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ESTATE AND BUSINESS SUCCESSION PLANNING
Succession Planning and Trusts

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CONTENTS

1 INTRODUCTION

References in this paper are commonly made to:

- the *Income Tax Assessment Act 1936* (Cth) ('**the 1936 Act**');
- the *Income Tax Assessment Act 1997* (Cth) ('**the 1997 Act**');
- *A New Tax System (Goods and Services Tax) Act 1999* (Cth) ('**the GST Act**');
- the *Bankruptcy Act 1966* (Cth) ('**the Bankruptcy Act**'); and
- the *Corporations Act 2001* (Cth) ('**the Corporations Act**').

Reference is also generally made (where relevant) to the legislation of the Australian Capital Territory, New South Wales, Victoria and Queensland. References to the legislation of other States is made (where relevant) in footnotes only.

2 ISSUES TO CONSIDER WHEN TRANSFERRING WEALTH AND CONTROL HELD SUBJECT TO A TRUST

2.1 Importance of the terms of the trust

Typically the terms of trusts are provided in trust instruments. Such terms may include both the rights and obligations of trustees of the trust, such as the powers, duties, trusts and discretions that a trustee of a trust has, as well as the rights of beneficiaries.

As a result, the usual tensions arise with respect to whether the powers under the trust are wide, and the potential resulting tensions that arise as between trustees (who control the trust estate) and beneficiaries. This may be an issue (for example) if there is property held subject to a trust by a sole trustee, for the benefit of more than one (adult) beneficiary.

Further, the flexibility of the use of the trust fund (for example, power of investment, amalgamation of trust fund etc) may be drafted narrowly for the purposes of protecting the trust fund, but may become an issue when dealing with the trust fund some time after the establishment of the testamentary trust.

As such, it may be appropriate to vest a 'discretion' in the trustee when, for example, the needs of the beneficiaries may vary from time to time. From a tax planning prospective, such flexibility may enable the trustee to distribute the trust income in such a way (ie. to those beneficiaries and in those amounts) so as to minimise the overall tax liability on the total trust income or on the total income of the family group for an income year.

2.2 Minor beneficiaries

It should be noted that a distribution to minor beneficiaries under the terms of a trust creates a legal entitlement in favour of the minor beneficiary. As a result, the distribution must either be physically paid to the minor beneficiary, or a loan account in favour of the minor beneficiary will be created, which will ultimately be payable to the minor either at demand, or when the trust vests.

2.3 More than one trust?

A common issue that arises in the context of succession planning, particularly in the context of establishing testamentary trust(s) by a testator with a number of (adult) children, is whether one or more testamentary trusts should be established under a will.

For example, should one child be the trustee and appointor to hold the trust fund for the benefit of all of the children, should a testamentary trust be established for each of the testator(s) children, or a mixture of both?

This will depend on the individual circumstances of the family group.

2.4 The position of Appointor

The position of Appointor is often a powerful position in a trust, as the Appointor has the right to hire and fire the trustee ie. replace a trustee or add an additional trustee. A new trustee might be expected to bend to the will of the Appointor.

It should be noted that the position of Appointor is a personal position, and is not an item of 'property'. In *Re Burton; Wily v Burton* - BC9405738, Davies J in the context of bankruptcy law, observed that '*… the power which Mr Burton holds as Appointor is not 'property' which vests in his trustee in bankruptcy nor a power 'as might have been exercised by the bankrupt for his own benefit*'. As a result, the position of Appointor, because it is not an item of property but rather is a personal appointment, it was held that the position does not pass to a trustee in bankruptcy.

Similarly, in the context of succession laws, the position of appointor passes to a deceased's personal legal representative, and does not enter into a deceased Appointor's estate. For example, section 40 of the *Probate and Administration Act 1898* (NSW) provides that the existence of 'property'[1] within the jurisdiction (i.e. NSW) is essential to grant probate and letters of administration: '*The Court shall have jurisdiction to grant probate of the will or administration of the estate of any deceased person leaving property, whether real or personal, in New South Wales.*' The only exception to this rule is a grant of administration to permit an application to be made under the family provision legislations (see section 91 of the *Succession Act 2006* (NSW)).

As a result, a position of appointor created under a testamentary trust, unless otherwise provided for, will pass to the appointor's personal legal representative and not the appointor's estate. The position of appointor will not be dealt with by (and for example) the *Probate and Administration Act 1898* or the *Succession Act 2006*.

2.5 Family provision legislation

Further considerations must be given to the interaction between the family provision legislation in succession planning. In New South Wales, the provisions contained in Chapter 3 of the *Succession Act 2006* (NSW) ('**the Succession Act**') regarding family provisions, which replaced the *Family Provision Act* 1982 (NSW), seek to limit the freedom of testation to the extent consistent with the purposes of the Act and the Bill. That purpose is to:-

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[1] The term 'property' is defined in section 3 of the *Probate and Administration Act 1898* (NSW) as follows:

> ***Real estate** extends to messuages, lands, rents, and hereditaments, of freehold or any other tenure, and whether corporeal, incorporeal or personal, and to any undivided share thereof, and to any estate, right, or interest (other than a chattel interest) therein, and in part 2 includes lands held under building leases or any lease for twenty-one years and upwards.*
>
> ***Personal estate**, except in part 2 as hereinbefore mentioned, extends to leasehold estates and other chattels real, and also to moneys, shares of government and other funds, securities for money (not being real estates), debts, choses in action, rights, credits, goods, and all other property whatsoever, which, prior to the coming into operation of the Real Estates of Intestates Distribution Act of 1862, commonly known as "Dr. Lang's Act", by law devolved upon the executor or administrator, and to any share or interest therein.*

> *'enable a court to override the terms of a deceased person's will or the distribution of a deceased person's estate on intestacy if it determines it is necessary to do so to ensure that the family and other dependants of a deceased person are adequately provided for'*[2].

The conflict between testamentary freedom (often expressed as 'the freedom to leave my property to anyone I like') and the 'community standards' often referred to by judges in deciding family provision cases leads to situations of emotion and stress. The plaintiff cannot understand why he or she has been left out, and the beneficiaries under the will cannot understand why the plaintiff is not happy with his or her lot. Often, the impact of the will can be minimised before death; rarely can it be totally avoided.[3]

An understanding, even if only a general one, of the impact and reach of the family provision legislation is important in considering the position of wills in estate and succession planning. For will drafters, there are considerations of inclusion of relatives, for provision of reasons for exclusion, and the advice which can be given as to possible applications by disappointed family members. For succession planners, considerations need to be given to the effectiveness of strategies to remove property from the estate.

2.5.1 Overview of family provision

Under Chapter 3 of the Succession Act, the Court may make a family provision order in relation to the estate of a deceased person in favour of an eligible person on application by the eligible person to the court[4]. However, the Court may only make the order if the eligible person has not been adequately provided for by the testator for the person's maintenance, education or advancement in life[5].

An eligible person as defined in section 57 of the Succession Act include the spouse, child, former spouse, a person who was wholly or partly dependent on the deceased who is either a grandchild or was a member of the deceased's household, and a person with whom the deceased person was living in a close personal relationship at the time of the deceased person's death.

Under subsection 58(2) of the Succession Act, any applications made under the Succession Act must be made within 12 months from the date of death of the deceased unless otherwise ordered by the court.

2.5.2 Family Provision and Trusts

Section 63 of the Succession Act contains a list of property that may be used for family provisions orders, which include:

> *(1) A family provision order may be made in relation to the estate of a deceased person.*
>
> *(2) If the deceased person died leaving a will, the estate of the deceased person includes property that would, on a grant of probate of the will, vest in the executor of the will, or would on a grant of administration with the will annexed, vest in the legal representative appointed under that grant.*
>
> *(3) A family provision order may not be made in relation to property of the estate that has been distributed by the legal representative of the estate in compliance with the requirements of section 93, except as provided by subsection (5).*
>
> *(4) Where property of the estate of a deceased person is held by the legal representative of that estate as trustee for a person or for a charitable or other purpose, the property is to be treated, for the purposes of this Chapter, as not having been distributed unless it is vested in interest in that person or for that purpose.*
>
> *(5) A family provision order may be made in relation to property that is not part of the estate of a deceased person, or that has been distributed, if it is designated as notional estate of the deceased person by an order under Part 3.3.*

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[2] Explanatory Note, Overview of Bill, *Succession Amendment (Family Provision) Bill* 2008.
[3] For an entertaining review of this conflict, see Professor Croucher's *Conflicting Narratives in Succession Law* (2007) 14 APLJ 179.
[4] section 59, Succession Act.
[5] section 59, Succession Act.

As can be seen from subsection 63(4), properties subject to the testamentary trust are properties that may be used for family provisions orders.

Further, Part 3.3 of the Succession Act enables the court to make an order designating property that the deceased disposed of before death as being property that forms part of the deceased's 'notional estate', and the court may make a family provisions order out of this notional estate under subsection63(5), Succession Act.

The Note to Part 3.3 in the Succession Act summarises the notional estate provision:

> *Property may be designated as notional estate if it is property held by, or on trust for, a person by whom property became held (whether or not as trustee), or the object of a trust for which property became held on trust:*
>
> > *(a) as a result of a distribution from the estate of a deceased person (see section 79), whether or not the property was the subject of the distribution, or*
> >
> > *(b) as a result of a relevant property transaction, whether or not the property was the subject of the transaction (see section 80), or*
> >
> > *(c) as a result of a relevant property transaction entered into by a person by whom property became held, or for whom property became held on trust, as a result of a relevant property transaction or a distribution from the estate of a deceased person (see section 81), whether or not the property was the subject of the relevant property transaction.*
>
> *Property may also be designated as notional estate if it is property:*
>
> > *(a) held by the legal representative of the estate of a person by whom property became held as a result of a relevant property transaction or distribution referred to in paragraphs (a)-(c) above and who has since died (known as the 'deceased transferee'), or*
> >
> > *(b) held by, or on trust for, a person by whom property became held, or for the object of a trust for which property became held on trust, as a result of a distribution from the estate of a deceased transferee,*
>
> *whether or not the property was the subject of the relevant property transaction or the distribution from the estate of the deceased person or the deceased transferee (see section 82).*

As a result of the provisions in Part 3.3, properties subject to a testamentary trust may become part of the deceased's notional estate.

In *Kavalee v Burbidge* (1998) 43 NSWLR 422, the New South Wales Court of Appeal held that assets transferred by the deceased in a series of transactions during his lifetime to a foundation established under the laws of Liechtenstein were available to be designated as notional estate. The Court found that instructions could be given from time to time by the deceased to the 'Founder' controlling the foundation, who was legally obliged to implement the instructions of the deceased.

Mason P (with whom Meagher JA agreed) said at 446-7:

> *'... I do not see s 22(1)(a) [Now s75(1) of the Succession Act] as confined to acts or omissions that are the operative cause of property becoming held by the deceased's intended disponee. To do so would ignore the thrust of this liberal enactment which emphasises its scope with the words "directly or indirectly", "as a result of which" (emphasis added) and "whether or not the property becomes "so held immediately"... The legislation is clearly intended to operate in a context of human agents where several may have to act in concert and where there is the possibility that one may not co-operate. To paraphrase Mason J in Fagan v Crimes Compensation Tribunal (at 673), "the fact that other unconnected events may also have had some relationship to the occurrence is not material if the "act was a cause, even if not the sole cause"...*
>
> *The respondents dispute that it is correct to approach the issue of causation in this way. They support Windeyer J in his conclusion that the relevant act or omission must be the effective cause. We were reminded that the Act interferes with property rights. But the critical issue is the extent of that potential interference. In my view, the choice of a looser test of causation is open. For the reasons given, s 22(1) suggests, and certainly permits, the looser approach to the factual issue*

of causation that I have adopted. Schaeffer (at 318) citing Wenthworth v Wentworth (Bryson J, 14 June 1991, unreported) identifies:

> *"... a purpose of the Legislature that the notional property provisions should extend the powers of the Court to the full range of benefits and advantages controlled by testators. In so far as any question of construction presents a choice, a construction which would promote this purpose is to be preferred: see s 33 of the Interpretation Act 1987."*

... In any event, s 22(1)(a) extends to omissions. And since, as I have held, the deceased had the legal power to direct the Founder to do his bidding, the failure to exercise this power before death must surely be seen as an operative cause of the by-law remaining in its final form. That by-law "designate[d] as beneficiaries" of the Foundation those persons referred to in the "bequests" section of the memorandum. By omitting to exercise his entitlement to direct the Founder to revoke the by-law, the deceased omitted to do an act as a result of which the bequests stipulated in the by-law came to be paid by the Foundation, which was obliged to obey its terms.'

Mason P then considered at pages 450-454 whether or not there might be a prescribed transaction due to the deceased's omission to exercise the power to appoint or to dispose of the property of the foundation and:

'The appellants submit that, during his lifetime, the deceased could have caused the assets of the Gartner Foundation to be dealt with as he pleased. They rely upon the trial judge's finding that the deceased had control of Mr Defago who in turn had control of the Foundation through the capacity to compel the exercise of the full gamut of Founder's rights that were vested in DFC at the time of the deceased's death. I have already indicated that I accept that such control existed.

Windeyer J held that s 22(4)(a) [Now s76(2)(a) of the Succession Act] did not apply because:

(a) the deceased had no power to appoint or dispose of the property of the Foundation; and

(b) the property of the Foundation did not become held by another person as a result of the deceased's omission to exercise the power before his death (in the terms of s 22(4)(a)(i)).

The respondents support these propositions. The appellants dispute them and also invoke s 22(4)(a)(ii)..

(a) Did the deceased have the power to appoint or dispose of the property of the Foundation during his lifetime?

Windeyer J answered "no". He did not find it necessary to consider (as I have) whether the deceased had legal rights to compel Mr Defago, and through him the Founder, to do his bidding. And he distinguished between the power of the deceased over the Founder on the one hand, and the power of the Founder over the Foundation on the other...

...

In my opinion, the distinction drawn by the learned trial judge (between a power to or dispose of property that was directly exercisable, and one which depended upon compelling Mr Defago to execute various documents) finds no support in this legislative scheme. What I have described as the deceased's legal power to compel Mr Defago, through DFC, to cause the Foundation to deal with its assets as the deceased might stipulate was in effect an entitlement to exercise a power to dispose of the property in the Gartner Foundation. That power existed (albeit indirectly) through the agency of Mr Defago and his firms, SCF and DFC. A "power to ¼ dispose of property" is not a technical term of law. In context it must mean something more than a traditional power of appointment, assuming that the latter concept were limited in any presently relevant way.

...

Returning, as I must, to construing s 22(4)(a) in context, and faithful to the purpose of Pt 2, Div 2 of the Act as expounded in Schaeffer (at 318-319). I am satisfied that the deceased had until his death an entitlement to exercise a power to dispose of property which was not in his estate, being the property vested in the Foundation.

I accept that there is a vital distinction between de facto control and legal entitlement: see Re Sutton Coldfield Grammar School (1881) 7 App Cas 91; National Companies & Securities Commission v Brierley Investments Ltd (at 287). Section 22(4)(a) requires entitlement. However, entitlement and immediate enjoyment are different. Here the powers of DFC as

Founder were at the deceased's disposal as a matter of right, through the rights which the deceased had over Mr Defago. And, if he chose, the deceased was, as a matter of right, able to have the Founder replaced by a Founder that would do the deceased's bidding. Indeed, the deceased could have required DFC to appoint the deceased himself as the Founder. All steps to effect an appointment or disposal of assets as the deceased chose were really administrative once the deceased determined to act.

I have no difficulty in conceding that the power to appoint or dispose of the assets of Gartner (through art 6) was vested in the Founder for the time being. Absent a contrary direction from the deceased, the Founder immediately before and after the deceased's death (DFC) was entitled to exercise that power of disposition. But more than one person may have concurrent powers to deal with or dispose of the same item of property...

(b) Did the omission to exercise the power before death cause either of the events in s 22(4)(a)(i) or (ii)?

I agree generally with Windeyer J on s 22(4)(a)(i). The property of the Foundation remained vested in it before and after the deceased's death. It did not "become held by another person" as a result of the omission to exercise the relevant power and the deceased's death.

However, s 22(4)(a)(ii) must also be considered. The death of the deceased F either led to the transmission of the deceased's rights over the Founder according to the law of the deceased's domicile, or it terminated those rights ... If the former, there was obviously "another person" (cf s 22(4)(a)(ii)) who became entitled to exercise the deceased's power of disposition, and this occurred as a result of the deceased's omission to do so and his death.

If the latter, the expiry of the deceased's rights left the Founder's powers G intact. Can it be said that as a result of the deceased's omission to exercise his power and of his death, the Founder "continue[d] to be, entitled to exercise the power" (to which it was previously entitled) to dispose of the assets of the Foundation?

The respondents are correct in their submission that "the power" referred to in subpar (ii) must be the same power as that which was enjoyed by a deceased before he or she ceased to be entitled to exercise it. But the very fact that the subparagraph contemplates that "another person" may continue to be entitled to exercise the power shows that the provision embraces the situation of two or more persons having a concurrent power to dispose of property with one of those persons (being the deceased) ceasing to exercise it as a result of the prior omission to exercise it and death. ... The Founder's entitlement to exercise the power preceded the deceased's death and continued after it. This satisfied subpar (ii) if it were the case that the deceased's entitlement was non-transmissible.

This alone is not sufficient to satisfy s 22(4)(a)(ii). It must also be shown that the continuation of the Founder's power came about "as a result of" the deceased's omission to exercise his concurrent power and of his death. The respondents submit that it is at this point that the appellant's argument breaks down. They submit that there is no link or connection between the continuation of the Founder's powers under the articles of the Foundation and the deceased's omission to dispose of the Foundation's assets (as he could have, through his power over the Founder that I have found to exist) before his death. And the respondents emphasise (correctly) that the same "power" is involved wherever it is mentioned in the paragraph.

... I would reject the respondents' argument for the following reasons. If the deceased had exercised the power which he held yet omitted to exercise, then the assets of the Foundation would have been effectively disposed of. For example, the deceased could have directed the Founder to make a by-law whereby the corpus of the Founder's assets (after payment of the "bequests") were paid to one or more of the appellants. That by-law could have been made irrevocable ... The deceased did not procure this during his lifetime. It can therefore be said that his omission to do so before his death was a cause of the assets remaining in the Foundation. The Founder's concurrent powers of disposition (through making by-laws) remained as it stood under the articles. It continued after the deceased's death. The provision does not require that the concurrent powers of disposition should be exercisable in identical ways. That continuation was causally linked to the deceased's omission in that the omission contributed to the continuation of the Founder's power of disposition under the (unamended) articles, and left the Founder with assets at its disposition in the Foundation.

The decision of *Kavalee* was considered by the New South Wales Supreme Court in *Flinn v Fearne* [1999] NSWSC 1041. In *Flinn*, Master McLaughlin distinguished *Kavalee* and said:

'23 It must, however, be recognised that the decision in Kavalle v Burbidge was essentially a decision upon its own facts, dealing with the legal rights of a testator in the context of the law of Liechtenstein, and the specific legal powers vested in

the testator in that case (see the judgment of Mason P at 451E), which are to be distinguished from the powers vested in the deceased in the instant case. Whereas, in Kavalle v Burbidge there was a legal duty imposed upon Mr Defago, the trustee, to act in accordance with the directions of the testator, in the instant case there was no such legal duty imposed upon the trustee to act in accordance with the directions of the deceased.

24 There is no doubt, in the instant case, that the deceased during his lifetime, in his capacity as the Nominator, had the power, to remove the trustee named in the deed and to appoint another trustee of the G & A Fearne Family Trust. It seems to me, however, that that power is very different from the power of de facto control of the trust asserted by the plaintiffs to have reposed in the deceased. Indeed, the entire basis of that assertion of de facto control appears to depend upon assumptions, firstly, that the deceased would be able to find another potential trustee who would be amenable to the dictates of the deceased, and, secondly, that any such entity or person, when appointed trustee, would disregard his duties as a trustee (see Jacobs' Law of Trusts in Australia, 6 ed (1997), 51, paragraph 265; 409, paragraphs 1609ff).

25 It was submitted on behalf of the defendant that the deceased held his power in a fiduciary capacity and that he could exercise it only in such a fiduciary capacity. Whether or not that was so, it is abundantly clear that the deceased could not have properly given, and the trustee could not have properly received, a direction that the trustee dispose of the trust property. The most that the deceased could have done was to remove the nominated trustee and to appoint as a new trustee a person or entity whom the deceased might have expected would act in accordance with his direction. (It was suggested on behalf of the plaintiffs that the deceased could even have appointed as such new trustee a company controlled by the plaintiff.)

26 Nevertheless, there could be no certainty that either the original trustee or any replacement thereof appointed by the deceased would necessarily have acted in accordance with such a direction by the deceased, since the conduct of the trustee, were he merely to have acted as directed by the deceased, without independently carrying out his duties and exercising his discretion (in the manner described in the foregoing passages from Jacobs), would have constituted on the part of the trustee a clear breach of trust. (If the deceased had appointed as a replacement trustee a company which he himself controlled, it is possible that any disposition of trust property to the deceased by such a trustee would have been in contravention of clause 18(a)(ii) of the deed.)

27 It seems to me that a clear distinction must be drawn between, on the one hand, the conduct of the deceased in failing to exercise his powers as the Nominator, and, on the other hand, the conduct of the trustee. It is all very well for the plaintiffs to say that the deceased could have dismissed the trustee and could have appointed a fresh trustee who would be malleable and would act in accordance with the wishes of the deceased. Nevertheless, the essential question is whether the deceased himself entered into a prescribed transaction, not whether the trustee, by his failure to do anything, allowed the property to remain subject to a trust.'

2.6 Bankruptcy Act considerations

Under the Bankruptcy Act, there are two main provisions which will allow a trustee in bankruptcy to claim back assets or their value when they are transferred to a trust (or for that matter any other entity, including a spouse).

2.6.1 Undervalue transfers

Section 120 of the Bankruptcy Act is concerned with transfers of assets from a person prior to bankruptcy at less than their market value. It is very much time dependant. Section 120 has been recently amended to alter the time limitations when transfers are made to an associated person.

The rules in section 120 are:

- If the transferor was solvent at the time of the transfer and the transfer was not to a 'related entity' then the trustee in bankruptcy is limited to transfers which occurred within two years before the commencement of the bankruptcy;
- If the transferor was solvent at the time of the transfer but the transfer is to a related entity then the clawback period is four years;

- In any other case the clawback period is five years i.e. where the transferee cannot prove that the transferor was solvent at the time of the transfer.

It should be noted that the commencement of bankruptcy can be up to six months prior to the date a petition is lodged[6].

The transferee has the burden of proving that the transferor was solvent at the time of the transfer.

A new provision was introduced in 2006[7] that establishes a rebuttable presumption that the transferor was insolvent if it is established that the transferor:

(a) had not, in respect of that time, kept such books, accounts and records as are usual and proper in relation to the business carried on by the transferor and as sufficiently disclose the transferor's business transactions and financial position; or

(b) having kept such books, accounts and records, has not preserved them.

There are two safe harbours:

1. Plan early so that the clawback period will have expired if financial problems arise. The best planning is that which is never needed.

2. Have the transferee pay market value. This, of course, will not immediately reduce the net worth of the transferor. However, if the transferor consumes the value provided by the transferee on living, holidaying, school fees etc, there is nothing for the trustee in bankruptcy to recover. Meeting mortgage expenses of the spouse's home may not be a wise decision. This is discussed below.

As to planning early the proposition is simple, if time starts to run at the earliest opportunity the relevant time period for clawback by a trustee in bankruptcy may have expired when the triggering act of bankruptcy occurs. On the second point the transferee must give at least market value consideration for the transfer of the property. There are no special rules about determining the market value of property for bankruptcy purposes[8].

The decision of the Federal Magistrate in *Thomas v. Tyler (No 2)*[9] shows that the usual contest between opinions of valuers takes place in this context. It also illustrates another exceptionally important point. If the valuation is not correct and the property is transferred at an undervalue the appropriate order, unless it is an exceptional case[10], is that the property be reconveyed to the trustee in bankruptcy by the transferee. The transferee is repaid the amount of the undervalued consideration but the critical upshot is that any increase in the value of the property will accrue to the trustee in bankruptcy and not the purchaser.

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[6] The bankruptcy commences at the time of the earliest act of bankruptcy committed within the 6 month period preceding the date the petition is lodged: Section 115 *Bankruptcy Act*. For the definition of 'act of bankruptcy' see section 40 Bankruptcy Act.
[7] Subsection 120 (3A) Bankruptcy Act.
[8] It was relevantly observed in the Explanatory Memorandum to the *Bankruptcy Legislation Amendment Bill* 1999 that:

> '*The expression 'market value' is intended to refer to the value of the property concerned if it were disposed of to an unrelated purchaser bidding in a market on an ordinary commercial basis for property of the kind disposed of, without any sort of discount or incentive for purchase being offered. The expression is not intended to include a situation where the property was being disposed of at a fire sale, at discounted prices because of some immediate need on the part of the owner to liquidate his or her assets'*,

Refer *Victorian Producer's Co-Op Co Ltd v. Kenneth* [1999] NSWSC 155.
[9] [2005] FMCA 342.
[10] cf the observation made by Raphael FM in *Thomas v. Tyler (No 2)* that the decision of Driver FM in *Schmierer v. Horan* [2004] FMCA 16 to cause the transferee to pay the trustee in bankruptcy the shortfall was motivated by a desire to maintain the bankrupt's family in the family home and, in any event, there was a small difference which on the balance of convenience justified the order, as exceptional.

A tactical reaction to this is that the transferee should purchase the property at its market value (with, in this case the market value determined at the high end of the scale). The transferor would provide vendor finance and then release all of the balance of the debt. The property transferred in that case at an undervalue is the debt which is released. The growth in the value of the property originally transferred remains with the transferee as there should be no order for reconveyance of the property.

Of course, there is always the question of whether the property has been truly transferred to the trustee of the trust[11] or the transactions are shams[12].

2.6.2 Transfers to defeat creditors

The other clawback mechanism available to a trustee in bankruptcy is section 121 of the Bankruptcy Act. This provision is driven by motive and is not time dependent. The High Court found in *Cummin's Case*[13] that transfers of property up to 15 years earlier were void as against his trustee in bankruptcy.

Section 121 provides that a transfer is void if:

- the transferor's main purpose was to prevent the transferred property from becoming divisible among the transferor's creditor (or to hinder or delay that process); and

- the property would probably have become part of the transferor's estate or would probably have been available to creditors if the property had not been transferred.

The transferor is taken to have the required main purpose if it can be reasonably inferred from all the circumstances that the transferor was at the time of the transfer insolvent or about to become insolvent.

There is also the same rebuttable assumption about the failure to keep books, accounts and records, or to preserve them as in section 120[14].

If the transferee gave at least market value consideration for the transfer and did not know or could not reasonably have inferred that the transferor's main purpose was to defeat his or her creditors and that the transferor was or was about to become insolvent then the transfer is not void.

Again, if the transferee pays market value consideration and is innocent of the transferor's state of mind (and objectively so) then the value paid can be dissipated on consumption[15].

There is an alternative approach. If it can be demonstrated that the bankrupt would have dissipated value actually transferred by the bankrupt (prior to bankruptcy) that value will not be caught by section 121. This is because it must be shown (by the trustee in bankruptcy) that the property would probably have become part of the transferor's bankrupt estate available to the creditors.

The main issue of concern with section 121 is whether it strikes at generic asset protection planning. Say a person about to engage in a financially risky enterprise eg. accounting or law, transfers assets to a discretionary trust before commencing business. In those circumstances can section 121 provide the trustee in bankruptcy with a clawback when there are no unsatisfied creditors and none looming?

Sackville J in the Federal Court decision in *Cummin's Case* considered this situation[16] and concluded that:

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[11] *Ramaldi v. Reeves* [2007] FMCA 408.
[12] *Sharment Pty Ltd v. Official Trustee in Bankruptcy* [1988] FCA 179 and *Hyhonie Holdings Pty Ltd v. Leroy* (2003) NSWSC 624 and (2004) NSWCA 72. In *Sharment* Lockhart J observed that in order to find a sham there needed to be a strong finding. The strength of that finding may have been very recently diluted by the decision of the High Court in *Raftland Pty Ltd v. FC of T* [2008] HCA 21.
[13] (2006) HCA 6.
[14] Subsection 121 (4A) Bankruptcy Act.
[15] For an extreme example of this see *Jessup v. Mountain View Farm* [2002] FCA 312.

> '*It does not seem to me that Ex Parte Mercer necessarily means that a barrister who transfers assets in order to keep them out of the hands of clients or potential clients, who at some stage in the future might sue for professional negligence, is outside the scope of s121(1)(b) of the Bankruptcy Act should the transfer be subsequently impugned. It must be borne in mind that s121(1)(b) may be satisfied even if the transferor was solvent at the time of the transfer and even if the transferor had no creditors at that time. It seems to me that the answer to the question is likely to depend on the facts of the particular case. I am prepared to assume for the purposes of this case, without deciding, that if all that is known is that a professional person:*
>
> - *transferred the bulk of his or her assets to a family member for no consideration;*
> - *has no creditors at the time of the transfer (or retains sufficient to meet all liabilities known at the time);*
> - *has not engaged and does not propose to engage in any hazardous financial ventures; and*
> - *intends to protect the transferred assets from any actions brought by a client who might in the future sue for professional negligence (there being no such suit in the offing at the time of the transfer;*
>
> *then s121(1)(b) of the Bankruptcy Act does not render the transfer void against the person's trustee in bankruptcy. For the reasons that appear, I do not think that assumption is of assistance to the respondents in the circumstances of the present case.*[17]'

It is difficult to gain any confidence from this statement, one way or the other. Perhaps there is a slightly favourable view being expressed. Unfortunately none of the judges in the Full Federal Court or the High Court sought to resolve the issue. The High Court simply concluded that it was good enough to be aware of impending liabilities and did not consider the wider question about general asset protection[18].

The issue is, however, readily resolved for practitioners. When there is no choice but to make the transfer to protect the family home and to keep the family from the poor house it must be done and the consequences (if any) suffered later.

In the context of section 121 motive is everything. It helps, therefore, if the transaction is driven by another significant motive such as commercial (including taxation) or family domestic reason.

In *Florance*[19] the Court was persuaded by the evidence of Mrs Florance, the non-bankrupt spouse and option holder, that she wished to retain the properties in question against her husband's desire to give up legal practice and move to the country, ie. purely 'domestic considerations'.

2.7 Asset protection: The current state of play following the fall out from the Richstar's case

The *Richstar Enterprises Case*[20] concerned the collapse of the Westpoint Group. The Australian Securities and Investment Commission ('**ASIC**') had already obtained orders that receivers be appointed to the property of a number of Westpoint directors and companies controlled by them. The point of these actions was to preserve property of the individuals and companies to prevent it being dissipated pending the ASIC enquiries.

The question before the Court was whether a receiver could be appointed to property held in trust. The relevant provision was section 1323 of the Corporations Act. This section allowed the Court on application by ASIC or an aggrieved person to appoint inter alia a receiver to property of a person, who is

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16 *Prentice v. Cummins (No 6)* [2002] FCA 1503.
17 [2002] FCA 1503 at paras. 102-103.
18 [2006] HCA 6 at paras. 29-33.
19 Re *Florance Ex parte: Andrew v. Florance* [1983] FCA 357.
20 *Australian Securities and Investments Commission: In the matter of Richstar Enterprises Pty Ltd (ACN 099 071 968) v. Carey* (No 6) [2006] FCA 814.

subject to an investigation being carried out under the ASIC Act or the Corporations Act. 'Property' is defined as meaning:

> *'any legal or equitable estate or interest (whether vested or contingent) in real or personal property of any description and includes a thing in action'.*[21]

The Court was satisfied that it could make such an order where the property was held as trustee by the persons being investigated and in relation to superannuation funds where the individuals were members. In each instance it was considered that the individuals subject of investigation had an 'interest' (legal or equitable).

The 'interest' of the individuals in discretionary trusts posed a more difficult question because the objects have nothing more than a right to be considered by the trustee as a potential beneficiary of the trustee's largesse as to income or capital.

French J undertook a detailed (but in the writer's view not exhaustive) review of the case law on the powers of trustees and their controllers. The two most telling observations made by the Court were these:

> *'in the ordinary case the beneficiary of a discretionary trust other than perhaps the sole beneficiary of an exhaustive trust, does not have an equitable interest in the trust income or property which would fall within even the most generous definition of 'property' in s9 of the Act and be amenable to control by receivers under s.1323. I distinguish the 'ordinary case' from the case in which the beneficiary effectively controls the trustee's power of selection. Then there is something which is akin to a proprietary interest in the beneficiary.'*[22]

And:

> *'I am inclined to think that a beneficiary in such a case … at arm's length from the trustee, does not have a 'contingent interest' but rather an expectancy or mere possibility of a distribution … On the other hand, where a discretionary trust is controlled by a trustee who is in truth the alter ego of a beneficiary, then at the very least a contingent interest may be identified because, in the words of Nourse J 'it is as good as certain that the beneficiary will receive the benefits of distributions either of income or capital or both'.*[23]

In a wealth preservation and tax planning context it might well be said that 'it is as good as certain that the beneficiary <u>will not</u> receive the benefits of distributions …'

The Court Concluded that a Mr Beck who was the sole director and secretary of a corporate trustee of a discretionary trust had an interest in property of the trust (it did not matter that his wife was the Appointor):

> *'Mr Beck is a beneficiary of the Agribusiness Annuity Trust of which Eagle Bluff Nominees Pty Ltd is a trustee. He is the director and secretary of that trustee company. He is the original appointor under the trust and his wife, Anne Beck, the current appointor. The trustee has a wide discretion including the power to prefer one or the other beneficiary to the total exclusion of any other beneficiary. Mr Beck would appear, through his trustee company, to have effective control of the assets of the trust. At the very least he has a contingent interest in the sense used earlier. His interest would appear to amount to effective ownership of the trust property. The property of that trust is, in my opinion, amenable to control by the receivers and s.1323'.*[24]

Does this decision sound the death knell of discretionary trusts as wealth preservation mechanisms?

In this writer's view – no and for two reasons. The first, technical differences between the legislation under consideration in *Richstar* and the Bankruptcy Act. The second reason, a practical one, lack of assured funds on the part of trustees in bankruptcy.

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[21] Section 9 Corporations Act.
[22] *Richstar* at para. 25.
[23] *Richstar* at para. 36.
[24] (2006) FCA814 at para. 41.

The property of a bankrupt at the time the person became a bankrupt passes to the trustee in bankruptcy.[25] However, property held on trust for another is specifically excluded.[26] In addition, the power of appointment of the trustee is not property which passes to the trustee in bankruptcy.[27]

Division 4A of the Bankruptcy Act specifically contemplates and makes provision for the circumstances where a bankrupt controls a trust.[28] In these circumstances it can be vigorously argued that the Bankruptcy Act recognises that the interest of the bankrupt in a discretionary trust is not attainable by a trustee in bankruptcy. For a somewhat contradictory view see the paper prepared by Justice Branson for the ITSA Bi-Annual Congress 2006.[29]

In any event, if the contingent interest that French J has identified passed to the trustee in bankruptcy – what is the true practical effect. The right as a beneficiary is to be considered and no more. That is not an attractive outcome for a trustee in bankruptcy.

The more practical aspect is that a trustee in bankruptcy personally takes on the risk of litigation. If he or she fails then there is a personal loss. This is a significant deterrent to pursuing cases which have a significant risk of failure.

It is recognized that a trustee in bankruptcy may have access to litigation funding. However, a litigation funder would take a very considered view of the implications of *Richstar* (after having first identified significant assets which might be accessed).

In the writer's view the decision is not one which will cause the trust edifice to crumble. However, it may in truly risky environments be wise take French J's structuring message into account. Actions which might be taken are:

- the risk exposed person might be excluded as a direct object of the trust. An indirect benefit might be obtained through another discretionary trust brought into the objects clause through the spouse or children;
- the risk exposed person might be one only of a number of directors of the corporate trustee and the decisions need genuinely to be made jointly;
- the risk exposed person would not be the Appointor or, if an Appointor, is one of a number of such persons and does not have a casting vote. An Appointor stripping clause may also be appropriate.

Careful attention to the trust deed may avoid the implications of the decision in *Richstar.*

3 CLONING AND SPLITTING OF TRUSTS

Trust '**cloning**' or '**replication**[30]' and trust '**splitting**' are very popular mechanisms for family succession planning. Ostensibly they are quite straightforward. However, there are significant tax and trust law traps for the unwary.

In this paper:

- '**splitting**' means maintaining the one trust relationship but appointing separate trustees for different assets of that one trust. The trust obligations are undertaken according to the trust relationship spelled out in the trust deed establishing the trust;

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[25] Subsection 116(1) Bankruptcy Act.
[26] Paragraph 116(2)(a) Bankruptcy Act.
[27] *Re Burton; ex parte Wily v. Burton* (1994) 126 ALR 557.
[28] Division 4A relates to entities controlled by the bankrupt and 'entity' includes a trust.
[29] 'The Bankrupt, His or Her Spouse and the Family Trust: A consideration of Part VI Division 4A of the Bankruptcy Act.'
[30] The term '**cloning**' will be used in this paper.

- '**cloning**' involves the establishment of a new trust relationship in respect of assets held by the trustee. That trust relationship may come about by settling the asset on the new trustee or bringing into existence a new trust relationship and transferring the asset to the trustee of that new trust relationship.

Although trust cloning has been a popular mechanism for the purposes of succession planning in the context of discretionary trusts given the (perceived) availability of exemptions from capital gains tax (more particularly, exemptions from CGT events E1 and E2), Press Release No. 092 of the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs (dated 31 October 2008) announced the abolition of the possible exemption.

However, it should be noted that the Exposure Draft for the *Tax Laws Amendment (2009 Measures No. 6) Bill 2009* (Cth) ('**the Exposure Draft**') released by the Treasury on 2 September 2009 the Treasury contained a proposal to provide a limited CGT roll-over where assets are transferred between fixed trusts (i.e. unit trust) that have the same beneficiaries with the same entitlements and no material discretionary elements. The roll-over would have effect from 1 November 2008.

It is therefore expected that splitting will probably be the preferred method of ensuring the effective passing of control of trusts between generations.

3.1 Why Split or Clone?

During the latter part of the 20th century and early 21st century the use of trusts and, in particular, family discretionary trusts, has proliferated. Tax laws have to an extent driven small to medium business operators away from using corporate vehicles as such[31]. However, very often the second or third generations are left with trust structures that do not provide appropriate family succession outcomes.

Some of the things that lead to this conclusion are:

- the family members may be incapable of making joint decisions;
- family members may vary greatly in business acumen, intellect, risk adversity and time opportunities;
- second and third marriages can lead to imperfectly blended families;
- family members will often have different financial needs eg. accumulation vs. present consumption;
- it may be desirable to separate assets to more fully protect some of them from potential creditors' claims.

The splitting and cloning approaches are generally played out in the context of the one family relationship. Overwhelmingly discretionary trusts are established for the one family, the members of which may wish to go their separate ways (for the reasons discussed above). On rare occasions a discretionary trust is established for separate family groups (it is ill advised to do so) and splitting or cloning may have application. However, if family trust elections have been made (or interposed entity elections are required to be made) the transactions become problematical. The writer's experience has been that splitting and cloning of discretionary trusts is inevitably about single-family relationships but often with the added complexity of children from multiple marriages who owe allegiances to different parts of the family.

[31] The overwhelming factor in selecting a discretionary trust (or unit trust) structure rather than a corporate structure is the availability of the 50% CGT discount where the business assets are sold rather than the ownership interests in the entity. A capital gain made by a company in its own right is not a discount capital gain: section 115-10 1997 Act.

Unit trusts are commonly used for business (or investment) joint ventures by unrelated family groups. Cloning or splitting unit trusts have their own unique issues in this context and these are addressed briefly below.

Cloning and splitting hybrid style trusts also have their own unique problems. Often such hybrid trusts will involve members of completely different families. These issues are also considered but briefly in this paper.

3.1.1 Splitting – The Drivers

Splitting in the way described above rather than cloning is very often driven by stamp duty outcomes. It delivers imperfect separation of control and financial exposure for family members. Why stamp duty? The stamp duties legislation in all jurisdictions will exempt (or impose nominal duty only) on the replacement of a trustee, addition of a trustee or retirement of a trustee.

In the Australian Capital Territory, subsection 54(2) of the *Duties Act 1999* (ACT) provides:

> *'(2) Duty of $20 is chargeable in respect of a transfer of dutiable property to a person as a consequence of the retirement of a trustee or the appointment of a new trustee, if the Commissioner is satisfied that, as the case may be –*
>
> > *(a) except for a responsible entity of a managed investment scheme—none of the continuing trustees remaining after the retirement of a trustee is or can become a beneficiary under the trust; and*
> >
> > *(b) except for a responsible entity of a managed investment scheme—none of the trustees of the trust after the appointment of a new trustee is or can become a beneficiary under the trust; and*
> >
> > *(c) except if a responsible entity of a managed investment scheme acquires a beneficial interest in the managed investment scheme solely as a consequence of its appointment as the responsible entity—the transfer is not part of a scheme for conferring an interest, in relation to the trust property, on a new trustee or any other person, whether as a beneficiary or otherwise, to the detriment of the beneficial interest or potential beneficial interest of any person; and*
> >
> > *(d) the transfer is not made in connection with a tax avoidance scheme;*
>
> *and, if the Commissioner is not so satisfied, the transfer is chargeable with the same duty as a transfer to a beneficiary under and in conformity with the trusts subject to which the property is held.'*

In New South Wales subsection 54(3) of the *Duties Act 1997* (NSW) provides:

> *'Duty of $50 is chargeable in respect of a transfer of dutiable property to a person other than a special trustee as a consequence of the retirement of a trustee or the appointment of a new trustee, if the Chief Commissioner is satisfied that, as the case may be:*
>
> > *(a) none of the continuing trustees remaining after the retirement of a trustee is or can become a beneficiary under the trust; and*
> >
> > *(b) none of the trustees of the trust after the appointment of a new trustee is or can become a beneficiary under the trust; and*
> >
> > *(c) the transfer is not a part of a scheme for conferring an interest in relation to the trust property, on a new trustee or any other person, whether as a beneficiary or otherwise, to the detriment of the beneficial interest or potential beneficial interest of any person.*

> *If the Chief Commissioner is not so satisfied, the transfer is chargeable with the same duty as a transfer to a beneficiary under and in conformity with the trusts subject to which the property is held, unless subsection 3A applies.'*[32]

Subsection 33(3) of the *Duties Act 2000* (Vic) provides that:

> *'No duty is chargeable under this Chapter in respect of a transfer of dutiable property to a person other than a special trustee if the Commissioner is satisfied that the transfer is made solely:*
>
> *(a) because of the retirement of a trustee or the appointment of a new trustee or other change in trustee; and*
>
> *(b) in order to vest the property in the trustee for the time being entitled to hold it.'*

In Queensland Section 117 of the *Duties Act 2001* (Qld) provides the exemption:

> *'Transfer duty is not imposed on a dutiable transaction for the sole purpose of giving effect to a change of trustee if:*
>
> *(a) the transaction is not part of an arrangement:*
>
> *(i) involving a change in the rights or interest of a beneficiary of the trust; or*
>
> *(ii) terminating the trust; and*
>
> *(b) transfer duty has been paid on all trust requisitions for which transfer duty is imposed for the trust before the transaction.'*

These provisions contemplate nominal or no duty if the transfer of dutiable property is to give effect to the retirement of a trustee or the appointment of a new trustee. Both provisions require there to be no conferring of an interest in the trust property on the new trustee or any other person to the detriment of the beneficial interest or potential beneficial interest of any other person.

The Chief Commissioner of State Revenue in New South Wales made clear in Revenue Ruling No. DUT 37 that section 54(3) of the *Duties Act 1997* (NSW) only applies to exempt duties in trust splitting and not trust cloning due to a lack of pre-existing trust and pre-existing trust property in trust cloning:

> ***Pre-existing trust – distinction between trust cloning and trust splitting***
>
> *The requirement that the transfer be as a consequence of a change in the trustees appointed to administer an existing trust as distinct from a newly-created trust highlights the distinction between trust cloning and trust splitting.*
>
> - *Trust cloning' refers to the situation where a pre-existing trust is' cloned' by the execution of a new trust with the same or (substantially the same) terms and conditions, and with the same beneficiaries, as under the existing trust deed. The trustee of the new trust may be the same person as the trustee of the pre-existing trust or a different person. Where a trust is cloned, section 54(3) will not apply to any transfer of dutiable property from the trustee of the pre-existing trust to the trustee of the new trust, even though as a result of the transfer the same property will be held on trust for the same beneficiaries. This is because any such transfer is between the trustees of two different trusts rather than (as required by section 54(3)) as a consequence of a change in the trustee of a pre-existing trust within which the property continues to be held; that the beneficiaries of the respective trusts are the same is irrelevant: AG Lamattina & Sons Pty Ltd v Commissioner of State Revenue (VIC) (1996) 96 ATC 4474 at 4478). As section 54(3) does not apply to such a transfer, it will be liable to ad valorem duty calculated on the dutiable value of the property being transferred as at the date of the transfer.*
>
> - *Trust splitting' refers to the situation where there is an existing trust and the trust fund comprises a number of different items of property. The trust is then "split" in the sense that separate trustees are appointed for part of the trust property with the existing trustee(s) remaining as trustee(s) of the remainder of the trust property, although (unlike the position with a trust cloning) all the property remains held subject to the trusts of the existing trust deed.*

[32] subsection 54(3A) is not relevant in the circumstances.

> *In this situation (and unlike the situation with trust cloning), the transfer of the split property to the new trustee(s) of that property is a transfer to the new trustee(s) of a pre-existing trust, and section 54(3) will therefore apply to that transfer provided requirements (a) and/or (b) (as the case may be) and (c) of that section are satisfied.*

In Victoria the legislation is interpreted in a slightly different way in that under subsection 33(3) of the *Duties Act 2000* (Vic) the Commissioner must be satisfied that the transfer is made solely because of the appointment of a new trustee and in order to vest the property in the trustee[33]. In Revenue Ruling DA030 the State Revenue Office suggests that the Commissioner will not be satisfied if the transfer forms part of a transaction or series of transactions that have a separate commercial objective whether or not the transaction has the effect of avoiding the payment of duty. It is not clear what is meant by 'a separate commercial objective'. A splitting of a family trust arrangement has no commercial objective. It is a family arrangement.

All of the other stamp duty legislations have provisions, which exclude transfers to effect a mere change of trustee[34]. Most of them have similar anti-avoidance aspects.

In a land rich context Australian Capital Territory[35], New South Wales[36], Victoria[37] and Queensland[38] exempt changes of trustees.

From a stamp duty perspective extreme care needs to be taken that the express words of the exemption are complied with. There is a view about that it is necessary to appoint a co-trustee in respect of all of the assets of the trust and then have the original trustee resign (and presumably the new trustee resign in respect of those assets to be exclusively held by the old trustee) from their position in relation to those assets which are to be under the exclusive control of the new trustee. This is a reaction to the perceived disjunction between retirement of a trustee and appointment of a new trustee. This may be an over-reaction.

The requirement that the arrangements do not confer a benefit in relation to the trust property on the new trustee or any other person must be at least considered in the light of the decision of the High Court in *CPT Custodian*[39]. The High Court has made it plain that the trustee has an equitable interest in the trust property and the beneficiaries' interest is subject to the priority of that interest. When a new trustee is appointed that trustee obtains a right to be indemnified – '*the right of the trustee under the general law to reimbursement or exoneration for the discharge of liabilities incurred in the administration of the trust*'[40].

If, as is commonplace, the old trustee assigns its right to be indemnified out of the trust assets the new trustee will obtain a benefit in relation to the trust property. However, the potential for that benefit to eliminate the exemption is itself excluded by the requirement that there be a detriment in relation to the beneficial interest of some other person. No beneficial interest, save that of the retiring trustee, is altered detrimentally by the acquisition by the new trustee of a claim in respect of the trust assets. The retiring trustee does not suffer a detriment because the claims against it must be reduced as a result of its retirement (or it has a right to be indemnified by the continuing trustee).

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[33] a '*new trustee*' is '*a trustee appointed in substitution for a trustee or trustees or a trustee appointed in addition to a trustee or trustees*': subsection 33(1) *Duties Act 2000* (Vic).

[34] NT — Item 6 in Schedule 2 *Stamp Duty Act;*
TAS — section 37 *Duties Act 2001;*
WA — paragraph 73AA(1)(a) *Stamp Act 1921*.

[35] Section 91 imposes a nominal duty to interests that are subject to landholder duty under Part 3.2 of the *Duties Act 1999* (ACT) that is acquired under section 54 (change in trustee).

[36] Land rich duty under Chapter 4 of the *Duties Act* 1997 (NSW) will not apply if the provisions of section 54 would have imposed nominal duty of $10 only: para. 163A(f).

[37] Subsection 85(1) *Stamp Duties Act* 2000 (Vic) exempts the acquisition of an interest in a land rich entity if the transaction, had it taken place in relation to the underlying land, would have been exempt.

[38] Section 191 of the *Duties Act 2001* (Qld) excludes land rich duty if the relevant acquisition is for the sole purpose of giving effect to a change of trustee, if the acquisition is not part of an arrangement involving a change in the rights or interests of a beneficiary of the trust or terminating the trust, the acquisition is not part of an arrangement to avoid the imposition of duty and transfer duty has been paid on all trust acquisitions for which transfer duty is imposed for the trust before the acquisition.

[39] *CPT Custodian Pty Ltd v. Commissioner of State Revenue (Vic)* [2005] HCA 53.

[40] [2005] HCA 53 at p.20.

Ordinarily this should not pose a problem but, again, great care needs to be taken with respect to the precise requirements of the relevant provision.

3.2 Splitting – Is there a Resettlement?

This subject can be described in this way — can a transfer of assets to another trustee, but subject to the precise terms of the trust instrument, bring into existence a different trust relationship? The argument that this is a new trust derives out of the rationale that a trust is a personal relationship in regard to property subject of the trust instrument between the trustee, the settlor and the beneficiaries. It follows in this argument that, if there is a new trustee, there must be a new trust relationship. This approach emphasises the relationship between the parties as the hallmark of a trust. The alternative view is that the true character of a trust relationship is to be found in the nature of the beneficial entitlements and the identity of the trustee is irrelevant. The writer prefers this latter approach – an appointment of a new trustee in respect of particular assets of the trust but adhering to the terms and conditions is not a new trust relationship but a continuation of the old relationship. Whether or not there is a resettlement turns on the question whether there is an alteration to the substratum of the trust sufficient to constitute it a new trust relationship. The observations of Megarry J in *Re Ball's Settlement*[41] are telling in this regard:

> *'If an arrangement changes the whole substratum of the trust then it may well be that it cannot be regarded merely as varying that trust. But if an arrangement, while leaving the substratum, effects the purpose of the original trust by other means, it may still be possible to regard that arrangement as merely varying the original trusts, even though that means employed are wholly different and even though the form is completely changed.'*

The question is whether the changes, which have been made, constitute 'a new charter of future rights and obligations' as observed by the High Court in *Davidson v. Chimside*[42].

In *Roome v. Edwards (Inspector of Taxes)*[43] it was said:

> *'There are a number of obvious indicia which may help to show whether a settlement, or a settlement separate from another settlement exists. One might expect to find separate and defined property, separate trusts and separate trustees. One might also expect to find a separate disposition bring the separate settlement into existence. These indicia may be helpful, but they are not decisive.'*

The fact that a trustee newly appointed to the trust property declares that it holds the property subject to the terms of the original trust should not in the usual case be a resettlement ie. in Lord Wilberforce's words 'a settlement separate from another settlement'. This was the outcome in Farrar's Case[44] where a declaration was found to be a mere acknowledgment of a pre-existing trust in a New South Wales stamp duty context.

In many jurisdictions the particular provision in the *Trustee Act* allowing appointment of separate trustees prima facie contemplates that the trust property will be held on separate and distinct trusts.

In the Australian Capital Territory subsections 6(1), 6(5), 6(6) and 6(9) *Trustee Act 1925* (ACT) provide:

> *'(1) A new trustee may by registered deed be appointed in place of a trustee, either original or substituted, and whether appointed by the Supreme Court or otherwise.*
>
> *…*
>
> *(5) The appointment may be made for the whole or any part of the trust property.*
>
> *(6) The following provisions apply to appointments under subsection (1):*

[41] (1968) WLR 899 at 905.
[42] [1908] HCA 65.
[43] [1982] AC 279 at 292-293 per Lord Wilberforce.
[44] *Farrar v. Commissioner of Stamp Duties* (NSW) (1975) 5 ATR 364.

> *(a) 2 or more trustees may be appointed concurrently;*
>
> *(b) the number of trustees may be increased up to 4;*
>
> *(c) a separate set of up to 4 trustees may be appointed for any distinct part of the trust property held on trusts that are distinct from those relating to any other part of the trust property even if a new trustee is not to be appointed for the other part;*
>
> *(d) any existing trustee may be appointed or remain one of the separate set of trustees;*
>
> *(e) if only 1 trustee was originally appointed – a separate trustee may be appointed for the distinct part;*
>
> *(f) it is not necessary to appoint more than 1 new trustee if only 1 trustee was originally appointed or to fill up the original number of trustees if more than 2 trustees were originally appointed.*
>
> *…*
>
> *(9) Every new trustee appointed under this section, as well before as after all the trust property becomes by law or by conveyance or otherwise vested in him or her, shall have the same powers and discretions, and may in all respects act as if he or she had been originally appointed a trustee by the trust instrument.'*

In New South Wales subsections 6(1), 6(5) and 6(8) *Trustee Act 1925* (NSW) provide:

> *'(1) A new trustee may by registered deed be appointed in place of a trustee, either original or substituted and whether appointed by the Court or otherwise.*
>
> *…*
>
> *(5) The appointment may be made for the whole or any part of the trust property, and on the appointment:*
>
> *(a) two or more trustees may be appointed concurrently;*
>
> *(b) the number of trustees may be increased, but not beyond four;*
>
> *(c) a separate set of trustees may be appointed for any distinct part of the trust property, that is to say, for any part for the time being held on trusts distinct from those relating to any other part or parts, notwithstanding that no new trustees or trustee are or is to be appointed for other parts, provided that the number of trustees in any separate set shall not exceed four;*
>
> *(d) any existing trustee may be appointed or remain one of the separate set of trustees.*
>
> *…*
>
> *(8) Every new trustee appointed under this section as well before as after all the trust property becomes by law or by conveyance or otherwise vested in the new trustee, shall have the same powers, authorities and discretions, and may in all respects act as if the new trustee had been originally appointed a trustee by the instrument, if any, creating the trust.'*

Subsection 12(2) *Trusts Act 1973* (QLD) provides:

> *'On the appointment of a trustee or trustees for the whole or any part of the trust property:*
>
> *…*
>
> *(b) a separate set of trustees may be appointed for any part of the trust property held on trusts distinct from those relating to any other part and whether or not new trustees are or are to be appointed for any other part of the trust property; and any existing trustee may be appointed or remain 1 of the separate set of trustees or if only 1 trustee were originally appointed then 1 separate trustee may be so appointed for the part of the trust first in this paragraph mentioned.'*

Section 42(1) of the *Trustee Act 1958* (Vic) provides:

> *'On the appointment of a trustee for the whole or any part of trust property:*
>
> *(a) the number of trustees may, subject to the restrictions imposed by this Act on the number of trustees, be increased; and*
>
> *(b) a separate set of trustees, not exceeding four, may be appointed for any part of the trust property held on trusts distinct from those relating to any other part or parts of the trust property, notwithstanding that no new trustees or trustee are or is to be appointed for other parts of the trust property, and any existing trustee may be appointed or remain one of such separate set of trustees, or, if only one trustee was originally appointed, then, save as hereinafter provided, one separate trustee may be so appointed.'*

The references to '*trusts distinct from those relating to any other part*' (Qld) and '*held on trust distinct from those relating to any other part*' (ACT, NSW and Victoria) raise concerns about whether the trust deed has to specifically provide for separate and distinct trusts before there can be separate trustees appointed in respect of separate trust assets. In the writer's view this appears to be an unjustifiable conclusion. It may be that the provisions simply require the particular trust property to be discernibly held subject to the terms of the trust. However as a surfeit of caution if a split is to be pursued the necessary provisions should be set out in the trust deed.

Subsection 6(15) of the Trustee Act 1925 (ACT) provides:

> *'This section applies to a trust except so far as the contrary intention appears in the trust instrument.'*

Subsection 6(13) of the *Trustee Act 1925* (NSW) provides:

> *'Except as otherwise provided in subsection (12), this section applies only if and as far as a contrary intention is not expressed in the instrument, if any, creating the trust, and shall have effect subject to the terms of that instrument and to the provisions therein contained.'*

There is no specific exclusion in Victoria and Queensland. Those in pursuit of an effective split will want to make sure that the trust deed specifically allows a separate trustee to be appointed in respect of specific assets held subject to the trusts.[45]

3.2.1 Varying the Deed to Allow Separate Trustees

Can the power of amendment be used to allow for appointment of separate trustees where no such power existed or does the amendment amount to a resettlement. Common sense suggests, no (unless there is something in the deed which provides that a single trustee was an absolute requirement or that separation of assets and trustees was prohibited by the deed). Based on the views of Brightman J in *Hart v. Briscoe*[46], Lord Wilberforce in *Roome v. Edwards*[47] and Mahoney J in *Kearns v. Hill*[48] the use of a power of amendment set out in the trust deed (and without any relevant imbedded limitations being breached) to allow the appointment of separate trustees to the trust assets is unlikely to be a resettlement so that a new trust estate comes into existence.

As David Raphael has observed[49:]

> *'Despite Kearns v. Hill and Re Lancedale Holdings case there is a body of law to the effect that a power of amendment is not likely to be held to extend to vary the trust in a way which would destroy its substratum: see Re Dwyer (1935) VLR 273; Re*

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[45] The legislation in Northern Territory and Western Australia is similar. It should be noted that in all States and Territories except NT, SA and TAS the number of trustees for a private unit trust is limited to four.

[46] [1978] 1 All ER 791.

[47] [1982] AC 279.

[48] (1990) 21 NSWLR 107.

[49] D Raphael: '*Variation & Resettlement of Trusts*' paper presented at a seminar conducted by the Taxation Institute of Australia: NSW Division on 7 April 2004 particularly at paras. 26 and 27.

> *Ball's Settlement Trusts (1968) 1 WLR 899 at 904. The underlying purpose for the furtherance of which the power was initially created or conferred will be paramount: see Duke of Bedford v. Marquess of Abercom (1836) 11 My and Ca 312.*
>
> *However, this general principle is unlikely to be an appropriate consideration where the evident purpose of the power is to ensure maximum flexibility such as would be the case in most modern superannuation funds or discretionary trusts or unit trusts. Indeed the converse is the case. Nonetheless, as I have said in relation to the Tax Acts, it is more likely than not that Re Ball's Settlement will be followed.'*

3.2.2 Appointment of Separate Appointer

It is suggested immediately above that the segregation of assets to be held by separate trustees is unlikely to be a resettlement. What if the trust deed has an office of appointor and the deed is amended to provide for different appointors in respect of the different trustees. Would such an amendment be a resettlement?

The power of appointor is a fiduciary power, which must be exercised in the interests of the beneficiaries[50]. It gives the appointor no interest in the trust property.

An appointor has, simply by holding that office and wielding the power attached, no interest in the property of the trust[51]. This is notwithstanding that a Court might conclude for special purposes that the appointor is the '*owner'* of property of the trust[52].

Provided the trust deed allows sufficient flexibility or it can be introduced by amendment the introduction of an appointor with powers restricted to appointing the trustee of say Parcel 2 assets while the limitation of the power of the original appointor to the appointment of the trustee to Parcel 1 assets appears to the writer to be an administrative matter not going to the substratum of the trust. It should not, either by using powers that already exist in the deed or by amending the deed, effect a resettlement of the trust property. The principles are the same as discussed above.

David Raphael also points out that many trust deeds will not empower the trustee to amend the deed so as to affect the appointor's power or to allow further appointors to be engaged. This is because many trust deeds provide the trustee with the power to amend the trusts but not the powers granted by the deed.

3.2.3 Splitting and Family Trust Elections

The relationship between the two trustees and the trust assets remains the one trust estate. If the trustee of the trust has made a family trust election pursuant to section 272-80 (Schedule 2F) of the 1936 Act that should continue to be effective notwithstanding the fact that an additional trustee has been appointed. The ramifications of having made a family trust election (or interposed entity election) flow from actions taken by the trustee of the trust from time to time notwithstanding the fact that the trustee is not the same person as the trustee that made the election[53].

3.2.4 The CGT Events

When the original trustee disposes of a CGT asset to the additional trustee there is a change in legal title i.e. a change of ownership for the purposes of subsection 104-10(2) of the 1997 Act. However, the change of ownership does not occur if it happens '*merely because of a change of trustee*'.

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[50] *Re Wiley v. Burton* [1994] FCA 1146 and Gilbert v. Stanton [1905] HCA 1.
[51] See *Edwards v. Klaville Pty Ltd* [1996] FCA 411.
[52] As in the case of Section 1323 of the *Corporations Act 2001* and ASIC: *In the Matter of Richstar Enterprises Pty Ltd ACN 099 071 968 (No. 9) v. Carey* [2006] FCA 1242.
[53] For example, a tax liability for family trust distributions tax arises when 'the trust confers a present entitlement to, or makes a distribution of income or capital of the trust': subsection 271-15, Schedule 2F of the 1936 Act.

CGT event E1 will not happen if no trust is created by declaration or settlement[54]. All of the reasoning above has been to the effect that there will be no declaration of trust by merely appointing a new trustee or no resettlement. CGT event E2 is not relevant because there is no other existing trust to which the CGT assets are transferred.

CGT event E3 is not relevant. CGT event E4 could be relevant in the context of a unit trust or hybrid trust.

CGT event E5 operates on the basis of a beneficiary becoming absolutely entitled as against the trustee. In the splitting approach no beneficiary becomes absolutely entitled to a CGT asset of the trust.

CGT events E6, E7 and E8 are not relevant to a splitting.

Subject to there being no resettlement triggering a CGT event E1 there should be no relevant CGT event arising on a splitting.

3.3 Splitting – Tracing Assets

This is really an asset protection topic. What if the trustee in relation to Parcel 1 assets falls into financial difficulty (for example, experiences a call on its margin lending facility against its share portfolio). Is the trustee of Parcel 2 assets protected against the claims of the creditors of the original trustee?

If the creditors arose in respect of debts incurred by trustee 1 after the Parcel 2 assets were transferred to trustee 2 the answer appears to be reasonably clear. Unless there are special circumstances eg. misrepresentation or fraud, there is no right to recover. The trustee's right to indemnity from trust assets comes into existence when the liabilities are incurred. If trustee 1 incurs liabilities after the Parcel 2 assets have been transferred to trustee 2 the creditors have no right to be subrogated to claim against assets that trustee 1 no longer has legal title to nor had at the time the liability was incurred.

A trustee is only liable for its own acts and liabilities incurred. The Trustee Acts make this plain[55]:

- Section 59(2) of the *Trustee Act 1925* (ACT) provides:

  'A trustee shall be answerable and accountable only for his or her own acts, receipts, neglects, or defaults, and not for those of any other trustee, nor for any bank, broker, or other person with whom any trust money or securities may be deposited, nor for the insufficiency or deficiency of any securities, nor for any other loss, unless the same happens through his or her own wilful neglect or default.' [56]

- Subsection 59(2) of the *Trustee Act 1925* (NSW) provides:

  'A trustee shall be answerable and accountable only for the trustee's own acts, receipts, neglects, or defaults, and not for those of any other trustee, nor for any banker, broker, or other person with whom any trust moneys or securities may be deposited, nor for the insufficiency or deficiency of any securities, nor for any other loss, unless the same happens through the trustees own wilful neglect or default.'[57]

- Subsection 36(1) of the *Trustee Act 1958* (Vic) provides:

  'A trustee shall be chargeable only for money and securities actually received by him notwithstanding his signing any receipt for the sake of conformity, and shall be answerable and accountable only for his own acts, receipts, neglects or defaults, and not for those of any other trustee, nor for any banker, broker or other person with whom any trust money or securities may be deposited, nor for the insufficiency or deficiency of any securities, nor for any other loss unless the same happens through his own wilful default.'

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[54] Subsection 104-55(1).
[55] See also: NT – section 26 *Trustee Act* (NT); SA – section 35 *Trustee Act 1958* (SA); TAS – section 27 *Trustee Act 1898* (Tas); WA – section 70 *Trustee Act 1962* (WA).
[56] This provision is expressly subject to the term of the trust deed: subsection59(3) *Trustee Act 1925* (ACT).
[57] This provision is expressly subject to the term of the trust deed: subsection59(3) *Trustee Act 1925* (NSW).

- Section 71 of the *Trusts Act 1973* (Qld) provides:

> *'A trustee shall be chargeable only for money and securities actually received by the trustee, notwithstanding the trustee signing any receipt for the sake of conformity; and shall be answerable and accountable only for the trustee's own acts, receipts, neglects or defaults, and not for those of any other trustee, nor those of any financial institution, broker or other person with whom any trust money or securities may be deposited, nor for the insufficiency or deficiency of any securities, nor for any other loss, unless the insufficiency, deficiency or loss occurs through the trustee's own default.'*

As Dr John Glover has put it[58]:

> *'If the trust deed so provides, the powers of multiple trustees can be exercised without the concurrence of all or a majority of their number, or alternatively can be exercised by co-trustees acting unilaterally. Not infrequently one out of a body of co-trustees is given the sole responsibility for conducting a business and is made the sole signatory who can enter agreements on the business's behalf. Co-trustees, ordinarily, are not liable for the exercise of powers by other trustees to whom those powers have been exclusively allocated'*

A trustee has an equitable lien over the assets of the trust as they existed at the time the trustee incurred liabilities on behalf of the trust. That lien continues notwithstanding the fact that the person is no longer the trustee but has been replaced. In *Coates v. McInerney*[59] it was argued that the right of indemnity was lost when the trustee was removed from office. Anderson J observed:

> *'It is said that under this clause only the trustee actually in office is indemnified. However, I must disagree. Any right of indemnity would arise upon the liability arising and the question is whether that right of indemnity, arising at that time, that is to say, during the holding of the office by the trustee who held office at the time that the liability was incurred, is then lost by subsequent loss of office.*
>
> *There is abundant authority that it is not so lost. I do not need to refer to all of the authorities. It is, I think, sufficient to refer to Kemtron v. Commissioner of Stamp Duties (1984) 15 ACR 627 at 634. The question is whether there is anything in clause 12 which would affect the general equitable doctrine that loss of office does not terminate the right of indemnity. In my view there is nothing in clause 12 which would modify the general equitable doctrine'.*[60]

In *Rothmore Farms* Mansfield J, when confronted with the same issue, found that the trust assets secured the indemnity as they existed from time to time. Mansfield J appears to have allowed equitable tracing into the hands of those in whom the assets were ultimately vested[61]. Equitable tracing is a very difficult topic and beyond the scope of this paper.

The reference in the decision of Anderson J in *Coates v. McInerney* to clause 12 of the deed raises issues about whether the trust deed can by its terms oust the right to indemnity. In South Australia the indemnity cannot be excluded[62]. In New South Wales the better view is that it cannot be excluded[63]. In Victoria the right to be indemnified can be excluded by the terms of the trust deed[64]. This is why it may be possible according to the terms of the trust deed to limit the right of the trustee to follow assets over which the trustee might otherwise have a lien[65].

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[58] Dr John Glover: '*Dissecting Trusts and Trusteeships: Capital Gains and State Taxation Consequences*': paper presented to Taxation Institute of Australia's 7th Annual States Taxation Conference (July 2007) at p.4 and also '*Dissecting Trusts and Trusteeship: CGT and Stamp Duty Consequences*' Vol. 36 No. 4 ATR (Nov 2007) p.201 at 203-204.
[59] (1992) 6 ACCR 748.
[60] at p.749-750 of 6 ACSR 748. See also *Rothmore Farms Pty Ltd v. Belgravia Pty Ltd* [1999] FCA 745; *Moyes* v. *J&L Developments Pty Ltd (No. 2)* [2007] SASC 261 and *Collie v. Merlaw Nominees Pty Ltd* [2001] VSC.
[61] [1999] FCA 745 at paras. 182 and 184.
[62] per Debelle J in *Moyes v. J&L Developments Pty Ltd (No. 2)* [2007] SASC 261 at paras. 37 to 48.
[63] *JA Pty Ltd v. Jonco Holdings Pty Ltd* (2000) 33 ACSR 691 per Santow J at paras. 50 and 67. See also ***Jacobs' Law of Trusts in*** *Australia* (7th Ed) at p.2106.
[64] *RWG Management Ltd v. Commissioner for Corporate Affairs* [1985] VR 385 at 394-5.
[65] *Tindon Pty Ltd v. Adams and Window Concepts Pty Ltd* [2006] VSC 172.

Notwithstanding whether or not a trustee may have a lien, the assets which trustee 1 held at the time the liability was incurred and then transferred to trustee 2 may be recoverable by the creditors of trustee 1 for a number of reasons:

- the creditors held security directly over those assets and the transfer was a breach of that security;

- trustee 2 knew that the Parcel 2 assets were depended upon by creditors for the advance of funds and was equitably bound to disgorge them when the claim was made against trustee 1;

- trustee 2 undertook to indemnify trustee 1 when the Parcel 2 assets were transferred;

- trustee 1 is an individual and the provisions of section 120 and 121 of the Bankruptcy Act could apply to allow the trustee in bankruptcy of trustee 1 to recover assets transferred for less than market value consideration[66] or where trustee 1 transferred the assets for the main purpose of avoiding the assets becoming available to meet creditors' claims;

- in the case of a corporate trustee the Corporations Act becomes relevant. Section 588FC, in relation to insolvent transactions (the company being insolvent at the time of the transaction), subsection 588FE(4) in relation to uncommercial transactions and subsection 588FE(5) in relation to avoiding creditors are the most relevant.

A liquidator of trustee 1 (a corporate trustee) may be successful in clawing back property transferred to trustee 2.

The position of a corporate trustee in relation to an undervalue transaction differs from that of an individual acting as a trustee because the 'uncommercial transaction'[67] must have been entered into when the company was insolvent or was a transaction which caused it to become insolvent. By contrast an individual acting as a trustee is exposed for up to 4 years regardless of their state of solvency where the transfer is to an associate[68].

In relation to transactions intended to defeat creditors an individual is exposed forever[69]. By contrast a company is exposed only for 10 years[70].

Trustee 2 may have a defence to the claim of the liquidator if it can show:

- it became a party to the transaction in good faith;

- there was no objective grounds for suspecting that trustee 1 was insolvent or about to become insolvent; and

- trustee 2 provided valuable consideration or changed its position in reliance on the transaction[71].

As the controlling mind of trustee 2 is likely to be that of trustee 1 or they will be closely associated it is unlikely that this defence can be made out. It is possible that the third point could be satisfied if trustee 2 undertook the liabilities of trustee 1 associated with Parcel 2 assets. However, this may not be sufficient if the effect of the transfer is to make trustee 1 insolvent in any event.

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[66] subsection 120 will allow the trustee in bankruptcy to recover back an asset transferred by way of a undervalue transaction to a related entity for a period of up to four years from the date on which the bankruptcy commenced.
[67] an '*uncommercial transaction*' is one that it might be expected a reasonable person in the company's circumstances would not have entered into having regard to the matters set out in subsection 588FB(1) of the *Corporations Act*.
[68] it is only beyond 4 years to 5 years that insolvency becomes an issue extending the clawback period.
[69] see Trustees of the Property of John Daniel *Cummins v. Cummins* [2006] HCA 6.
[70] subsection 588FE(5) Corporations Act.
[71] subsection 588FG(1) Corporations Act.

The potential impact of section 197 of the Corporations Act needs to be considered. This provision imposes joint and several liability on Directors in respect of liabilities incurred by a corporate trustee when the trustee is not entitled to be fully indemnified out of trust assets because of:

- a breach of trust by the company;
- the company acting outside the scope of its powers as trustee;
- a term of the trust denying or limiting, the company's right to be indemnified against the liability.

In the case of a split of a trust none of these things is likely to occur. In transferring assets to the new trustee, trustee 1 will be acting within the terms of the trust deed (perhaps as amended). Nothing in the terms of the trust deed need limit the recourse of trustee 1 to the assets of the trust. However, if there is an explicit provision in the deed that does limit the right to be indemnified to those assets and there is no recourse to the assets held by trustee 2 there might be potential application of section 197. Arguably, however, the right to indemnity is limited as a matter of the general law to the assets actually held by trustee 1. If this is the case then it is the fact of transfer of the assets that has limited the recourse and not the terms of the trust deed.

3.4 Trustee's Duties

All trustees are subject to duties. In the case of a trustee of a discretionary trust that duty is to:

- consider the exercise of discretion from time to time or as required by the trust deed[72];
- not act arbitrarily or in capricious disregard of the trustees' power;
- not to delegate the decision making but exercise it personally;
- not act dishonestly or to commit a fraud on its power.

Nothing more is required of the trustee. It is not possible to conceive of a transfer of assets from trustee 1 to trustee 2 pursuant to the terms of the trust deed in itself as in any way in breach of the trustee's duties bearing in mind that it is the one trust relationship.

In any event beneficiaries of discretionary trusts have great difficulty in establishing standing to take action against trustees.[73]

3.4.1 The Tax Return

One of the minor irritants of trust splitting is the need to have the trustees lodge an income tax return and BAS. The question also arises as to whether or not the trustees need separately to be registered for GST (if that is relevant in the circumstances).

Subsection 161(1) of the 1936 Act requires every '*person'* to lodge a return of income when required to do so by the Commissioner of Taxation ('**the Commissioner**'). A '*person'* is defined to include '*a person in the capacity of trustee of a trust estate*'. This appears to require/allow each trustee to lodge a return of income in respect of the income derived from assets it holds in relation to the trust.

Notwithstanding this possibility nothing will happen without a tax file number. Can each of the trustees acquire its own individual tax file number?

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[72] I J Hardingham & R. Baxt 'Discretionary Trusts': (1st Ed) Butterworths (1975) pp.92-114.

[73] See generally: K. Schurgott: '*Some Trust Oddities*', paper delivered to the Taxation Institute of Australia's 20th National Convention (March 2004 Perth) pp.29-37 and also C. Call: '*Trusts in the Court*' paper delivered to the Taxation Institute of Australia's (NSW Division) Trust Intensive (November 2005) pp.50-62.

Section 202B of the 1936 Act provides that a '*person'* may apply to the Commissioner for issue of a tax file number. Based on the definition of '*person'* each trustee appears to be entitled to apply. If the Commissioner is satisfied that the person's identity has been established the Commissioner '*shall issue*' a tax file number to the applicant subject only to:

- the Commissioner being satisfied that the person already has a tax file number;
- there not being an interim notice.[74]

It would appear that it is mandatory for the Commissioner to issue a tax file number if satisfied as to the applicant's identity. The exceptions should not apply. The legislation would appear to allow the separate trustee to obtain its own tax file number in respect of its role as trustee of the trust.

Are the trustees required to be separately registered for GST? An '*entity*' includes a '*trust*'[75]. The trustee of a trust is taken to be an entity consisting of the person who is the trustee, or the persons who are the trustees, at any given time[76]. An entity carrying on an enterprise that meets the registration turnover is required to be registered[77].

It would appear that the split trustees cannot be split for GST purposes. This would appear to be in contrast to the position for income tax. It poses a considerable difficulty for complying with the lodgement requirements in respect of BAS. From a practical perspective the Commissioner is likely not to complain if the trustees individually register.

3.5 Trust Splitting and ATO ID 2009/86

The Commissioner has considered whether the appointment of a separate trustee to hold certain of the assets (either the passive or active assets) pursuant to the terms of the two testamentary trusts would be a resettlement giving rise to a CGT event E1 in ATO ID 2009/86.

The relevant facts in ATO ID 2009/86 were:

- The X Family Trust is a family discretionary trust for the primary benefit of members of the X family. However, its terms are widely drawn such that the trustee also had the power to appoint income and capital to members of the Y family (X and Y were in fact brothers).
- The appointor of the X Family Trust (who had power under the deed to do so) appointed a new trustee to CGT assets formerly held exclusively by the old trustee (these were half of the units in a unit trust);
- The new trustee held these assets on the same terms as contained in the original settlement;
- The new trustee was a company controlled by Y family members;
- The trust deed made provision for the appointment of a different appointor in respect of the assets transferred to the new trustee. A member of the Y family became the appointor in respect of the assets transferred to the new trustee;
- The original trustee released the new trustee from any rights the original trustee might have to be indemnified out of the assets transferred to the new trustee;
- The new trustee released the original trustee from any rights the new trustee might have to be indemnified out of the assets that continued to be held by the original trustee;

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[74] section 202BA 1936 Act.
[75] paragraph 184-1(1)(g) GST Act.
[76] subsection 184-1(2) GST Act.
[77] section23-5 GST Act.

- The fiduciary obligations of each trustee to the beneficiaries was limited to the assets they held;
- The trustees were obliged to keep separate accounts;
- The new trustee caused the name of that part of the Trust to be changed;
- The appointment of the new trustee was part of a broader family restructure designed to split certain assets between the X and Y families. There was a family agreement which required the X family members to hold any assets held by the new trustee appointed to X family members on bare trust for the Y family members.

The Commissioner concluded that there was a new trust in respect of the assets transferred to the new trustee with the result that CGT event E1 would apply.

The Commissioner reached the conclusion as he considered that there has been a substantial alteration of the trust relationship in respect of the transferred assets since:

- The trustees' rights are altered in that the original trustee has no recourse to the assets held by the new trustee; and
- The beneficiaries' rights are altered in that the assets transferred to the new trustee are to be held exclusively for the Y family members, particular reference being made to the family agreement arrangements.

It should be noted that ATO ID 2009/86 only picks up the limitation on recourse by the old trustee to the assets transferred to the new trustee. This is because it is concluded that the action of the old trustee in transferring the assets is the event which triggers the creation of a new trust ie. the resettlement. The limitation on recourse by the new trustee to assets held by the old trustee is not considered. This may be because the Commissioner thought it was enough to take into account only the limitation imposed on the new trustee. It might also be the case that by dint of the *Trustee Act* 1925 (NSW) the new trustee has no right to recourse for new liabilities it incurs exclusively in respect of its trust obligations.

Subsection 59(2) of the *Trustee Act* 1925 (NSW) provides:

> *A trustee shall be answerable and accountable only for the trustee's own acts, receipts, neglects or defaults, and not for those of any other trustee, nor for any banker, broker, or other person with whom any trust moneys or securities may be deposited, nor for the insufficiency or deficiency of any securities, nor for any other loss, unless the same happens through the trustees own wilful neglect or default.*

The private ruling does not differ from ATO ID 2009/86 in its coverage of this issue.

There is, however, some reasons given in the private ruling to try to back up the conclusion that limiting the old trustee's right to be indemnified out of the assets held by the new trustee is a resettlement. The relevant extract from the private ruling is set out in full here (with deletions to preserve anonymity):

> *More particularly, factors which point to the assets being held pursuant to a different trust relationship following their transfer (and which factors are inconsistent with the continuity of the original trust relationship in respect of these assets) include the following:*
>
> - *The original trustee of the CT Family Trust (Carpet) will release the new trustee (Middle Co) from any rights Carpet may have to be indemnified out of the assets transferred to Middle Co.*
>   - *Having regard to the relevant Trustee Act, it is arguable that the only way in which Carpet can effectively release its right of indemnity is by creation of a new trust. That is, it is arguable that the trustee's statutory right of indemnity cannot be excluded by either the trust deed or by agreement[78]. It would follow that an*

[78] *Kemton Industries Pty Ltd v Commissioner of Stamp Duties (QLD)* [1984] 1 QDR 576.

effective release by Carpet in respect of particular trust assets necessarily involves the creation of a new trust in respect of those assets that is free of any obligation to indemnify Carpet.

- *Alternatively, the release effectively isolates the assets transferred to Middle Co from Claims by Carpet. Before the restructure, Carpet has a right to be indemnified out of the assets transferred to Middle Co for expenses properly incurred by it in administration of the trust – such right amounting to a proprietary interest in those assets in nature of an equitable lien over them79. But following the restructure Carpet will have no such rights as it will, by release, have surrendered its beneficial interest in the assets transferred to Middle Co. this represents a change in the rights and obligations attaching to the assets transferred to Middle Co.*

In short the first reason is that the release of the right to be indemnified cannot be effective at general law and therefore it can only be effective if there is a new trust created. In some States the trustee can give up its right to be indemnified (eg. Victoria). In others it cannot (eg. Queensland). The *Kemton Industries* decision is the authority for that position in Queensland. The authority for the contrary position in Victoria is *RWG Management Ltd v. Commissioner for Corporate Affairs* [1985] VR 385 at 394-5 and see also *Tindon Pty Ltd v. Adams and Window Concepts Pty Ltd* [2006] VSC 172. The position in New South Wales is not clear. The only authority is *JA Pty Ltd v. Jonco Holding Pty Ltd* [2000] 33 ACSR 691 per Santow J[80] which supports a conclusion that the right to be excluded but it is obiter.[81] The conclusion drawn by the author of the private ruling in this regard is simply wrong. The reverse reasoning that the indemnity can only be ousted by a declaration of a new trust is invalid. Either the indemnity can or cannot be released at general law.

The second bit of reasoning is based on an assumption that the release of the indemnity in respect of the assets transferred to the new trustee is effective. It follows that the rights of the trustee are sufficiently altered so that there is a new trust relationship. This reasoning is equally spurious. It would mean that every time an asset is disposed of or acquired by a trustee the trustee's rights to be indemnified changes and there is a new trust. The High Court's decision *in Truesdale v FC of T* (1970) 120 CLR 353 established that adding assets by way of gift or settlement to an existing trust did not in the usual case give rise to a new trust (but see *F C of T v Commercial Nominees of Australia Ltd* 99 ATC 5115 at 5122). Reducing the extent of the equitable lien cannot give rise to a new trust.

In an Addendum to his paper "The Trust has served its purpose – Now What?" delivered at the 2009 Tax Intensive Grahame Young made these observations:

> *The first [reason] was the waiver of rights of indemnity by the original trustee in respect of the transferred assets. It was said that constituted a substantial alteration of the trust relationship because of the alteration of the trustee's rights. But the trustee's rights are personal for their own benefit and are not held on trust. And as demonstrated in CPT Custodian the quantum of those rights is constantly fluctuating. Further if the judgement of McPherson J in Kemtron Industries referred to at 5.6 of this paper is correct then the rights may attach to some only of the assets. It cannot be the case every time the trustee accrues or discharges liabilities in acting as trustee. The quantum and identity of the trust estate may vary but the trust relationship is unchanged. The first reason does not stand scrutiny.*

For the above reasons, the writer does not consider that ATO ID 2009/86 is soundly based.

3.6 Trust cloning exposure draft legislation

On 2 September 2009 the Treasury released the Exposure Draft for the *Tax Laws Amendment (2009 Measures No. 6) Bill 2009* (Cth) ('**the Exposure Draft**') to give effect to the abolition of the trust cloning exceptions in CGT events E1 and E2 in the 1997 Act. The exposure draft also contains the new fixed trust rollover rules. The changes contained in the Exposure Draft will apply to CGT events happening after 31 October 2008.

[79] *Commissioner of Stamp Duties for New South Wales v Buckle* (1998) 192 CLR 226.
[80] at paragraphs 50 and 67.
[81] as the learned texts observe – see Jacobs' Law of Trusts in Australia (7th Ed) at p2106.

The new fixed trust rollover may apply if assets are transferred from the trustee of a trust (the ***transferring trust***) to another trust (the ***receiving trust***) where certain conditions are satisfied and both the trustees of the transferring trust and the receiving trust chose to obtain the rollover relief. Paragraph 1.10 of the explanatory memorandum accompanying the Exposure Draft states that:

> *'Broadly, the effect of the roll-over is to defer the making of any capital gain or capital loss in respect of the asset transfer. The cost base of beneficiaries' interests in the transferring trust is apportioned across their interests in both trusts.'*

Eligibility for the rollover relief depends on the following:

- Both trusts are eligible trusts for the rollover;
- The same beneficiaries have the same interests in both trusts; and
- No exception applies.

3.6.1 Eligible trusts for the rollover

For both the transferring trust and the receiving trust to be eligible trusts, beneficiaries' interests in each trust must satisfy a number of requirements. The requirements are:

- each beneficiary's membership interests in each of the trusts must be interests in, or rights relating to, the income and/or capital of the trust; and
- the nature and extent of each beneficiary's membership interests in each of the trusts must be capable of being worked out solely from t he constituent document of the trust (ie, the trust deed); and
- There must be no power for any entity (that is, including but not limited to the trustee) to:
    - material alter a beneficiary's membership interest in the trust;
    - issue or redeem membership interests in the trust at a discount of more than 10% of their market value; and
- CGT event E4 is capable of happening to all of the units and interests in each of the trusts at the transfer time; and
- The receiving trust must be a 'cleanskin' trust, being either:
    - A newly created trust; or
    - A trust with no CGT assets other than a small amount of cash or debt; and
- Both the trustees of the transferring and the receiving trust choose to obtain the rollover.

3.6.2 Same beneficiaries with the same interests

For the transferring trust and the receiving trust to have the same beneficiaries with the same interests, just after the transfer time the trusts must:

- have the same beneficiaries; and
- the receiving trust must have the same classes of membership interests that the transferring trust had just before, and has just after, the transfer time; and

- the sum of the market value of each beneficiary's membership interests of a particular class in both trusts must be the same as the sum of the market value just before the transfer time of the beneficiary's membership interests of that class in the transferring trust (disregarding any small amounts of cash or debt held by the receiving trust just before the transfer time in the calculation).

3.6.3 Exceptions

The rollover relief is not available if any of the following exceptions applies:

- The receiving trust is a foreign trust and the rollover asset is not taxable Australian property just after the transfer time; or

- Either the transferring trust or the receiving trust is a trust to which section 102K or 102S of the 1936 Act applies for the current year (that is, either trust is a corporate unit trust or a public trading trust); or

- Both trusts must have the same tax choices or election in force if the absence of the mirror choice would or could have an ongoing impact on the calculation of an entity's net income or taxable income for the current year or a later income year. The choice must be in force just after the transfer time unless the trustee makes the mirror choice before the first time the choice matters for tax purposes, or it would not be reasonable to require the mirror choice to be made.

4 NON-RESIDENT TRUST ESTATES

4.1.1 CGT implications of non-resident trusts becoming an Australian resident

Subdivision 855-B of the 1997 Act deals with the implications of a foreign resident becoming an Australian resident for Australian tax purposes. Broadly speaking, where the provisions apply, the first element of cost base and reduced cost base for each CGT asset that a taxpayer owns just before it becomes an Australian resident is the CGT asset's market value at that time. Further, the CGT rules apply to the CGT asset as if the taxpayer acquired the CGT asset at the time that the taxpayer became an Australian resident.

However, Subdivision 855-B of the 1997 Act does not apply to the extent that the CGT asset is 'taxable Australian property' – see subsection 885-45(1) of the 1997 for companies and individuals, and subsection 855-50(1) of the 1997 Act for trusts that are not 'resident trusts for CGT purposes'.[82]

The term 'taxable Australian property' is defined in section 855-15 of the 1997 Act. Relevantly, it includes 'taxable Australian real property' and 'indirect Australian real property interests'.

'Taxable Australian real property' is defined in paragraph 855-20(a) of the 1997 Act as including '*...real property situated in Australia..*.'.

'Indirect Australian real property interests' is defined in section 855-245 of the 1997 Act as (broadly) an asset that satisfies both the 'non-portfolio interest test' (see section 960-195 of the 1997 Act) and the 'principal asset test' (see section 855-30 of the 1997 Act). In essence, the 'indirect Australian real property interest' test is satisfied if a non-resident of Australia holds interests in interposed resident and foreign entities where they own 10% or more of that entity (the non-portfolio interest test) and more than 50% of the market value of the interposed entity is either directly or indirectly attributable to 'taxable Australian real property' (the principal asset test).

[82] The term 'resident trust for CGT purposes' is defined in section n995-1 of the 1997 Act as including '...for an income year if, at any time during the income year ... for a trust that is not a unit trust, a trustee is an Australian resident or the central management control of the trust is in Australia...'.

5 APPLICATION OF SECTIONS 99B, 96B AND 96C OF THE 1936 ACT

5.1 Section 99B

Section 99B of the 1936 Act is a catch all in that it operates to include all amounts paid to resident beneficiaries and then deducts amounts which are specified in the legislation.

Subsection 99B(1) provides that an amount which is property of the trust paid to or, applied for the benefit of a resident beneficiary is to be included in the beneficiary's assessable income unless it is covered by one of the exceptions described in subsection 99B(2). They are not really exceptions but rather, deductions from the subsection 99B(1) amount. Section 99C establishes circumstances in which an amount is deemed to be applied for the benefit of a beneficiary. These circumstances are very wide indeed but do not require consideration here.

The exceptions in subsection 99B(2) are critical. They are:

- amounts paid out of the corpus of the trust (except where the amount is attributable to an amount which would have been included in the assessable income of a resident taxpayer);
- an amount which if derived by a resident, would not have been included in the assessable income;
- conduit foreign income which is non-assessable, non-exempt income of the beneficiary because of Section 802-17 of the 1997 Act;
- an amount which has been included in the assessable income of the beneficiary under section 97 of the 1936 Act;
- an amount in respect of which the trustee has been assessed and is liable to pay tax under Section 98, 99 or 99A;
- an amount reasonably attributable to a part of the net income of another trust where the trustee of that other trust has been assessed and is liable to pay tax under subsection 98(4);
- an amount that has been included in the assessable income of any person, other than a company, under Section 102AAZD of the 1936 Act (in the transferor trust provisions);
- an amount included in the assessable income of a corporate beneficiary under Section 102 AAZD.

Where a trustee of a discretionary trust creates a right to income in the beneficiary and transfers property of the trust in satisfaction of that claim section 99B requires consideration. The amount transferred will be included in the assessable income of the beneficiary under section 99B. There will be a counter-vailing deduction to the extent that the amount has been included in the assessable income. The end result is zero.

Where an amount of capital is distributed (as in the example above the capital gain not covered by the discount) it will be from corpus and a deduction allowed.

If a Trust Deed adopts subsection 95(1) principles or allows the trustee to do so in its discretion, amounts which might be capital on an ordinary income basis will be income for the purposes of the Deed.

It is best to proceed by way of illustration. Say the Trustee of a discretionary trust has the settled sum of $10 and a real property which cost $100,000 five years ago and is now worth $200,000. One of the beneficiaries loaned the trustee $100,000 interest free to fund the purchase of the property.

The Balance Sheet on a market value basis is:

Assets $		Liabilities $	
Property	200,000	Beneficiary's loan	100,000
Cash	10	Settled sum	10
	200,010	Asset revaluation reserve	100,000
			200,010

The Trustee sells the property to a third party, repays the beneficiary and in exercise of its powers under the Deed pays $100,000 of the proceeds to the beneficiary (after having repaid the loan). The Trust's income is $50,000. The tax law net income of the Trust is also $50,000 after the 50% CGT Discount. The beneficiary includes $50,000 in his or her assessable income as statutory income under section 102-5 of the 1997 Act. The balance of the capital gain is corpus and excluded by the first exception in subsection 99B(2). The income amount is excluded because it has been included in the assessable income of the beneficiary under section 97. There is no section 99B amount.

What if the Trustee manipulates the result very artificially? In this further illustration the Trustee derives net rental income of $100,000 and dividend income of $100 (being fully franked – not that it matters). The Trustee has a broad discretion to determine what is an income receipt and what is a capital receipt. That discretion is exercised and the Trustee determines that rental income is capital. The income of the Trust is therefore $100. This is appointed and paid to a tax exempt charity. The Trustee exercises its discretion to advance capital of the Trust and pays the net capital receipts (being the rents) to the spouse of the controller of the Trust.

The tax exempt beneficiary is entitled to $100 of income but the share of the tax law net income determined under subsection 95(1) is $100,100. The question is whether subsection 99B(1) applies to the $100,000 paid to the individual beneficiary. It is corpus of the Trust by definition and therefore prima facie is deducted from the amount included under subsection 99B(1). The ultimate question is whether, had the rent been derived "by a taxpayer being a resident', would it have been included in the assessable income of that taxpayer? It might be inferred from the exception set out in paragraph 99B(2)(a) that the operation of the exception is limited in its operation to a non-resident trust estate[83] and foreign sourced income. However, there is nothing in Section 99B which explicitly limits its operations to non-resident trusts.

Paragraph 99B(2)(a) would appear to set up a hypothetical taxpayer (other than the trustee) and require the question to be posed - would the amounts derived by the Trustee have been included in the assessable income of the hypothetical resident taxpayer. If this postulation is correct, the answer is yes because rent is ordinary income. If this follows subsection 99B(1) would operate to include the net rental income in the assessable income of the 'capital' beneficiary. A conclusion the Commissioner would no doubt applaud (and justifiably so). If it does not follow, then the amount received by the beneficiary is part of the corpus and is to be deducted from the subsection 99B(1) amount.

What about the ordinary sort of case where expenses which are expensed for trust accounting purposes are not deductible for subsection 95(1) purposes? Numerically the tax law net income will exceed the trust accounting income. There is no subsection 99B(1) issue here because there will be a subsection

[83] Support for this view can be garnered from the decision of Hill J in Traknew Holdings Pty Ltd v F C of T 91 ATC 4272 at 4284.

99B(2) deduction to the extent that the amount distributed is included in the assessable income of the beneficiary. If subsection 95(1) terms are adopted the two will be arithmetically the same.

When the trust accounting income exceeds the subsection 95(1) amount; what then? To the extent that the distribution to the beneficiary equals the amount included in the assessable income of the beneficiary there will be a subsection 99B(2) deduction. The excess will not be included in the corpus of the Trust as it is income of the Trust. Consequently, it appears that the excess is caught by subsection 99B(1). That is not an outcome which would be expected.

The matter is resolved if the Trust Deed allows the Trustee to adopt subsection 95(1) principles. The two would then be arithmetically the same. The excess would be corpus and a deduction would be available under subsection 99B(2). The hypothetical taxpayer test discussed above would not throw up the exclusion as the net amount derived by the hypothetical trustee would be the tax law result[84]. The outcome is a sensible one.

5.2 Sections 96B and 96C

Sections 96B and 96C of the 1936 Act deals with beneficiaries of non-resident trust estates. Section 96B applies to an Australian resident who has an interest (including an interest that is to arise at a future time or is contingent on the happening of an event) in a non-resident trust and deems the individual to be presently entitled to a share of the income of the trust estate (equal to the amount calculated under section 96C of the 1936 Act) and to not be under a legal disability.

Considerations must also be given to any non-Australian source income that may be attributable to the Australian resident beneficiaries, such as the Controlled Foreign Company income under Part X of the 1936 Act and the Foreign Investment Fund income under Part XI of the 1936 Act.

6 PRESENT ENTITLEMENTS AND ESTATE CONSIDERATIONS

Under the 1936 Act, Australian resident beneficiaries are assessed on any income that they are presently entitled to or deemed to be presently entitled to in the trust.

The term ‘present entitlement’ is foreign to trust law. It is a conglomeration of concepts contained in both the law of estates and the law of trusts.[85] The authorities indicate that a beneficiary is ‘presently entitled’ to the income of a trust if:

> ***in accordance with the laws of estates*** - *the beneficiary’s interest is both:*
>
> > *(a) vested in interest; and*
> >
> > *(b) vested in possession; and*
>
> ***in accordance with the laws of trusts*** *– the beneficiary has a present right to demand payment of the income of the trust.*

Everett[86] relevantly observed that:

> *Ever since the 1930’s, when income tax was referred to the Commonwealth by the States, the determination of a beneficiary’s tax liability under a trust has been problematic. There have been continuing difficulties over the years in determining the nature of a beneficiary’s interest under a trust. The difficulties in determining one’s tax liability as a beneficiary under a trust will continue, unless there is change in the legislation that deals with this issue.*

Subsection 97(1)(a) of the 1936 Act provides that:

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[84] It is acknowledged in this regard that the concept used in the exception to paragraph 99B(2)(a) is a gross concept but so too is it in subsection 97(1) and while that troubles commentators from time to time it seems not to have overly troubled the Courts.
[85] see *FC of T v Whiting* (1943) 68 CLR 199.
[86] Everett, Anna. ‘An analysis of the concepts of ‘present entitlement’ (2003) Revenue LJ 147 at 148.

Subject to Division 6D, where a beneficiary of a trust estate who is not under any legal disability is presently entitled to a share of the income of the trust estate –

(a) the assessable income of the beneficiary shall include –

(i) so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was not a resident and is also attributable to sources in Australia …

Also, subsection 157(3) of the 1936 Act provides that:

Subject to subjection 3(A), for the purposes only of determining whether a person is carrying on a business of primary production, a beneficiary in a trust estate shall, to the extent to which he is presently entitled to the income or part of the income of that estate, be deemed to be carrying on the business carried on by the trustee of the estate which produces that income.

The Commissioner at paragraph 30 of Taxation Ruling TR 95/29 entitled *Division 16 – applicability of averaging provisions to beneficiaries of trust estates carrying on a business of primary production* concluded that:

'… a beneficiary will be presently entitled to the income of a trust estate if:

- *the beneficiary has an indefeasible, absolutely vested, beneficial interest in possession in trust law income; and*
- *the beneficiary has a present legal right to demand and receive payment of the trust law income (or would but for a legal disability), whether or not the precise entitlement can be ascertained before the end of the year of income and whether or not the trustee has the funds available for immediate payment'.*

It should be noted that cases dealing with section 97 of the 1936 Act deal with the concept of whether a beneficiary is 'present entitlement to a share of net income of a trust estate', with the term 'net income' defined under section 95 of the 1936 Act. Kitto J in *Union Fidelity Trustee Co of Australia & Anor v FC of T* 69 ATC 4084 discussed when there would be a present entitlement to the income of a trust estate as follows:

At no time during the year was any beneficiary presently entitled to any part of the income of the estate (though a very small part of the income was in fact distributed to the beneficiaries). This is so because 'presently entitled to any part of the income of a trust estate' ***refers not to the availability of any income for payment to him but to a present title in possession in respect of any income the estate may produce*** *… [emphasis added]*

Bowen CJ, Deane and Fitzgerald JJ in *FC of T v Totledge Pty Ltd* 82 ATC 4168 at 4173 – 4174 observed that:

A beneficiary under a trust who is entitled to income will ordinarily only be entitled to receive actual payment of the appropriate share of surplus or distributable income: the trustee will be entitled and obliged to meet revenue outgoings from income before distributing to a life tenant or other beneficiary entitled to income. Indeed, circumstances may well exist in which a trustee is entitled and obliged to devote the whole of gross income in paying revenue expenses with the consequence that the beneficiary entitled to income may have no entitlement to receive any payment at all. This does not, however, mean that a life tenant or other beneficiary entitled to income in a trust estate has no beneficial interest in the gross income as it is derived. He is entitled to receive an account of it from the trustee and to be paid his share of what remains of it after payment of, or provision for, the trustee's proper costs, expenses and outgoings …

The Commissioner in TR 95/29 considered that:

… it is quite consistent with the authorities that, provided there is some gross trust law income, a beneficiary may be presently entitled to income of a trust estate even if the trust:

- *has incurred a loss for the year for trust law purposes; or*
- *has incurred a loss for the year for tax law purposes; or*
- *has no net income for tax law purposes.*

6.1 Additional requirement for 'present entitlement' needed for funds that are merely 'vested and indefeasible'

In order for a beneficiary to be 'presently entitled', the beneficiary needs more than a vested and indefeasible interest. For example, subsection 95A(2) of the 1936 Act provides that:

> *For the purposes of …[the 1936 Act] … where a beneficiary has a* ***vested and indefeasible interest in any of the income of a trust estate but is not presently entitled to that income****, the beneficiary shall be deemed to be presently entitled to that income of the trust estate. [Emphasis added]*

The High Court in *Harmer v FC of T* 91 ATC 5000 at 5004 considered that a beneficiary is presently entitled to a share in trust income where:

> *(a) the beneficiary has an interest in the income which is both vested in interest and vested in possession; and (b) the beneficiary has a present legal right to demand and receive payment of the income, whether or not the precise entitlement can be ascertained before the end of the relevant year of income and whether or not the trustee has the funds available for immediate payment.*

6.1.1 When will a beneficiary have a 'vested and indefeasible interest'?

Arguably, in order for a unit holder to have a 'fixed interest' for the purposes of obtaining the 'family unit trust concession, or the restructure concessions, the beneficiary needs a 'vested and indefeasible interest' in the capital and / or the income of the trust estate.

Hill J in *Dwight v FC of T* (1992) 37 FCR 178:

> *The words 'vested' and 'indefeasible' in the context of trust law are technical legal words of limitation, which have a well understood meaning to property conveyancers.*

With respect to whether an interest is 'vested', it was held that:

> *Estates may be vested in interest or vested in possession, the difference being between a present fixed right of future enjoyment where the estate is said to be vested in interest and a present right of present enjoyment of the right, where the estate is said to be vested in possession … A person with an interest in remainder, subject to a pre-existing life interest, has an interest which is vested in interest, but being a future interest is not yet vested in possession. That person's interest will vest in possession on the death of the life interest.*

With respect to whether an interest is 'indefeasible', it was held that:

> *An interest is said to be defeasible where it can be brought to an end and indefeasible where it cannot. Thus, a beneficiary with an interest which is not contingent but which interest may be brought to an end by the exercise of a power of appointment, would be said to have a vested but defeasible interest.*

Paragraphs 13.3 to 13.9 of the Explanatory Memorandum to the *Taxation Laws Amendment (Trust Loss and Other Deductions) Bill 1997* (Cth) provides the Commissioner's interpretation of the meaning of the terms 'vested' and 'indefeasible':

> *What is a fixed entitlement to income or capital of a trust?*
>
> *13.3 A person (the beneficiary) will have a fixed entitlement to either income or capital of a trust (whichever is applicable) where the beneficiary has a vested and indefeasible interest in a share of the income of the trust that the trust derives from*

time to time (i.e. current and future income), or a share of capital of the trust [subsection 272-5(1)] . The share that the person has an interest in is expressed as a percentage of the total income or capital (whichever is applicable) of the trust.

What is a vested interest?

13.4 A person has a vested interest in something if the person has a present right relating to the thing. Stated simply, a vested interest is one that is bound to take effect in possession at some point in time. A vested interest is to be contrasted with a 'contingent' interest which may never fall into possession. If an interest of a beneficiary in income or capital is the subject of a condition precedent, so that an event must occur before the interest becomes vested, the beneficiary does not have a vested interest to the income or capital since such an interest is instead 'contingent' upon the event occurring.

13.5 In traditional legal analysis, a person can be said to be either 'vested in possession' or 'vested in interest'. A present interest, i.e. one that is being enjoyed, is said to be 'vested in possession'; a future interest, i.e. one which gives its holder a present right to future enjoyment, is said to be 'vested in interest'. A person is vested in possession where the person has a right to immediate possession or enjoyment of the thing in question. In the definition of fixed entitlement, 'vested' includes both vested in possession and vested in interest.

13.6 Because vested interests include future interests, a person can have a vested interest in a thing even though the person's actual possession and enjoyment of the thing is delayed until some time in the future.

When is a vested interest indefeasible?

13.7 A vested interest is indefeasible where, in effect, it is not able to be lost. A vested interest is defeasible where it is subject to a condition subsequent that may lead to the entitlement being divested. A condition subsequent is an event that could occur after the interest is vested that would result in the entitlement being defeated, for example, on the occurrence of an event or the exercise of a power. For example, where a beneficiary's vested interest is able to be taken away by the exercise of a power by the trustee or any other person, the interest will not be a fixed entitlement.

13.8 Where the trustee exercises a power to accumulate income or capital of the trust in accordance with the trust deed, the accumulation does not result in a beneficiary's interest being taken away or defeased as long as the beneficiary nevertheless remains entitled at some future time to enjoy his or her share of the income or capital which has been accumulated.

Example

13.9 A unit trust has 100 units. All of the units carry equal rights to income and capital of the trust. The trustee has no discretion to allocate income or capital of the trust to unit holders other than in accordance with the share of income and capital represented by their units. The trustee has the power to accumulate income of the trust if the majority of the unit holders agree to such accumulation. However, each unit holder retains their interest in the share of accumulated income represented by their units. All of the income and capital of the unit trust is subject to fixed entitlements. The mere fact that the income of the trust is accumulated in the trust in accordance with the terms of the trust deed does not prevent the beneficiaries of the trust from being treated as having a vested and indefeasible interest in the income or capital of the trust.

The mere fact that units can be issued or redeemed at market value does not mean an interest is defeasible.

6.1.2 Present entitlement requires an ‘additional element’ over and above ‘vested and indefeasible’

Where a beneficiary has a vested and indefeasible interest in a trust, an ‘additional element’ is required to convert that interest into a ‘present entitlement’.[87]

Kitto J in *Taylor v FC of T* 70 ATC 4026 considered the ‘additional element’ as ‘*… an interest in possession in an amount of income that is legally ready for distribution so that the beneficiary would have*

[87] See paragraph 26-135, Marks, B. ‘Trusts & Estates: Taxation & Practice’. *Law Institute of Victoria Practitioner Text*.

a right to obtain payment of it …'. Further, it was observed at 4176 that present entitlement to trust income is to:

> *'… income that was available for distribution regardless of whether the accounts necessary to enable its precise ascertainment had been completed at the end of the income year or whether it was actually held in a form ready for immediate payment …'.*

In *FC of T v Whiting & Ors* (1942 – 1943) 68 CLR 199 at 215, the High Court observed that:

> *… when the Act speaks of a beneficiary being presently entitled to a share in income, **it refers to the right of a beneficiary to obtain immediate payment**, rather than to the fact that a beneficiary has a vested interest … [emphasis added]*

It was held in *Taylor & Anor v FC of T* 70 ATC 4,026 at 4,030 that:

> *… 'presently entitled' refers to an interest in possession in an amount of income that is **legally ready for distribution** so that the beneficiary would have a right to obtain payment of it if he were not under a disability. [emphasis added]*

Similarly, in *Totledge Pty Ltd v FC of T* 82 ATC 4168 the Court considered that income to which beneficiaries are 'presently entitled' is '*… income that was available for distribution*'.

In *Pearson v Commissioner of Taxation* [2006] FCAFC 111, it was observed by the Full Federal Court that:

> *A beneficiary is 'presently entitled' to a share of the income of the trust estate if, but only if: (a) the beneficiary has an interest in the income which is both vested in interest and vested in possession; and (b) the beneficiary has a present legal right to demand and receive payment of the income, whether or not the precise entitlement can be ascertained before the end of the relevant year of income and whether or not the trustee has the funds available for immediate payment …*

That is, whilst a unit holder in a unit trust will typically have a proportionate vested and indefeasible interest in a trust's income / capital, to the extent that a trustee has the power to accumulate (income for example), then there will be no 'present entitlement' of that income – even though the unit holder may have a proportionate interest in that income (which may become corpus). In Trustees of the *Estate Mortgage Fighting Trust v FC of T* 2000 ATC 4,525 at 4,538, Hill J observed that:

> *No doubt where there is a trust to accumulate income during the year of income it will ordinary be true that where there could be no present entitlement, and thus an assessment for tax of the trustee under s 95A(4) is required. One exception which was relied upon by the trustee would be where, notwithstanding a trust to accumulate income, the trustees are empowered to apply income to or for the benefit of the beneficiaries and do so. In such a case the beneficiaries would be presently entitled to that income whether because of operation of s 101 or 95A(1) …*

However, the beneficiary will be 'presently entitled' if the entitlement is not directly paid to the beneficiary, but applied for the beneficiary's benefit. It was considered in *Sacks & Ors v Gridiger & Ors* 90 ATC 4,299 at 4,305 that:

> *It would be wrong to treat these formulations as excluding from the operation of the expression 'presently entitled' a case where the relevant entitlement under the trust was to have a payment made not directly to the beneficiary but otherwise for his benefit. The provision of sec. 101 corroborate the view that it is immaterial for the purposes of considering whether a beneficiary is 'presently entitled' to a share of income, to distinguish between the beneficiary's right to have a payment made to himself on the one hand and his right to have a payment made for his benefit, on the other.*

As a result, even if a beneficiary has a 'vested' and 'indefeasible' interest, without a deeming provision such as section 95A of the 1936 Act, the beneficiary will not be 'presently entitled'.

Interestingly, the Full Federal Court in *Pearson v Commissioner of Taxation* [2006] FCAFC 111 observed that:

> *Nothing was said in CPT Custodians to cast doubt on the principle … [regarding 'present entitlement'] …. That is not surprising because CPT Custodians was not concerned with the question of whether the beneficiary unitholder was 'presently entitled' to income of a trust estate for the purpose of Div 6 of Pt III of the ITAA.*

6.1.3 Present entitlement - knowledge of the beneficiary is irrelevant[88]

Knowledge on the beneficiary's behalf is irrelevant in determining whether a beneficiary is presently entitled.

The Full Federal Court in *Vengers v FC of T* 91 ATC 4213 held that '*… an entitlement under a trust is valid notwithstanding that the beneficiary has had no knowledge of it …*'. Further, in *Ramsden v FC of T* 2004 ATC 4659, it was held that:

> *'… a beneficiary has an entitlement to income under a trust for the purposes of s 97 of the Assessment Act from the moment it arises, notwithstanding that the beneficiary has no knowledge of it and might be able later to disclaim the entitlement'.*

6.1.4 Reinvestment plans – whether the unit holders may be 'presently entitled'?

A trust deed may provide that trust distributions of net income of the estate are to be automatically re-invested into additional units for the unit holders. In these cases, it is considered that the unit holders are 'presently entitled' to the income of the trust estate as the income (via the re-investment) is applied or dealt with at the unit holders direction.

In answering the question of whether a '*… taxpayer derived assessable income … in respect of a unit trust distribution that was automatically reinvested on the taxpayer's instructions into additional units in the unit trust …*' the Commissioner in ATO Interpretative Decision ATO ID 2001/647 entitled *Reinvestment of Unit Trust Distributions* considered that '*… the taxpayer …* [had] *… derived assessable income' as the '… income was applied or dealt with as the taxpayer directed.*'

Similarly, in *Edited Version of Notice of Private Ruling – Authorisation Number: 6269*, the Commissioner when considering whether '*… trust distributions you received from an Income and Growth Fund assessable income at the time they are reinvested back into the fund…*' made the following observation with respect to 'present entitlement':

> *A beneficiary will be presently entitled to the assets which are held in trust for them if they could take legal action to recover their share of income from the trust at any time. There are a couple of extensions to this rule, such as if the beneficiary is under a legal disability, or they have a vested interest in the trust, they are still deemed to be presently entitled to the asset. These extensions or conditions will be stipulate din the trust deed. In basic terms though, if the beneficiary is able to demand their share of the asset from the trustee, they will be presently entitled to the asset.*

The Commissioner concluded that:

> *Therefore, you are required to declare the net distribution you received from the Income and Growth Fund, despite the fact that you have not actually received the cash payment. This is because you are presently entitled to this income, which is specifically included as part of your assessable income by subsection 97(1) of the ITAA 1936. In essence, you have received the distribution, you have chosen to put that money back into the fund to purchase more units. This decision to reinvest the distribution in the form of more units rather than taking a cash payment does not alter the fact that you were still entitled to the income this financial year.*

6.1.5 Default distribution clause – may create a 'present entitlement'

Default distribution clauses may cause a beneficiary to be 'presently entitled' (*Ramsden v FC of T* 2005 ATC 4,136).

[88] See also paragraph 26-140 of Marks, B. 'Trusts & Estates: Taxation & Practice'. *Law Institute of Victoria Practitioner Text*.

6.1.6 Power to terminate trust does not amount to a 'present entitlement'

Although not free from doubt, it seems that the power of beneficiaries to cause the termination of a trust does not give rise to a 'present entitlement' (*Walsh Bay Developments Pty Ltd v FC of T* 95 ATC 4,378).

6.1.7 Beneficiary loan accounts and 'present entitlement'

In the recent NSW Supreme Court decision in *Wood v Inglis* [2009] NSWSC 601, Brereton J considered issues relating to a deceased beneficiary's present entitlements accruing in his loan account. In that case, Dr William Inglis, his wife and children were beneficiaries of a discretionary trust. Before he died, Dr Inglis, along with his wife and one of his children, were the directors of the corporate trustee of his discretionary trust. The trust funds were invested in shares and income was distributed to Dr Inglis and his families by crediting their beneficiary loan accounts, on which they drew for expenditure. The trust accounts were prepared whereby movements in the net value of the investments of the trust were treated on income account and distributed to the beneficiaries.

The issue in *Inglis's case* concerns whether the trustee may lawfully treat and have in fact treated the movement in the investment as income. If that was the case, the question then becomes whether the trustee has in fact made the disputed distributions to Dr Inglis and if so whether the trustee has discharged the obligation arising from the distributions made. The case arose because Dr Inglis left his residue estate, which includes the debt due to him from the Trust on his beneficiary loan account, solely to his wife in his will. Therefore if the distributions have been validly made, then the trust will need to pay the distributions (unless otherwise discharged) to his estate, to which his wife is the only beneficiary. On the other hand, if the distributions were not validly made, then any increase in value in the trust investments would remain in the trust, which Dr Inglis' children may benefit from.

Brereton J first considered the question of whether the trustee could, consistent with the trust deed, lawfully treat movements in the value of investments as income, and distribute it to beneficiaries. After considering the terms of the trust deed, Brereton J held that:

> 14 I do not accept that it cannot be said that a profit has been made (or "incurred", for the purposes of clause 10 of the Trust Deed), just because it has not been realised. Comparison of the value of the assets of an entity at the end of the relevant period with their value at the beginning of that period is one well-recognised means of ascertaining profit [*Re Spanish Prospecting Co Limited* [1911] 1 Ch 92, 98; *QBE Insurance Group v ASIC* (1992) 38 FCR 270, 284-5 [53] – [57]].
>
> ...
>
> *16 That conclusion is only reinforced by clause 6(f). I do not accept that the reference in clause 6(f) to "property or moneys held by the Trustee", coupled with the definition of "property", means that the reach of the clause does not extend to "unrealised capital gains"; the purpose of the clause is plainly to avoid disputation as to whether receipts, profits and distributions received by the trust are capital or income by empowering the Trustee to make that determination. The effect of treating "unrealised capital gains" as income is that so much of the value of a share (which is expressly within the definition of "property") as reflects that gain is treated as income. As has already been observed, the proviso contained in clause 6(f) demonstrates that the Trustee may chose to treat as capital in the Trust accounts what is income for income tax purposes (although a specific declaration to that effect is required); likewise it may (and without any such specific declaration) chose to treat as income in the Trust accounts what is capital for income tax purposes. In that context, submissions that "unrealised capital gains" are not income in the ordinary sense of the word are beside the point.*
>
> *17 Accordingly, the Trustee was entitled to treat the movements in the net value of investments as income. Accounts prepared on that basis were nonetheless "proper accounts". Moreover, even if the "unrealised capital gains" were not income, they could be distributed as capital under clause 5(a), which gave the Trustee a discretion to apply capital in favour of any eligible beneficiary at any time before the Perpetuity Date.*

Brereton J then went on to held that the trustee did in fact determined to include the unrealised gains as income. His honour found that Dr Inglis was the controlling mind of the corporate trustee, and that he had implied actual authority to make decisions concerning the affairs of the trust. Therefore, the fact that Dr Inglis approved the trust accounts which adopted an accounting methodology which bring to account unrealised capital gains as income was indicative of the trustee determining to include the unrealised gains as income:

> *66 Even though Mr Tierney's initial adoption of the "market value" methodology derived from a misapprehension, nonetheless the Company, as trustee of the Trust, by its agent Dr Inglis who had implied actual authority in respect of all affairs of the Trust, accepted the accounts so prepared by Mr Tierney for the purpose of clause 10 of the Trust Deed, and thereby validly determined to treat the increase in market value of investments as income for each of the financial years 1998/9 to 2005/6.*

Along the same lines, Brereton J also found that Dr Inglis acting on behalf of the corporate trustee has also validly and effectively made the distributions to his beneficiary loan account:

> *67 There was a valid and effective irrevocable and absolute distribution of the whole of the income shown as such in the annual accounts for each year in question to Dr Inglis, to the extent that it was not validly distributed to William or Mrs Inglis, by default under clause 3(d) if not expressly under clause 3(a).*

In relation to whether the obligation of the trustee to pay Dr Inglis' deceased estate the amount outstanding in his beneficiary loan account, Brereton J held that the estate has never released the trustee from the debt on its loan account:

> 44 Unilateral resolutions of the Trustee to change the amounts of liabilities recorded in its accounts cannot affect the rights of its creditors. Obligations owed to Dr Inglis in respect of his beneficiary loan account, could only be reversed with the concurrence of his estate. In that light, the essential question is whether the estate has released the debt owed in on Dr Inglis' loan account as at his death. Although much attention was given in the evidence and submissions to factual controversies surrounding the events which ensued after Dr Inglis' death, and the alleged conduct, motives and purposes of the protagonists, little turns on them.

It is clear from *Inglis' case* that the issue of unpaid present entitlements must be taken into account in succession planning, as it will form part of the assets of the deceased estate and the executor of the estate will be entitled to call in on the trust to pay the unpaid present entitlements.