Précis Paper

Discretionary Trusts

Both men have considerable experience in dealing with discretionary trusts and the pitfalls which are many. This first production by Jim and John is a powerful warning to practitioners. To present the good side – the argument for – these arrangements. I look forward to Jim and John presenting again for Benchmark in the near future. They have ample experience and there are good stories to tell.

Discussion Includes

- What is a discretionary trust?
- Why use discretionary trusts?
- The instability of ownership under discretionary trusts.
- What is the vesting date? Why is it important?
- The rule against perpetuities - which trusts come under the old rule?
- What should you be aware of when dealing with trusts?

Précis Paper

Discretionary Trusts

1. In this edition of BenchTV, Jim Main (Solicitor & Tax Advisor) and John English (Solicitor) discuss discretionary trusts: what they are, why they are useful and why they can be dangerous. Both Mr Main and Mr English have substantial experience in the area of equity and trusts in their general practice in Cootamundra.

<u>What is a Trust?</u>

2. A trust is an arrangement which lets a person or company hold property or assets for the benefit of others.

3. The essential elements of a trust:

    i. Must be a **TRUSTEE** to hold the trust assets
    ii. Must be a **BENEFICIARY** or a group of people who could be beneficiaries
    iii. Must be **TRUST PROPERTY** which is the subject of the trust e.g. real property or businesses
    iv. Must have a **TRUST DEED** which sets out the obligations, powers and duties of the trustee

4. The **SETTLOR** is the person responsible for setting up the trust and naming the beneficiaries, the trustee, and if there is one, the appointor. The **APPOINTOR** has the power to appoint and remove the trustee.

<u>Discretionary Trusts</u>

5. One of the most common trusts is the family discretionary trust. Discretionary trusts involve the trustee exercising a discretion as to who will be a beneficiary out of a group of potential beneficiaries. There are usually two groups of beneficiaries: (1) the default beneficiaries who will receive unless the trustee decides otherwise and (2) the discretionary objects who will only receive where the trustee actively selects them.

6. The beneficiaries of a discretionary trust have no defined entitlement or beneficial interest in the trust property unless and until the trust vests them with the property. It is for this reason that discretionary trusts are well loved by accountants because they are often used as effective instruments for tax-splitting purposes. Often, high net worth individuals will set up a discretionary trust with a company as the potential beneficiary. In this situation, the company can only be taxed at the corporate tax rate of 30% which is usually less than the

income tax payable for individuals. There has been a complex battle between legislators and tax planners as to whether and how these arrangements can succeed.

7. Trustees have a fiduciary duty to act in good faith in exercising their powers under the trust deed. This does not mean a duty to act fairly but to exercise their powers in line with the terms of the deed. The deed might provide that the trustee in any financial year may distribute the income to any one or more of the beneficiaries 'as they decide in their absolute discretion'. In such a situation, and reading the words literally, there would be no presumption of fairness and this is perfectly fine in trust law. What the duty to act in good faith means in this situation is that the trustee needs to have looked at the list of beneficiaries and even where one beneficiary is in desperate need and another is not, provided the trustee considers their positions, they can favour the rich over the poor. Mr Main also notes that the duty of good faith is rarely important, notwithstanding most trustees not following the duty, because beneficiaries will rarely complain either because they do not know they are beneficiaries, they are unaware of the duty or because they do not want to upset other members of the family in the case of a family trust.

8. Today, it is often misunderstood exactly what the legal repercussions are of placing assets in trusts particularly in relation to (1) the instability of ownership involved in trusts and (2) the limited life of trusts.

<u>Instability of Ownership</u>

9. One of the quirks of placing your property in a discretionary trust is that it cannot be said that anyone is the beneficial owner of the property. The trustee has the legal title but only when the trust funds are dispersed will there exist someone with a beneficial interest.

10. However, where an individual is both a majority shareholder of trust company (i.e. effectively can control the distribution of trust property) and a potential beneficiary, then that individual is said to be the 'effective owner' of the property.

11. A classic case on discretionary trusts is *Nicholls v Louisville Investments Pty Ltd* (1991) 10 ACSR 723. In *Nicholls*, a family discretionary trust was set up by a father and it was used to operate his business. It became a 'second generation' trust when the son took over the business, making everyday business decisions and allocating monies from the trust as it pleased him year by year. However, under the trust deed set up by the father, there was a list of potential beneficiaries including the son's sister, who had been overlooked by the son's distributions. The sister applied to the Supreme Court arguing the brother was not acting in good faith in the way equity demands in overlooking her and the son was duly removed as trustee (more on trustee duties below). The brother had thought he owned the trust property but ultimately

became only one of a group of potential beneficiaries that the trustee was obliged to consider.

12. This is a classic problem with second generation trusts. As another example, where you have 3 children and your will stipulates that all the residue goes to the 3 children equally and the assets include shares in the corporate trustee controlling the trust which might own millions in property then multiple things can happen. If the shares are transmitted jointly, then only the first-listed child retains the right to vote as a shareholder in the trust company, can elect themselves director and then they can vest the trust with themselves (bearing in mind director's duties etc.). Here again, the instability of ownership of trust property arises for settlors. Alternatively, even where all 3 children retain a vote as shareholders in a trust company, this does not prevent the possibility that any two children can outvote the third.

13. The unstable ownership of discretionary trusts will also be important when considering the effect of provisions in a will. Clients will often say they own a number of different properties where legal ownership is actually in the family discretionary trust. This can often mean that the beneficiary of the residue of a will may often receive trust property because the shares in the corporate trustee will often fall into this notwithstanding that the property was promised elsewhere because the testator did not actually own it to give it. Sometimes there may be an expectation that the trustee will follow the wishes of the testator. Alternatively, a commonly used method for getting around this is issue is where a settlor writes an 'expression of wishes' asking the trustee to transfer the trust property to certain beneficiaries. The issue with these expressions of wishes is that they might conflict with the requirement that you not feter a trustee's discretion. Again, the trustee follows the trust deed not the beneficiaries or the person who creates the trust, even in family trusts. Therefore, it is really important to consider who possesses 'effective ownership' with family discretionary trusts.

Time Limits on Trusts

14. In trust law, the rule against perpetuities means that a trust can only exist for a predetermined timeframe. Where a trust purports to last longer than the relevant 'perpetuity period' then it is void.

15. Under New South Wales law, for trusts created after October 1984, trusts have to have a perpetuity period of no longer than 80 years according to the *Perpetuities Act 1984* (NSW).

16. The relevance of the rule is that trust property cannot remain dormant in the trust indefinitely. Accordingly, where a person buys property via a trust, the individual may have a short term tax gain but in the long term, where the property must divest given the rule, often to children or grandchildren, the beneficiaries will then have a large tax liability.

17. The historic rule on perpetuities still applies to trusts created prior to October 1984. The rule provides that a trust must vest within 21 years of the death of someone who was alive when the trust was created. Often the nominated person will be a member of the royal family. Victoria had a slightly different 'wait and see' rule in the 1960's, which provided that a trust need not have a vesting date at all.

18. The article written by Mr Main entitled *Taxation: Dangerous Trusts and hidden tax stings* and published in the Law Society Journal provides a real example of the difficulties that tend to emerge from the rule. The article recounts a trust created in the 1970's which provided for 3 vesting dates: (1) a royal lives clause per the historic rule; (2) whatever the trustee might resolve and (3) 40 years from the date the trust was created. When the 40 year period was fast approaching, a solicitor attempted to amend the deed to change the vesting date. The deed provided that amendments to the vesting date could only be made where you did not infringe 'the rule against perpetuities'. Hence, the lawyer turned to the Act and identified the 80 year period so amended the trust providing for a vesting date 80 years after the date in the 1970's when the trust was created.

19. However, the commencement clause in the Act said the new rule only applied to trust created after October 1984 such that amending the deed infringed the old rule, the extension did not work and the trust vested against the client's wishes. The client's (and the solicitor) were lucky in that the default beneficiaries of the trust were the settlor's children and they automatically became the owner and this was satisfactory to the clients. Mr Main notes that if the default beneficiaries were differently defined the whole situation could have ended very poorly for the client – reiterating the difficulties with trusts in relation to instability of ownership and perpetuities periods.

<u>Amendment Provisions in Trust Deeds</u>

20. In the previous example, the notion of amending trust deeds was mentioned but exactly how this is done and the specific issues that arise require further clarification. Firstly, amendment provisions are usually included in trusts because a settlor may be concerned with tax, particularly the capital gains tax ('CGT').

21. Firstly, creating a trust usually has significant tax implications and the key with amendments is whether or not in amending a trust, a new trust is being created generating further tax liabilities. In the past, the tax commissioner has issued rulings suggesting that if you amend a trust in any way you are indeed creating a new trust. But over the Commissioner's views on this evolved such that more recently amendments to trust deeds may occur without creating a new trust when one follows the amending clause precisely. In *Mercanti v Mercanti* [2015] WASCA 206, a family wished to change the appointor of a family discretionary trust from the

father to one son. The amendment clause of the trust was used, the new appointor changed the trustee who became an effective owner. The change of the appointor was subsequently challenged because it only provided the power to amend any of the 'here or before' provisions in the deed. This was found to mean that only those provisions listed prior/above the amendment clause could be amended where as those that followed could not be. So that aspect of the case turned on the precise location of the appointor clause in the deed relative to the location of the amendment clause.

22. In addition to CGT implications, there are also stamp duty implications for trust resettlement (creating a new trust out of an old one). The Commissioner of Duties issued a ruling that when you make significant changes to a deed you are really declaring a new trust and are therefore liable to duties and rates, and CGT events E1 (creating a trust over an asset) or E2 (transferring an asset to a new trust) occur.

23. In summary, in order to avoid stamp duty you must be very careful in amending trust deeds not too significantly and you should ensure that you not use words of declaration when amending. In relation to CGT, you must follow the amendment clauses precisely. So if you amend the deed so that you create a trust over specific assets for specific beneficiaries, as was the case in *Oswal v Commissioner of Taxation* [2013] FCA 745, where a family discretionary trust held shares in a family company and it was organized that a declaration and amendment be made such that henceforth identified shares would only be held for two people in the list of beneficiaries, you have CGT event E1. Furthermore, it is possible that the new trust is not even a discretionary trust post the amendment because there is no discretion for the trustee.

<u>Property Transactions</u>

24. Discretionary trusts are often used as vehicles for property transactions and these trusts require some further exploration. Of course, the same considerations apply with regard to the effect of purchasing property on trust such that you lose beneficial ownership and also issues regarding perpetuities, CGT and duties. However, further specific concerns are linked to why people tend to purchase property via trusts. Accountants will often recommend such instruments both for the favourable tax implications but also for asset protection purposes where divorce or bankruptcy is contemplated by the settlor. The idea with asset protection is that if property is purchased via trust the settlor will not hold legal interests in the property and as such the property will not enter the pool for property settlement on divorce nor will a trustee in bankruptcy be able to claw at the property. However, today, ordinary discretionary trusts offer virtually no protection to claims under the *Family Law Act 1975* (Cth). Mr Main recommends that special purpose trusts which limit the discretion of the trustee are what is required if asset protection is the key objective.

25. The presenters also mentioned that the rules on stamp duty in relation to property under trust are very far reaching beyond applying where resettlement occurs. For example, if you are transferring shares in a company that owns land in NSW valued at more than $2M then the trust is classified as land rich (with an exception for farmers) and a transfer of shares in that family company has the same liability for stamp duty as a straightforward transfer of the land. Furthermore, if that company is the potential beneficiary of a totally different trust that owns land, then under s 159 of the *Duties Act 1997* (NSW) the company is taken to be the owner of all the land in the trust. However, there is an exception to this treatment under s 163H of the Act where the Commissioner considers that the operation of s 159 would be unreasonable. What the presenters emphasise is that so often a transaction is made and these things are not even thought of, and although discretionary trusts may sound eminently prudent in the words of an accountant it is important to consider issues such as these.

Trusts within Trusts

26. Another relevant consideration for CGT purposes, is whether trusts have been cloned or split. Trust cloning involves a separate trust being set up with the same instructions as an original trust but with a different trustee. Formerly, there were no CGT consequences for transferring assets between such cloned trusts but this rule was abolished because it was seen to be avoiding too much tax. Now, practitioners have been 'splitting' trusts whereby you amend the deed (following the rules exactly) and create a situation where you have multiple trustees of the one trust but each trustee controls one fund under the trust. However, where you amend the beneficiaries of the two asset pools under the trust you are really just creating a new trust.

The Law of the Trust

27. Another consideration for discretionary trusts is that it is important to identify the law to which the trust applies. Often the trust deed will specify the law to be applied to the trust e.g. NSW Law or American Law etc., but many will not. In that situation, courts will then look to factors including where the trustee lives, where the trust property is, and where most of the trust activity takes place. The significance of whether different laws apply is that often different reporting duties are required for property in trusts (e.g. the US) and in France they have issues with death duties applying to beneficiaries of trusts. Furthermore, what law applies is important for stamp duty because different duty legislation is different across the states but not so important for beneficiaries or for tax purposes.

Income Splitting

28. Finally, family trusts are often set up for 'income-splitting' purposes as there is a temptation to take advantage of young children's tax free thresholds or lower tax rates. The same

thinking applies to sharing the monies of a high-earning spouse with a low earning spouse via a trust for tax minimization purposes. The issue in both situations is that either the child or the spouse may turn around and claim the money because in order for the set up to avoid tax, they must become 'presently entitled' to the funds and thus such a claim will be successful. This will be particularly relevant where a child marries and then divorces, and then the monies paid to the child via the trust might form part of the marriage pool to be divided. A similar situation occurs where the child goes bankrupt.

29. Often discretionary trusts use the word 'spouse' rather than the name of the spouse to take care of the possibility of remarrying. Alternatively, having a truly independent appointor might avoid the possibility of effective ownership being found. That said, Mr Main thinks the office essentially does nothing (you can just change the trustee using the powers under the *Trustee Act 1925* (NSW)) and will possibly create future problems.

<u>Implications</u>

30. In the words of Mr Main, "that is the thing with discretionary trusts, they become so familiar to people and yet so fraught when you start looking at the rules".

31. However, Mr Main "does not want to unduly demonize family discretionary trusts. They are a commonly used vehicle and they most definitely have their place. We are frequently involved in setting up businesses and we frequently recommend the setting up of a family discretionary trust".

32. What the presenters highlight is that advice should be sought in setting up such trusts and people should bear in mind issues of unstable ownership, perpetuity periods, tax and CGT consequences, let alone the specific provisions including small business CGT exceptions and exceptions to stamp duties from certain intergenerational transfers under s 274 of the Duties Act.

BIOGRAPHY

Jim Main

Accredited Specialist Business Law & Certified Tax Advisor (TIA) - JMA Legal Sydney and Cootamundra

Mr Main was admitted in 1976. He is an Accredited Business Law Specialist and practises with an emphasis on business succession, estate planning and tax law. He is also a Chartered Tax Advisor with the Tax Institute of Australia and has provided tax advice to accountants, lawyers and clients for many years. Jim writes the well-known Tax Sting articles in the NSW Law Society Journal.

John English

Business Lawyer - JMA Legal, Cootamundra

John English is a business lawyer with experience in estate planning, employment law, business law matters and conveyancing. He has a background in agribusiness and a Bachelor of Laws (LLB).

BIBLIOGRAPHY

Cases

Mercanti v Mercanti [2015] WASCA 206
Nicholls v Louisville Investments Pty Ltd (1991) 10 ACSR 723
Oswal v Commissioner of Taxation [2013] FCA 745

Legislation

Duties Act 1997 (NSW)
Family Law Act 1975 (Cth)
Perpetuities Act 1984 (NSW)
Trustee Act 1925 (NSW)

Articles

Jim Main, *Taxation: Dangerous Trusts and hidden tax stings*, LSJ 2(11) 2015, 93