TRUSTS - RESPONSIBILITIES & RISKS FOR ACCOUNTANTS

NZ Trusts

Popularity of NZ trusts

Trusts have long been a central piece of the legal infrastructure of NZ and other jurisdictions sharing our common law heritage. Trusts are governed by the Trustees Act 1956 and a large body of common law, all of which is currently under review by the Law Commission and Government with a view to introducing a modern NZ Trusts Act in the near future that codifies much of the recent body of common law. While the popularity of trusts in NZ appears to be declining as some of the benefits of trusts have been reduced (whilst the costs of administering them has continued to increase), it is estimated there are 300,000 to 500,000 trusts active in NZ today. Most accountants will be involved as advisers to or professional trustees of trusts to some greater or lesser extent.

What are the benefits of trusts?

The effectiveness of trusts comes from two key attributes. Firstly, they provide legal separation of the ownership of assets from those who benefit from those assets and secondly, they enable assets to be held collectively rather than individually. These attributes have ensured that trusts remain a proven and flexible way of protecting assets from claimants and for managing them for the benefit of both current and future generations of beneficiaries. In some circumstances, they can also be used to minimise taxation by the allocation of income to beneficiaries who have personal marginal tax rates below the maximum marginal tax rate of 33% (NB: minor beneficiaries below age 16 are taxed at the trustee's income rate of 33% on any income allocated in excess of $1000 pa).

Role in asset protection plans

A basic asset protection strategy for families using trusts is to transfer assets that will appreciate in value into a trust and gift off the debt owed back by the trust to the donor. There is no longer any gift duty and therefore limits as to how much can be gifted duty free. However there are other considerations that may require legal advice. One of these is future eligibility for the residential care subsidy which is means tested.

Responsibilities & Duties of Trustees

What roles & responsibilities have been codified?

Accountants acting as professional trustees need to clearly understand their responsibilities and duties as a trustee. These are spelled out in the current Trustees Act 1956 and common law cases, which have now been codified as a set of recommendations for the mandatory and default duties in the new act by the Law Commission Review of the Law of Trusts as follows:

Mandatory Duties

a. *Mandatory Duties*
   - Know the terms of the trust deed and act in accordance with these
   - Act honestly and in good faith
   - Act for the benefit of the beneficiaries or to further the purpose of the trust
   - Exercise stewardship over the trust property for the benefit of the beneficiaries or to further the purpose of the trust
   - Exercise their powers for a proper purpose

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Default Duties

b. *Default Duties*

- Not to exercise any power for the direct or indirect benefit of the trustee
- Actively or regularly consider the exercise of the trustee's power and not to restrict the future exercise of these powers
- Avoid a position of conflict of interest
- Maintain financial accounts of the trust property that adequately identify the assets, liabilities, income and expenses of the trust and are appropriate to the value and complexity of the trust's financial affairs
- Not be unfairly impartial to some beneficiaries to the detriment of others otherwise specified by the trust deed
- Not make a profit or accept a reward that has not been permitted by the beneficiaries or is in accordance with the trustee's right to be reimbursed for legitimate expenses or disbursements
- Act unanimously where there is more than one trustee, unless otherwise provided in the trust deed
- Manage the trust and exercise trustee powers with such care and skill as is reasonable in the circumstances. Where a trustee has or holds themselves out as having special knowledge or experience or is acting in the course of their business or profession, that trustee has a duty of care to exercise the level of care, diligence and skill that it is reasonable to expect of a person who is acting with that kind of knowledge or acting in the course of that kind of business or profession

  Invest prudently by exercising the care, diligence and skill that a prudent person of business would exercise in managing the affairs of others

In exercising these duties, there is no requirement that beneficiaries be treated equally, only that all beneficiaries are considered and treated in accordance with the terms of the trust. Also, default duties may be excluded or modified by the terms of the trust deed but not to the extent that these changes are inconsistent with the mandatory duties.

General risks vs special risks

In addition to the general risks arising from a failure to fulfil the mandatory or default duties of a trustee, accountants acting as an adviser to or professional trustee of a trust face a special risks that deserve to be highlighted. These are:

- Being drawn into the giving of financial advice
- Managing investments

Special Risk #1

The Giving of Financial Advice

Given that many clients see their accountants as the financial expert in their lives, it's not surprising that being drawn into the "giving of financial advice" is a special risk that accountants will almost inevitably face at some stage. An understanding of the Financial Advisers Act 2008 is essential for accountants advising on or making investment decisions on behalf of their trust clients. Specifically, this legislation covers the following activities:

- *Giving financial advice* – financial advice is defined as making a recommendation, or giving an opinion to a client in relation to the acquiring or disposing of a financial product.
- *Providing an investment planning service* – this is defined as a service to design (or offer to design) for a client a plan which analyses their overall current and future financial situation (including investment needs), identifies their investment goals and gives a recommendation or opinion on how to realise some or all of those goals.
- *Providing a discretionary investment management service* – this is defined as a service to decide which financial products to acquire or dispose of on behalf of a client, while acting under an authority granted to them (or their employer or principal) to manage some or all of the client's holdings of financial products.

CAANZ members limited exemption

CAANZ members (but only those who are Chartered Accountants) may be exempt from the requirement to be an authorised or registered financial adviser in order to be able to give financial advice in certain circumstances:

- Firstly, if these financial adviser services are given in the "ordinary course of business" as a Chartered Accountant as determined by the specific set of circumstances
- Secondly, if these financial adviser services are provided are "incidental" and carried out to facilitate or are ancillary to the non-financial services of the CA business as determined by the specific set of circumstances

CAANZ exemption still subject to competency test

In all cases CAANZ's Code of Ethics applies which means you must also ensure you are competent to undertake the specific financial advisory services you are being asked to provide to the trust. In other words, unless one of the above exemptions clearly applies and you can also demonstrate competency to advise on the specific financial matters under consideration, then accountants should ensure that the trustees:

- Seek out professional, competent advice from a fee-only and independent Authorised Financial Adviser (AFA)
- Test that advice for soundness
- Understand the advice given. Passive acceptance or the mere participation of trustees is not enough
- Expect a fiduciary responsibility of care from the adviser and hold them accountable to act in accordance with this duty of care

Managing Investments

Special Risk #2

The management of investments is often the most difficult task and the area of greatest legal vulnerability for trustees. Honesty and good faith are vital to this task but in today's legal environment this is not enough. At a minimum, trustees must also ensure that they:

- Invest within the powers of the trust deed and the Trustees Act
- Exercise prudence and reasonableness
- Exercise due care to avoid a permanent loss of capital

- Have a defensible investment process and strategy

Have a defensible investment process & strategy

A defensible investment process and strategy is one whereby the trustees can demonstrate:

- How the strategy was developed
- Adequate diversification
- What consideration was given to protection of capital, income needs, liquidity needs, risk, inflation and taxation
- What consideration was given to the sustainability of distribution rates to beneficiaries having regard to the uncertainty of future investment returns and the health/longevity of beneficiaries
- Why they consider it to be prudent given these specific circumstances of the trust

Balancing the contradictory needs of capital and income beneficiaries can be particularly challenging for trustees. But any potential legal liabilities generally arise from a failure to properly diversify or a lack of proper process, rather than the actual investment outcomes. Of course, poor investment outcomes will usually be the trigger for beneficiary dissatisfaction that then leads to potential legal liabilities.

Demonstrate proper process through documentation

The key to being able to demonstrate proper process is having documentary evidence of a robust process in the form of a Statement of Investment Policy (SIPO or IPS) & Investment Plan. Of particular importance is that the investment plan reflects the trust risk profile in terms of the level of risk taken and therefore the level of future returns that can be reasonably expected. The risk profile of a trust is a combination of the following 4 factors:

- Investment time horizon - the shorter the horizon, the greater the need for liquidity and lower risk
- Personal tolerance for risk (how far the portfolio value can fall before trustees/beneficiaries are uncomfortable)
- Capacity to absorb risk (by earning income outside the investments)
- Distribution Requirements- accumulative (reinvesting the income) or distributive (consuming the income)? More distributive requires more liquidity and often lower risk

A final word of warning

The Importance of Good Trust Administration

A trust will only stand close scrutiny and fulfil its intended role in an asset protection and estate plan if, firstly, the trustees properly exercise their powers and not just “rubber stamp” the settlors actions and secondly, the trustees administer the trust in a manner that is genuine and credible. This is also vitally important if the trustees are to fulfil their duties under the law and avoid liability for breaches of trust.

Once again, it often falls onto the shoulders of the accountant to ensure that the trust meets the necessary standards of administration, record keeping and reporting. Particular attention needs to be paid to:

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Standards of administration, record keeping & reporting

- The minute book which should record all decisions and resolutions made by trustees, signed by all trustees and with copies of any supporting documentation in relation to these decisions
- A separate trust bank account if the trust engages in any financial transactions and all such transactions should be conducted through the trust bank account
- Financial accounts of the trust property that adequately identify the assets, liabilities, income and expenses of the trust and are appropriate to the value and complexity of the trust's financial affairs. This includes the trust's tax returns
- Legal documents relevant to the formation and management of the trust including:
    - Trust deed and variations thereto
    - Deeds of appointment and retirement of trustees
    - Deeds of acknowledgement of debt and gifts
    - Agreements for sale or purchase entered into
    - Any other written contracts entered into
- Regular or at a minimum, annual trustee meetings to review the trust position and the needs and circumstances of the beneficiaries. These meetings should be minuted.
- Provision of information to beneficiaries. The new Trust Act is proposed to have a mandatory obligation on trustees to provide beneficiaries with sufficient information to enable them to enforce the trust. Under normal circumstances this will include the need to notify beneficiaries of their status, their right to information about the trust and upon request, the provision of this trust information within a reasonable period of time

Don't forget – no time limit on records!

Often overlooked is the requirement for trust information to be retained for the life of the trust - the convenient 7 year limitations to record keeping allowed by NZ Inland Revenue simply do not apply.