Asset Protection

A number of years ago the Herald featured an article criticizing people who "***are dodging rest-home fees and qualifying for assistance by hiding their assets in family trusts***" and asked "***is it fair?*** The article provoked responses ranging from "***I will go to any length to prevent the greedy Government from stealing the assets my wife and I have built up through our own efforts***" to "***I object to this policy (trusts) strongly. We are paying for other others who are well-off enough to keep their hard earned cash but live off the backs of the rest of the population***".

In our experience very few people form a trust so that they can qualify for a subsidy because the Social Security Act says a benefit or subsidy can be withheld from anyone who directly or indirectly deprived themselves of assets or income.

The debate has however served as a very useful reminder of the care you must exercise when you start to accumulate assets. In our experience very few people plan for the future with the result that we are usually asked for advice about asset protection when something happens which causes them to realise their assets are at risk. This realisation can be triggered by the looming failure of a business, a professional colleague being sued or the breakdown or beginning of a relationship to name a few. Whatever the reason, if you accumulate assets in your own name you are placing those assets at risk.

This is curious because most people do not like taking risks. If we buy a car we take out car insurance in case we are involved in an accident. The insurance industry is constantly introducing new policies which offer protection against some perceived new form of risk. When it comes to our assets however very few people consider the risk factor before making a decision.

In the following pages we will examine:-

1. Asset protection generally and the various methods available to minimise claims from creditors.

2. Family trusts and the value of trusts in protecting assets.

3. The Property (Relationships) Act, its benefits and pitfalls.

4. Wills and their role in protecting assets.

1. Asset protection

In order to minimise your potential liability from claims from creditors, or reduce the likelihood of your assets being used to pay for your long term needs in a rest home or a private hospital, there are various options available including:-

(a) Equalization of assets

A husband and wife or de-facto or civil union partners should endeavour to ensure that their respective assets are approximately equal in value. Although less common, there are still many examples where all or most of the assets of a couple are in one partner or spouse's name. This should be avoided and equalization can be achieved with the partners or spouses transferring assets to each other by way of a relationship property agreement.

(b) Minimise exposure

For a business or professional person all security documents, for example mortgage debentures and guarantees should, where possible, be limited to the most vulnerable assets so that in the event of the business collapsing, or a claim on the professional person, there will be some assets not exposed to a creditor's claim.

There are many situations where both spouses or partners jointly own the family company business, the family home, the beach house, and all other assets. The only borrowings are from a bank, are business related and those borrowings are secured by a mortgage over the home and beach house with a general security agreement over the family company. Unless the business is guaranteed not to fail, or suffer a down turn, then something should be done to protect the family assets. The couple should consider signing a property relationship agreement under which one partner or spouse transfers his or her shares and interest in the company to the other partner or spouse, while the second partner or spouse in turn transfers his or her interest in the home and beach property and perhaps other assets to the first partner or spouse.

At the same time the couple should try to refinance the bank mortgage on the home so as to reduce/repay the loan to the bank so that the bank's lending to the company is only secured over the family company. In this way if the family company collapses at least the family home and the beach house and perhaps some other assets are protected.

Whenever possible guarantees should be avoided or limited in amount. There has been a noticeable increase in the number of court cases where guarantors are being called upon to honour guarantees.

(c) Transfer of growth and/or other assets to a family trust

Of immediate concern to older persons is the announcement that in future all older persons who require long term residential care, whether it is in a rest home or a private hospital ***will be needs assessed and income and capital tested*** according to need assessment protocols and targeting regimes.

Anyone with a family will also be concerned about the constant changes being made to both the eligibility for and the amount of national superannuation. In future retired persons will have to find an increased share of their income needs and an important source of capital will be family inheritances.

A couple with substantial assets should proceed with some asset protection measures as soon as possible so that they can conduct an organised and considered gifting programme rather than leave it until they are too old.

For example, Mr A (aged 65) on his retirement receives a lump sum superannuation payment of $500,000. Mr A should consider signing a matrimonial property agreement with his wife thereby transferring $250,000 to her in terms of the agreement. Both Mr and Mrs A should take independent financial advice before each investing their $250,000. At the same time they may wish to consider forming a trust and sell some of their investments to the trust. The trust will have to purchase the assets, and because the trust is unlikely to have the necessary funds, it is usual to lend the purchase price to the trust, free of interest, repayable on demand. Documents recording the loans to the trust need to be prepared and signed. Both Mr and Mrs A will immediately reduce their respective loans to the trust by $27,000. Mr and Mrs A, hopefully, will have quite a few years of life ahead of them to continue with an annual gifting programme and in this way reduce the amount of the loans.

Other assets, which are suitable for transferring to either a family trust or other individuals, for example children, are the family beach property and any large term life insurance policies.

(d) Separately owned assets

Married, de-facto or civil union couples should, where possible, ensure that their respective assets, not just the home, are separately and not jointly owned as is often the case. A couple should also review their wills and consider leaving a life interest to the surviving spouse or partner rather than leave all the assets to the survivor and so risk all the family assets being used to meet the residential care needs of the surviving spouse or partner.

(e) Management or redirection of inheritances

If you anticipate inheriting assets from a parent or other close relative it may be advisable to request the person from whom you expect to benefit to leave the assets either to your children or to your family trust.

(f) Asset protection - general comments

For anyone who is in business on his/her own account who does not enjoy the protection offered by a limited liability company it is important to ensure that at least some assets are protected against the potential failure of their business. This is particularly important for persons who are in partnership as is evidenced by the very sad events which flowed from a situation in which a partner embezzled a very large sum from a partnership.

2. Overview of trusts

A trust is an entity where one person (the settlor) binds others (the trustees) to deal with certain property (the trust property) transferred by the settlor and/or others to the trustees for the benefit of a person or persons (the beneficiaries). The powers, obligations and constraints under which the trustees must operate are encompassed in a trust deed. Further requirements are imposed by statute under the Trustee Act 1956 which adopts the (prudent person) approach to investments. Section 13B of the Act states that "***a trustee exercising any power of investment shall exercise the care, diligence and skill that a prudent person of business would exercise in managing the affairs of others***".

The usual trust deed recites:-

(a) The name and occupation of the settlor.

(b) The names and occupations of the trustees who are usually two or three in number.

(c) The amount being paid to the trust by the settlor on the initial settlement, usually $10.00 or $100.00.

(d) The term of the trust. All trusts other than charitable trusts have a limited life span and cannot be created for a term exceeding 80 years.

(e) The name of the trust.

(f) The names of the beneficiaries. Most trusts are "***discretionary trusts***" and the potential beneficiaries are usually extremely wide.

(g) The names of the final beneficiaries. This is usually the spouse or defacto or civil union partner of the settlor and the settlor's children.

The principal benefit of a trust is that all assets transferred to a trust no longer belong to the person who formerly owned the assets. The settlor will loose some degree of control over the assets because the settlor can no longer deal with the property as if it is the settlor's own. This loss of control can however be mitigated by first ensuring that the settlor is one of the trustees, and secondly, by giving the settlor the sole power to appoint or remove the trustees and to appoint additional trustees. This enables the settlor to have a large degree of control over who administers the trust assets. In addition, following the abolition of estate duty, the settlor can also be a beneficiary in the trust.

The value of trusts in protecting assets from creditors

The benefit of transferring assets to trusts to avoid creditors has become apparent since the 1987 sharemarket crash. You only need to look at the homes and lifestyles of some of Auckland's so called bankrupts to realise that the banks, financial institutions and other creditors have, unfortunately for them, been unable to recover all their losses. Asset protection, however cannot be done immediately and advance planning is essential. The Insolvency Act 1967 provides that any assets gifted or disposed of within certain specified periods from the date of insolvency, varying from four months to five years depending on the circumstances, are treated as part of your assets as far as creditors are concerned. For this reason, by the time financial disaster strikes, it is normally too late to protect your assets.

3. Overview of the Property (Relationships) Act

The principal object of the Property (Relationships) Act 1976 is to recognise the equal contribution of spouses or partners to a marriage, defacto or civil union partnership ("relationship"). The Act lays down a general rule that relationship property is to be split 50/50 when a relationship ends. The Property (Relationships) Act is primarily concerned with the equitable division of the assets of spouses or partners on the break-up of a relationship, and it is a very significant piece of social legislation.

There is a provision in the Property (Relationships) Act (Section 21) which enables spouses or partners to contract out of the provisions of the Act. It did not take long before the legal profession realised that this "contracting out" provision is a very useful tool for estate planners. The provision enables spouses or partners to transfer relationship assets from one spouse or partner to the other, usually to approximately equalize their respective estates, without any gift or stamp duty consequences. The High Court however has a discretion to declare void any agreement where it would be unjust to give effect to the agreement.

One of the more difficult aspects of the Act is the definition of relationship property. The clearest examples of relationship property are the family home and the family chattels. The equal division of these assets are, generally, unaffected by the question of contribution.

If one spouse or partner owns a home, enters into a relationship, the spouses or partners live in the home for a number of years and then there is a break-up of the relationship, the spouse or partner's home constitutes relationship property. If the relationship was of short duration, under three years, in all probability the court will order that a greater share be given to the spouse or partner who owned the home. If the relationship was for three years or more the division will almost certainly be equal.

An asset is likely to be regarded as relationship property if it is directly or indirectly produced by the joint and several efforts of the spouses or partners during the effective relationship. In general, such property is to be distinguished from property acquired before the relationship or acquired while the parties are living apart, or acquired gratuitously from third parties. Thus, assets acquired during the relationship, superannuation rights where contributions are made after the relationship and increases in the value of separate property due to the actions of the non-owner spouse or partner are all likely to be considered part of the relationship property. Relationship property of this kind may be regarded as a product of the relationship.

Property and assets other than relationship property are called "***separate property***" and these assets are not subject to the basic 50/50 split on a relationship break-up. The best examples of separate property are assets acquired by a spouse or partner before the relationship, not being the relationship home, and not intermingled in any way with relationship property. For example, Mrs A's parents died before Mrs A married. Mrs A invested, before her marriage, her share of her parents' estates and keeps the investment separate after marriage. Although the income from the investment may possibly be deemed to be relationship property the investment itself will probably be separate property. However, if Mrs A sells her separate investment and invests the sale proceeds in a relationship home, or any other relationship property, by way of repairs, improvements, or additions, then by intermingling her separate property with the relationship property the proceeds of the separate property becomes relationship property. Section 9 of the Act provides that all property acquired by either spouse or partner while they are not living together as a married, defacto or civil union couple is to be separate property unless the court considers that it is just in the circumstances to treat such property or any part thereof as relationship property.

Benefits of the Property (Relationships) Act

By giving a fixed interest in relationship property to both parties the Act gives security and certainty to the couple whether it be a married, de facto or civil union couple. The security of interest given by the Act will diminish the incidents of oppressive bargaining and encourage couples to settle property problems without recourse to litigation.

Disadvantages or pitfalls

It is fair to say that the over-readiness in the Act to convert pre-relationship assets, gifts and inheritances into relationship property is a major and unnecessary cause of contracting out. One of the things to be wary of is the couple who are so concerned with asset protection that they proceed with a relationship property agreement which is structured solely for that purpose. The vulnerable assets, for example, the one spouse or partner’s business or shares in a family company are transferred to the other spouse or partner, and the secure assets, for example, the relationship home is transferred to the other spouse or partner. Subsequently, the business collapses and as a result of the financial pressures placed on the spouses or partners the relationship breaks up and all of a sudden one partner may be out on the street with nothing. However, the disadvantages and pitfalls should not obscure the fact that the Property (Relationships) Act has achieved the principal object of proprietary equality in marriage and defacto or civil union partnerships.

4. Wills and their role in asset protection

At the outset we mentioned that in order to achieve asset protection it is necessary to ensure that the assets of a married, defacto or civil union couple are separately owned. The reason for this is that if assets are jointly owned, as opposed to tenants in common in equal or unequal shares, then the asset passes to the surviving spouse or partner automatically by law and this is unaffected by the deceased's will. If you wish to prevent your assets being used to pay the long term residential costs of the surviving spouse or partner then it is important not to own any joint assets. For this reason, if you own a valuable home as joint tenants it will usually be advisable to change the ownership to a tenancy in common. It may also be preferable to leave a life interest to the surviving spouse or partner so that s/he enjoys the income only from the deceased's separately owned assets and does not receive the capital. In life interest wills it is common to provide for the right of the surviving spouse or partner to call for additional capital to supplement his/her income if that income is, in the opinion of the trustees, insufficient to enable the survivor to maintain a lifestyle that the deceased spouse or partner would have wanted for the survivor.

Although in many circumstances full life interest wills are appropriate they do have certain disadvantages including:-

(a) The inability of the surviving spouse/partner/life tenant to spend capital, although this is partially offset by providing for the right to call for capital as mentioned above.

(b) The surviving spouse/partner/life tenant may pay income tax on income excessive to his or her needs.

(c) It prevents the residuary beneficiary from enjoying the benefit of the assets subject to the life interest until after the life tenant has died.

Because of these disadvantages it is often preferable for spouses or partners to leave their respective assets to a discretionary trust, rather than leaving a straight life interest. ***In this way, greater flexibility can be achieved than is possible with a life interest created by a will***.

Life-interest wills also have the benefit of protecting assets for the children where the deceased's spouse or partner feels that the surviving spouse or partner may spend/squander the assets to the detriment of the children.

5. Conclusion

All asset protection measures require careful thought and planning. ***They all have one thing in common and that is you must dispose of the asset, although as we have noted a family trust does allow you to retain a large measure of control.*** If you dispose of assets to your children do not be disappointed if your children do not use the asset in the way you intended. In general we recommend those persons who undertake any asset protection measures to implement the measures progressively and to assess the benefits gained by the first stage before you implement the second and later stages. Your prime responsibility is to ensure that your spouse or partner and yourself can, as far as possible, maintain the lifestyle you have enjoyed. Under no circumstances should you place yourself in a position where you are beholden to your children.

If, having read this discussion paper, you require any further information please contact us immediately because as we mentioned in the course of the paper it takes time to implement any asset protection programme.

Finally we wish to emphasise that the information contained in this paper is generalised and does not take the place of professional advice. Every effort has been made to ensure the accuracy of the contents but there is no substitute for specific advice on such important matters.

For More Information

Visit our website at www.gellertivanson.co.nz or call us on (09) 575 2330.