

LITTLE SHOP OF HORRORS ESTATE PLANNING FOR FAMILY BUSINESS PROPRIETORS

Therese Catanzariti, 13 Wentworth Chambers

One of the key advantages of the company structure is the company's perpetual existence. Effective estate planning ensures that the company's perpetual existence is not compromised by the death of one of the company's key protagonists.

Final Stages of the Testator's Life

Effective estate planning should include the final stages of the testator's life, when the testator may be alive but not functioning effectively.

The testator should execute an enduring power of attorney. However, an enduring power of attorney has limitations.

First, if a person is voting at a meeting pursuant to a power of attorney, the power of attorney must comply with sections 250A and 250B of the Corporations Act which are the requirements for a valid proxy.¹

Second, the principal cannot authorise an attorney to act for the director because the role of a director is a personal role. In *Mancini v Mancini*², Bryson said³

“The office of a director is a personal responsibility, and can only be discharged by the person who holds the office. If there is any exception, it must be found in the constitution of the company and in some authorisation there found to act by an alternate or other substitute or delegate. The office of a director is not a property right capable of being exercised by an attorney or other substitute or delegate of the person holding the office; many rights as shareholder can be distinguished in this respect because they are rights of property.”

The *company* may grant a person a power of attorney, and the attorney can act for the company. However, the individual director cannot.

There is a statutory exception in relation to self-managed superannuation funds. Self-managed superannuation funds require that the trustees, or all of the directors of the corporate trustee are members of the superannuation fund or a relative of the member. This causes a problem if it is a sole member / sole director superannuation fund, and the sole member has a legal disability – the member cannot act as a director or trustee because the member does not have capacity, but the member cannot delegate the member's director's role or trustee's role because it is personal. The *Superannuation Industry Supervision Act* provides that a fund may still be a self-managed superannuation fund if the member has a legal personal representative who acts as trustee or director of the corporate trustee whilst the member is under a legal disability or if the legal personal representative has an enduring power of attorney.⁴ Legal

¹ para 7.560, Ford's Corporations Law, Lexis Nexis 2010; *Cordiant Communications (Aust) Pty Ltd v The Communications Group Holdings Pty Ltd* (2005) 55 ACSR 185; 23 ACLC 1859; 194 FLR 322; [2005] NSWSC 1005

² *Mancini v Mancini* [1999] NSWSC 799

³ *ibid* at [30]

⁴ section 17A(3)(b) Superannuation Industry Supervision Act 1993

personal representative is defined to include a trustee of the estate of a person under a legal disability or a person who holds an enduring power of attorney.⁵

Business Continuity Plans

Estate planning should include whether the business has crisis management plans or more broader business continuity plans to take effect if the testator can no longer function effectively or dies suddenly.

The company should have a choice of interim CEO/chair/director, emergency succession plan and communication plan for the business and its key stakeholders. The board may be required to make decisions at short notice, so there may need to be emergency decision making protocols.⁶

Testator's Assets

Estate law practitioners should have a close working relationship with testator's financial advisers to ensure that the testator's estate planning is aligned with the testator's current financial and corporate circumstances.

The estate practitioner needs to understand the testator's current *financial* circumstances, the testator's current asset portfolio –real estate, share portfolio, managed funds, timeshare, superannuation, life insurance. The practitioner should confer with the testator's financial advisers as well as conduct LPI property searches, and ASIC searches. The practitioner cannot rely on the testator, because the testator may not fully appreciate the full extent of their assets. In *Kerr v Badran*,⁷ Windeyer J said at [49]

“In dealing with the *Banks v Goodfellow* test it is, I think, necessary to bear in mind the differences between life in 1870 and life in 1995. In England in 1870, if you had property it was likely to be land or bonds or shares in railway companies or government backed enterprises. Investment in ordinary companies was far less common than now. Older people living today may well be aware that they own substantial shareholdings or substantial real estate, but yet may not have an accurate understanding of the value of those assets, nor for that matter, the addresses of the real estate or the particular shareholdings which they have. Many people have handed over management of share portfolios and even real estate investments to advisers.:

This ensures that the testator's will is current and the testator does not inadvertently bequeath an asset that has already been disposed of, or inadvertently bequeath a larger gift than what the testator intended (for example, the testator has recently converted the testator's shares into cash and one lucky grandchild previously entitled to a modest amount in a bank account is now entitled to a much larger amount).

The financial adviser may advise that certain assets that are registered in the testator's name are in fact owned by the testator as trustee of a trust, or are owned in the testator's capacity as a partner of a partnership, or are owned jointly with another person who automatically inherits the jointly owned asset on survivorship. Alternatively, the financial adviser may advise that assets that the testator treats as the testator's own are in fact not owned by the testator but owned by a corporate trustee or as part of a partnership.

The financial adviser may not only confirm the elements of the testator's current asset portfolio, but may be able to give some guidance about potential tax consequences relating to particular assets in the asset portfolio such as assets that were purchased before capital gains tax was introduced on 20 September 1985, or conversely assets that are particularly exposed to capital gains tax because of a relatively low cost base.

⁵“legal personal representative” section 10 Superannuation Industry Supervision Act 1993

⁶ “Risk: Issues for Boards” Module 5, AICD Company Directors Course 2016

⁷ *Kerr v Badran* [2004] NSWSC 735

The financial advisor may also clarify the business or strategic importance of each asset— the land that is farmed by the family trading trust, the shop or office that is used by the family business. This may assist the estate practitioner advising the testator how the testator should deal with the estate.

Less obviously, the financial adviser and ASIC searches may reveal the testator’s current *corporate* circumstances. This include the corporate roles that the testator may have – chair, director, CEO or CFO; the powers of appointment that the testator may have; the proxies that the testator holds; and what corporate delegations and powers of attorney are in place.

The estate practitioner can then work with the testator to determine the testator’s preferred succession outcomes, and whether it may be appropriate to progressively transition the roles over the next few years, or change the scope of the delegations or powers.

Executor

The estate practitioner needs to counsel the testator about selecting an appropriate executor. A testator appointing their spouse or all of their children together is touching, but ineffectual if the nominees are not legally or commercially sophisticated or otherwise do not understand the testator’s business; or do not work effectively with the testator’s network of advisers, the business’ management and the business’ key stakeholders; or indeed do not work well with each other!

The testator also needs to be aware of the chain of representation – that the executor of a sole or last surviving executor of a testator is the executor of that testator.⁸ If the testator is likely to be the executor of another estate (for example, their business partner’s estate) then the testator needs to select an executor who is not only sophisticated and diligent enough to understand and administer the *testator’s* estate, but also the estates of persons who may have appointed the testator as executor.

The testator also has to be aware that if they pass away, the executor does not automatically assume the testator’s director position. If the testator is the only director and the only shareholder of a proprietary company, then the executor or administrator may *appoint* a person as the director (including appointing themselves).⁹ However, if the testator is *not* the only shareholder or *not* the only director, then the usual protocols in the company’s constitution or otherwise the Corporations Act apply, that the company must appoint a person as a director by resolution at a general meeting,¹⁰ or the other directors may appoint a person provided it is later confirmed by a meeting of the company.¹¹ This means that the testator may be a significant shareholder in a company (and indeed, may be the majority shareholder) but the testator’s interests in the company are not “protected” and do not have a “voice” by having a director on the company’s board.

The testator’s executor or administrator may be exposed to the extent that they are expressly appointed director. They are also exposed if they become a de facto director, that is, they act in the position of a director,¹² or become a shadow director, that is, they start calling the shots such that the directors of the company act in accordance with their instructions.¹³ They are then liable for directors duties including the duty to prevent insolvent trading by the company.¹⁴ It may be that the executor or administrator appoints themselves as director merely to put the company into administration, or has a voluntary liquidation or applies to the court for a court liquidation.

⁸ Section 13, Imperial Acts Application Act 1969

⁹ Section 201F, Corporations Act

¹⁰ Section 201G, Corporations Act

¹¹ Section 201H, Corporations Act

¹² “director” (b)(i), section 9, Corporations Act; *Grimaldi v Chameleon Mining NL (No 2)* (2012) 200 FCR 296;

¹³ “director” (b)(ii) section 9, Corporations Act; *Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd* (2011) 81 NSWLR 47

¹⁴ Section 588G, Corporations Act

Similarly, the executor does not automatically assume the testator's trustee position. When a trustee dies, a new trustee *may* be appointed but does not need to be appointed.¹⁵ The new trustee is appointed by the person who has the right to appoint trustees in the trust deed. If there is no such person, or such person is unwilling to act, then it is by the surviving trustees. It is only if there is no person appointed in the trust deed *and* there are no surviving trustees that the legal personal representative of the testator is entitled to appoint a new trustee.¹⁶ Again, this means that the testator's interests may have no "voice" in the trust administration.

The legal personal representative may appoint themselves.¹⁷ Again, however, the legal personal representative needs to be conscious of their obligations as trustee including their fiduciary duties to each of the beneficiaries, and objects of a discretionary trust.

Inventory of Probate

The executor and administrator needs to take care how to record the values of assets and liabilities in the inventory of probate. The practitioner should ensure that the values are consistent with any representations made to the Australian Tax Office for example for a small business capital gains tax exemption,¹⁸ or GST registration, or to ASIC for example that it is a small proprietary company.¹⁹ The practitioner should also be aware that the values may ultimately be used for the purpose of determining the cost base of assets that only become liable to capital gains tax after the testator's death.

Division 7A Loans

Division 7A of the Income Tax Assessment Act 1936 ("**1936 Tax Act**") prevents a company distributing its profits to its shareholders or their associates as tax-free payments, loans or forgiven debts

A private company is deemed to have paid a dividend if it pays an entity or lends money to an entity and the entity is a shareholder or an associate of the shareholder of the company²⁰ and consequently the payment is assessable income.²¹ However, loans are not assumed to be dividends if they are loans made in the ordinary course of business on ordinary commercial terms,²² or, relevantly, loans that meet criteria for minimum interest rate and maximum term.²³ When accountants refer to Division 7A loans, they are referring to loans which are designed to satisfy section 109N with prescribed minimum interest rate and maximum term.

The company's accounts department may pay the client's (and indeed sometimes the client's spouse's and client's children's) credit card, school fees, rates notices, electricity bills and plumbers invoices, and record it all against the "director's loan account". The directors of the company declare a dividend each year equal to the minimum interest payments prescribed by *section 109N Corporations Act*. And this continues for some years – the directors loan balance increases, and dividends are declared each year which are never physically received by the testator but are instead used to pay the minimum interest.

The testator may be blithely oblivious to the increasing "directors loan" or "shareholders loan". And then the music stops and there is a large loan account balance. This is not a "paper transaction", but reflects real hard cash outgoings, and needs to be recorded as a liability in the application for probate or application for letters of administration, and needs to be repaid. Non-payment may trigger debt forgiveness tax issues. Non-payment may also threaten the company's solvency and viability as the loan account may be one of the company's largest assets. As a practical matter, the proceeds of sale of the

¹⁵ Section 6(2) Trustee Act 1925

¹⁶ Section 6(4) Trustee Act 1925

¹⁷ Section 6(3) Trustee Act

¹⁸ Division 152, Income Tax Assessment Act 1997

¹⁹ Section 45A Corporations Act 2001

²⁰ section 109C, 109D 1936 Tax Act

²¹ section 44, 1936 Tax Act

²² section 109M, 1936 Tax Act

²³ section 109N, 1936 Tax Act

testator's shares in the company may need to be used to pay off the testator's loan, effectively cancelling out each other.

It may be possible to pay off the loan by the company declaring a large dividend equal to the amount of the outstanding loan. However, there are three challenges. First, the company can only declare a dividend if the assets exceed liabilities, it is fair and reasonable to the company shareholders as a whole, and it does not materially prejudice the company's ability to pay its creditors.²⁴ Second, if there are other shareholders, the company also has to pay the other shareholders a dividend, and they may not want a dividend (especially if it is unfranked). Third, if the dividend is unfranked, this could cause tax issues for the estate.

Estate practitioners should monitor the directors loan account to ensure that it is within manageable limits. The estate practitioners may also wish to (delicately!) enquire of the testator whether the testator is aware of the extent to which the testator's spouse, children and grandchildren have received and are receiving a benefit from the directors loan account and in particular the relative benefit and proportionality between different children and grandchildren.

Unpaid Present Entitlements

The testator may have been an object of a discretionary trust, such as a family trust or a trading trust. The trust fund does not form part of the testator's estate.²⁵ However, the testator's *unpaid present entitlements* are not part of the trust fund but are distributions from the trust to the testator and form part of the testator's estate.

If a trust generates income, then the trust is taxed at the highest personal tax rate if there are no persons who are presently entitled to the income.²⁶ Therefore, to ensure that *someone* is presently entitled, a trustee will distribute the trust income to its selection of discretionary objects of the trust before 30 June each year, or the trust deed will include provisions that the trust's income is distributed by default to discretionary objects of the trust specified in the trust deed if the trustee has not made a distribution by 30 June. However, the person *may not actually receive the income* because the trust may not have the cash to pay the distribution. Instead, the trustee makes the distribution to the discretionary object, and the discretionary object lends the money back to the trust. The trust accounts show the trust has a liability to the discretionary object for the amounts of the distributions that were made but not paid, the "unpaid present entitlements".

These unpaid present entitlements are not just "paper transactions", and are not outside the scope of the estate because they involve a trust. These unpaid present entitlements are real, valuable assets, distributions from the trust, that have been beneficially received by the testator, and the testator has paid tax on. The unpaid present entitlements need to be included as assets in the inventory of probate attached to the application for probate or letters of administration.

The practitioner should monitor the level of the testator's unpaid present entitlements to ensure that it is within manageable limits.

Ideally, the executor may distribute the unpaid present entitlement in specie to a "friendly" beneficiary who is comfortable continuing to hold the unpaid present entitlements. However, in some circumstances, the executor may be compelled to call on the trustee for the trust fund to pay the unpaid present entitlements so that the executor may pay the testator's debts, or may pay the testator's legacies. Similarly, the beneficiary who receives the unpaid present entitlement in specie may call on the trust to pay the unpaid present entitlements.

²⁴ section 254T, Corporations Act

²⁵ A discretionary trust may be designated as notional estate for the purposes of a family provision order pursuant to Part 3.3 Succession Act 2006, if the testator is the sole individual trustee, or the sole or controlling shareholder or sole director of the corporate trustee – *Wardy v Salier* [2014] NSWSC 473

²⁶ Division 6 "Trust Income" 1936 Tax Act

This could have ripple effects on the trust which may have solvency issues and may have to sell assets to pay the unpaid present entitlements, which may trigger adverse capital tax consequences, or indeed may lead the trustees to decide to wind up the trust. This affects all of the objects of the discretionary trust, which may be broader than the testator and the testator's immediate family, and may include several strains or generations of the testator's extended family, or may include the testator's business partners and their families.

Conclusion

When anybody passes away, there is a gaping personal and emotional hole in the world of the deceased's family, friends and acquaintances. When a person passes away who is the lynchpin of a business, there is also a *commercial* hole in the business and its ecosystem.

The illness or death of a chair of the board, CEO, CFO, or sole or key director is a foreseeable organizational risk. The way that a person has structured their affairs may jeopardise the continued viability of the business. Publicly listed companies are required to have a risk management framework and periodically review the effectiveness of the framework²⁷, and it is prudent practice for *all* business to have a risk management framework.²⁸ Effective estate planning is a critical component of many business' risk management.

²⁷ ASX Corporate Governance Council's Corporate Governance Principles; Principle 7

²⁸ see for example AS/NZS ISO 31000:2009 Risk Management: Principles and Guidelines