should the principle not apply to any trust to the extent it holds assets that would otherwise have been relationship property or separate property subject to a court order – subject to the interests of other beneficiaries and the right to contract out of that regime.

If the principle of equal sharing is to be paramount, a single set of provisions dealing with trusts ought to be contained in the Property (Relationships) Act. This would replace the provisions in the Property (Relationships) Act 1976 and the Family Proceedings Act.

If the principle of equal sharing is not to be paramount, then s182 of the Family Proceedings Act should remain.

(v) Income Tax

New Zealand's income tax legislation imposes tax on net income that taxpayers derive annually. Trusts are included within this taxation regime in the normal way, subject to the special statutory election that operates in terms of which either a trustee or a beneficiary of a trust (but not both) will be taxed on any item of annual income derived.

Income tax legislation, like other taxation legislation, would not normally contain rules that would allow Inland Revenue to disregard a legal vehicle like a trust so as to gain access to its assets for the purposes of satisfying creditor and other obligations. Normally those “look through” rules for accessing assets would be found in bankruptcy and insolvency laws and in other statutory and general law contexts, giving rights to the government and others to access and enforce debts owed by persons associated with the trust relationship – e.g. a trustee, beneficiary or settlor.

Income tax legislation sits alongside other corporate and commercial laws. As the raft of recent cases involving prosecutions and claims (both criminal and civil) against trustees (sometimes settlors) demonstrates, there are sufficient powers within existing laws to recoup money from trusts that default on their tax and other legal obligations. The criminal and civil offence provisions of the Tax Administration Act 1994, coupled with the civil shortfall penalty and other penalty rules in that legislation (including the use-of-money-interest rules), provide a broad range of remedies.

More specifically, the anti-avoidance rule in sBG 1 of the Income Tax Act 2007 provides an effective remedy against trusts that are involved in tax avoidance activities or otherwise not accounting for tax in the correct way. The rule operates as a “look through” rule because it abolishes for tax purposes (only) transactions a trust may have been involved with (including distributions to beneficiaries, loans, trading transactions etc) and re-adjusts assessable income to any person involved in the “avoidance” arrangement. Conventionally this may include a trustee, beneficiary, settlor or related third party.

As the Commission also correctly notes, the “settlor rules” in the Income Tax Act for determining jurisdictional issues associated with trusts are economic- and substance-oriented rules, like the United States of America grantor trust rules, designed to look at the commercial reality of a trust relationship and those involved with it, as opposed to its pure form. These rules are important for ensuring that the maximum pool of trusts with a New Zealand “connection” account for taxation here.

The “associated persons” rules, while again not “look through” rules, are specifically designed to ensure that related parties undertaking real property transactions cannot by operating through a trust (and other vehicles) escape income tax liability.

In addition, the statutory “minor beneficiary” rules align the tax rate of certain beneficiaries with the trustee rate, to overcome aggressive income-splitting practices.

The right of taxpayers to use trusts in their business and private affairs has been endorsed by the courts at the highest level. However, the courts have no tolerance for artificial trust and trust-related arrangements designed purely to avoid taxation, and have shown a willingness to use doctrines such as shams and sBG 1 to ensure that there are the right taxation outcomes and no unnecessary erosion of the tax-base.

In summary, the present rules operating in the taxation context in respect of trusts are working well to protect the integrity of the taxation system and these, when coupled with other normal statutory and commercial laws, provide a complete legal framework to prevent trusts being used in an abusive way to avoid their proper tax obligations. Inland Revenue acts swiftly to close any legislative loopholes, actively pursues tax obligations owed by trusts, and has the choice to act legislatively at any time in terms of tax rates or otherwise to counter the inappropriate use of trusts for tax purposes.

(vi) Residential care subsidy and legal aid

The State provides assistance for people in relation to residential care subsidies and legal aid. A common premise is that people should use their own resources before calling on the State. However, whilst there are broad similarities in approach, the relevant laws use different criteria to assess whether a person has an interest under a trust sufficient to mean the interest in the trust should be considered the person's own property.

The Social Security Act 1964 provisions and the Social Security (Long-term Residential Care) Regulations 2005 are of general application (so they do not just apply to disposals to trustees of trusts), and revolve around the concept of intentional deprivation of property. In practical terms the provisions are limited by the regulations specifying a 5-year "look back" period. The clear disadvantage of this 5-year period is that, in effect, it provides a bright line for settlors wishing to dispose of assets to trustees. However this will need to be considered carefully and possibly amended as a result of the proposed abolition of gift duty.

The legal aid eligibility criteria in the Legal Services Regulations 2006 contain provisions specifically aimed at trusts. The assessment is driven by the applicant's opportunity to benefit from a trust, as opposed to the intentional deprivation of property.

As noted above, the focus of each of these regulations is different and requires a different approach to assessment (and therefore criteria). There is, however, room for improvement and some harmonisation of approach. The regulations should have more focus on the

"interest" (in the broad sense of the word) of the beneficiary under the trust and should have regard to the likelihood of the beneficiary receiving a benefit. If deprivation of property is to remain part of the test for residential care subsidy purposes, a purpose or intention test coupled with a rebuttable presumption operating for a longer "look back" period could be adopted.

Q7: Do you think that the principle that trusts should have a purpose or effect that is lawful and not contrary to public policy, or some other principle, should be included in New Zealand's trusts legislation?

General trust rules contain a number of long-standing and well-established doctrines and principles that address the *vires* of trusts established to promote or facilitate an unlawful or fraudulent purpose. These principles are discussed in legal authorities like *Nelson v Nelson* (1995) 184 CLR 538 (HCA).

Given that general trust law rules have never endorsed or ratified the existence of a trust established for an unlawful purpose or one contrary to public policy (e.g. to evade taxation), it seems unnecessary for any new trusts legislation to confirm what is now established and well-understood existing law.

There are equally well-established principles (and specific statutory rules) that regulate the position of unlawful settlements onto a trust and unlawful distributions and appointments from the trustees of a trust to its objects.

For example, sBG1 of the Income Tax Act 2007, s60 of the Property Law Act 2007, the anti-avoidance rules in the Social Security Act 1964, the "voidable" disposition rules in the Insolvency Act 2007, and certain rules in the Criminal Proceeds (Recovery) Act 2009 specifically address the position of trusts established (and trust-related alienations of property) for unlawful or improper purposes (e.g. trust alienations to defeat creditors when insolvent) and provide comprehensive sanctions and solutions to address the position of offenders.

In New Zealand, the Crown has always had ample powers to address so-called "abusive or illegal trust" situations. The Crown is now increasingly using these powers to properly enforce those existing rules (e.g. through the prosecution of directors and trustees associated with collapses in the finance company sector).

This is not an area that requires further legislative change. All that is required is continued enforcement of existing statutory and general law rules that target the misuse of trusts for unlawful purposes.

Q8: Are there any further adverse impacts of the proposed repeal of gift duty in relation to trusts? Are there changes that should be made to trust law to address these adverse impacts?

The Law Society refers the Commission to its submission to the Finance and Expenditure Select Committee on clause 110 (repeal of gift duty) of the Taxation (Tax Administration and Remedial Matters) Bill.⁴

Q9: Is the law on sham and alter ego trusts satisfactory? If not, in what respects might it be altered? Is the “bundle of rights” concept satisfactory? Does it provide an acceptable way of addressing inequities in the area of relationship property? Should the law in these areas be left open to the courts to develop or is a legislative response called for?

Is the law on sham and alter ego trusts satisfactory?

The Law Society considers that the law is not satisfactory as to shams, but is satisfactory as to the *alter ego* doctrine.

The leading case in New Zealand is *Official Assignee v Wilson*, which was referred to in the Law Society’s response to the Commission’s Introductory Issues Paper, and is discussed by the Commission in its Second Issues Paper at paragraphs 4.15ff.

The ratio of the Court of Appeal decision was that the Official Assignee could not challenge a trust if the bankrupt could not have challenged it prior to the bankruptcy. *Obiter* in the case indicated that a high level of evidence would be necessary to show a sham trust in any event, and that there is no doctrine of *alter ego* in New Zealand.

As previously submitted by the Law Society, the ratio of *Official Assignee v Wilson* appears to be incorrect. The Commission has noted the criticisms of it at footnote 141 of the Second Issues Paper. The Court did not receive the benefit of proper argument on the point, and seems to have overlooked s412 of the Insolvency Act. The Official Assignee ought not to be constrained from doing something that a creditor could do, this being consistent with broader principles of insolvency law. Moreover, the Official Assignee is likely to be the obvious

plaintiff in many cases where a sham of a trust structure is being raised as a shield against the payment of debts. The Law Society therefore considers that the position of the Official Assignee ought to be as it was before the Court of Appeal decision. That is, the Official Assignee should be free to allege sham structures whether or not the bankrupt could have, and the standard of proof should be the usual civil standard.

As to the definition of “sham”, there is no clear pathway to a single reform, although it is agreed that reform is needed. If *Official Assignee v Wilson* is put to one side, then the courts can continue to consider allegations of sham with less restraint. Wider definitions are available than the narrow *Snook*⁵ definition used in *Official Assignee v Wilson*. A very recent example is to be found in *Antle v The Queen* (2010) FCA 280, a decision of the Federal Court of Appeal of Canada. This case is discussed in a recent article by Anthony Grant in *NZ Lawyer*.⁶ It appears that the thrust of the more liberal approach is not to require the direct connivance of all trustees, but to allow the court to take a more holistic approach to the overall circumstances and consider whether it would make sense for a trustee to say “no” to the person holding the real power. This seems like an elegant approach: it stops settlors hiding behind tame trustees who could theoretically say “no”, and it allows an examination of the past record of administration of the trust.

Alternatively, there could be more detailed legislative reform. The Law Society does not support any detailed prescriptive reform generally. However, consideration could be given to allowing a class of people (Official Assignee, creditors, perhaps people adversely affected) to seek a declaration that a trust structure is a sham and for the courts to determine for whom the assets are held. To take the mechanics further, there could be provision for the appointment of a receiver (strictly already available under the powers of the court) or a liquidator. A test would have to be developed.

Early and tentative suggestions about the test are that it would be focussed on the question, for whom in reality are the assets held notwithstanding the beneficiaries so named or described. The courts might be directed to consider the circumstances by which the trust was created, the means by which the trust came into its assets, the standing of the trustees relative to people who might otherwise appear to have an interest in the trust, the administration of the trust to date, and the interests of the beneficiaries. It would make sense that if the courts, having conducted the enquiry, found there was no sham but if the trust’s affairs had been

⁴ Referred to above, in relation to Question 2.

⁵ *Snook v London & West Riding Investments Ltd* [1967] 1 All ER 518.

⁶ *NZ Lawyer* Issue 153, 11 February 2011.

very poorly managed (as in *Official Assignee v Wilson*) then it could appoint an independent trustee or trustees.

The ignoring of or “looking through” a trust structure is not as radical or unprecedented as might first seem. The Child Support Act and the Legal Services Act allow the taking into account of wealth in a trust, and those provisions are routinely applied. Although not specific to trusts, s72 of the Social Security Act 1964 allows alienation to a trust to be ignored. No time limit is imposed in s72 of the Social Security Act 1964. For a considerable period of time, trusts in which the settlor had retained some sort of interest (the “strings attached concept”) were ignored for the purposes of the Estate and Gift Duties Act 1968. There is a body of case law on the application of this.

The time within which a challenge might be made also needs consideration. First, there needs to be differentiation between the establishment of the trust and the creation of its wealth. It is likely to be the latter that is important, with the former possibly being evidence to take into account. Secondly, there needs to be a period after which the transfer of wealth to a trust is immune from challenge. If there were not, then the law would be excluding the time honoured estate-planning custom of protecting assets for dependents. Perhaps ten years before reaching a safe-haven?

The doctrine of *alter ego* was tentatively adopted from Australia in the short time before *Official Assignee v Wilson*, and seems to have been an attempt to work around inequities involving division of property and family trusts. It has been supplanted by the “bundle of rights” approach. It is no longer relevant. The Law Society would not want to see it re-established. It appears that *alter ego* concepts in respect of trusts can be put to one side as an historical aberration.

Is the “bundle of rights” concept satisfactory?

The Law Society believes strongly that the “bundle of rights” concept is unsatisfactory. It is inconsistent with principles of equity and trust law. Its application is variable and unpredictable. If it is to remain, then ideally the courts would develop the concept into something less uncertain. However, that very development would have ramifications as to the true nature of trusts. The “bundle of rights” approach has been widely discussed and criticised, and it seems unnecessary for the Law Society to do more than note that criticism.

Does it [the “bundle of rights” concept] provide an acceptable way of addressing inequities in the area of relationship property?

The “bundle of rights” concept is clearly a response of the courts to do justice in the area of relationship property only because of the absence of any other provisions available. To that extent it might be said to provide an acceptable way of addressing inequities, but it is better said that it is the only way at present and that it is generally unsatisfactory.

A better way, as foreshadowed in the Law Society’s response to the Introductory Issues Paper, would be to amend the legislation relating to relationship property such that a trust established by the parties and fitting a suitable definition could be altered, restructured or distributed by the courts. This is essentially the existing power in s182 of the Family Proceedings Act 1980, although that power is presently limited to the time of or shortly after the dissolution of a marriage. The Law Society believes that third party trusts (e.g. a parent placing property in trust for a child) ought not to be affected in any way by any such reform, and the suggestion made is limited to where couples themselves have funded wealth into a trust. If this type of reform were instituted, then the “bundle of rights” approach would disappear. It is noted that outside of trust reform, in the area of relationship property reform, the powers in s182 could usefully be carried over to the Property (Relationships) Act.

Should the law in these areas be left open to the Courts to develop or is a legislative response called for?

A legislative response is required to correct the ratio in *Official Assignee v Wilson*. A possible legislative response may be called for with sham trusts.

A legislative approach is required to give the Family Court the necessary powers to deal with family trusts that are part of the affairs of couples.

No legislative response is required for the doctrine of *alter ego*.

Q10: Should there be a statutory provision, such as that proposed in paragraph 5.47, enabling the Courts to set aside a Trust following consideration of a range of factors? Are there any other factors that should be considered?

The Law Society does not believe there should be a statutory provision enabling the Courts to set aside a trust. The issue of validity of trusts should be left to the courts to determine according to trust law as it currently stands.

There are some serious disadvantages in trying to legislate about when a trust is invalid:

- (a) There are conceptual disputes that would need to be determined first (such as whether both a trustee and a settlor need to be party to a sham).
- (b) The issues in each case are likely to be very fact specific. This will make it difficult to cater for various scenarios through legislation.
- (c) This could constrain judges from making appropriate findings in some cases.
- (d) There will likely be technical drafting problems in defining just when a trust should be found invalid.

However, remedial legislation may from time to time be necessary in limited areas. For example, the result of the Court of Appeal's decision in *Official Assignee v Wilson* [2008] 3 NZLR 45 in relation to the Official Assignee's standing (referred to in paragraph 4.16 of the Commission's paper) should be addressed by legislation to strengthen the Official Assignee's standing to make claims as assignee of a bankrupt settlor. Reference has already been made to possible legislative mechanisms in the areas of relationship property, and such statutes as the Family Protection Act and the Law Reform (Testamentary Promises) Act.

Supplementary comments from a rural perspective

Farmers form trusts for a variety of reasons, which may change over time.

In the 1960s and 1970s, trusts were formed to avoid death duty. Some of those trusts still exist but have generally been “parked” because of their inflexibility. The assets were normally transferred to discretionary family trusts with a debt back during the lifetime of the settlor. It was necessary for farmers to form these trusts to preserve succession of the family farm to the next generation and to maintain the farm’s economic viability by avoiding the payment of a significant amount of tax on the death of the owner.

In recent times, farmers have formed joint discretionary family trusts to implement a tax planning structure or for “protection”, usually on the advice of their accountant.

The tax regime has now changed, rendering the trust tax structures largely ineffective. On closer examination, there is very little trading risk faced by farmers. Fortunately, joint discretionary family trusts are effective vehicles for estate and succession planning for farming families. They also provide a great deal of protection, if properly implemented, for future inheritances in the hands of the children, especially with regard to the Property (Relationships) Act 1976.

From the rural community's perspective, trusts should be able to be used to protect assets and to facilitate and enhance estate plans and ongoing succession of farmland to successive generations. Any change to the law that might prevent or inhibit this process would be significantly detrimental to farmers and their families, and therefore to the economy and citizens of New Zealand.

Trusts should not be able to be used for any unlawful purpose or for a purpose that is contrary to public policy. The rural sector has historically used trusts in proper and sometimes creative ways. It would be disappointing if limits were placed on the way in which trusts can be used. Their creation was innovative, and they should be allowed to continue to be used in appropriate ways to protect assets and preserve wealth. In the case of the rural sector, the preservation of wealth can be difficult because in most cases the return on capital is low. Trusts are important for protecting rural capital.

The extent of control that a settlor may retain is a vital issue for any settlor in the rural sector. Any change in the current law of trusts around control could be detrimental to farmers by making it risky to find innovative legal vehicles through trusts to arrange their affairs and protect the farm for future generations.

The reason for the high number of trusts in New Zealand was initially tax management, but latterly the rural sector and its advisers realised that trusts are excellent estate planning vehicles if set up and administered properly.

Although the initial reason and purpose of forming discretionary joint family trusts was primarily tax driven, such trusts have provided the farming community with the perfect vehicle to properly manage an estate plan and, if appropriate, a succession plan. Protection from claims by children's spouses is also significant.

The repeal of gift duty could be positive for farmers. It will enable them to divest wealth to a trust to ensure the success of an estate or succession plan. In a few cases it will also avoid the difficulties faced by farmers under the Family Protection Act.

There are concerns that the repeal of gift duty may eventually lead to the reintroduction of stamp duty or capital gains tax which would be contrary of the interests of farm succession in this country.

These cases potentially present a problem by creating uncertainty about the effectiveness of an estate or succession plan for a farming family. However, over time and with the benefit of close examination of the structures that are in place and the way that they are administered, most of these

issues are imagined rather than real. In most cases the case law has very little if any impact on a well-structured and properly administered estate or succession plan using a joint discretionary trust.

The bundle of rights concept raises some important issues on how the estate plan or succession plan can effectively operate when the settlor, during his or her lifetime, will almost always want to have the power of appointment. Such cases do result in innovation by ensuring that any inheritance trust for the children is settled by the parents rather than by the children.

Parliament should pause and consider carefully whether to respond legislatively to the natural evolution of the law. In other words, Parliament should be looking at the Property (Relationships) Act 1976, not the Trustee Act, to address the issues arising out of the courts.

Conclusion

This submission has been prepared with assistance from the Law Society's Property and Family Law Sections. If you have any queries regarding this submission please contact the Property Law Section manager, Kim Oelofse, by telephone (04) 463 2991 or email (kim.oelofse@lawsociety.org.nz).

Yours sincerely

A handwritten signature in black ink, appearing to be 'Andrew Gilchrist', written in a cursive style.

Andrew Gilchrist
Vice-President