

Trusts in the family law arena – Part 1

WITH THE INCREASED USE OF ASSET PROTECTION STRUCTURES, FAMILY LAWYERS MUST CONSIDER A NUMBER OF ISSUES WHICH WERE TRADITIONALLY CONSIDERED “COMMERCIAL LAW MATTERS”. PART 1 OF THIS ARTICLE ACTS AS AN INTRODUCTION TO TRUSTS AND HIGHLIGHTS THOSE ISSUES WHICH CAN ARISE IN ANY FAMILY LAW PROCEEDINGS.

The common use of trusts for business and investment structuring means that issues concerning the control of trusts, distributions and loans from trusts (both from the past and into the future) and beneficiaries of trusts have now become matters that family lawyers must consider. To provide solutions to problems that arise in family law matters which involve trusts requires knowledge of both trust and taxation law. These matters are often not the focus of the family law proceedings.

The purpose of this article, being the first in a two part series, is to provide an introduction to the trust issues that can arise when considering trusts in the family law context. The article in next month's journal will discuss the implementation of family law orders relating to trusts.

Throughout this article we will focus on family or discretionary trusts in the family law context, and each reference to a “trust” will be a reference to a trust of this nature. It is beyond the scope of this article to consider the tax consequences of the issues raised.

CHANGES TO CONTROL

The key parties involved in the control of a trust are the trustee and the appointor. If the trustee is a company, it will be necessary to review the identity of the directors and shareholders of the company. Commonly the directors and shareholders of the company may have been both the husband and wife. Therefore, if the control of the trust is to be transferred to one party (the continuing party), it will be necessary for the other party (the outgoing party) to resign as a director and transfer their shares to the continuing party or an entity nominated by him or her. Before this can be done the constitution or articles of association of the

company should be reviewed to ensure that it allows a single director to control the company. The constitutions of companies incorporated before 1995 will generally have a minimum requirement that two directors be appointed. In these circumstances it will be necessary to amend the constitution to allow for a single director prior to the resignation of the outgoing party. In relation to the change in shareholding, consideration should be given to the shares being transferred from the outgoing party to a protected entity or an individual that is not subject to the same business risks as the continuing party.

If the trustee is the husband and wife jointly, then resignation of the party that is not to control the trust will obviously be necessary. It would also be prudent at this time to analyse whether it is appropriate for the continuing party to remain as the sole trustee. If the trustee operates a business, then the preferred structure would be to appoint a corporate trustee. If the trustee holds investment assets, then careful consideration should be given to the risk profile of the continuing party to determine whether as a sole trustee the assets of the trust are exposed to risk.

Whether the trustee is a company or one or more individuals, it is important that the trust deed is reviewed to identify the process set out in the trust deed for the removal and appointment of trustees. A common requirement is for the appointment and removal to occur by deed and to be executed by the retiring trustee and the new trustee. If the process in the deed is not followed then the removal and appointment may be invalid. A requirement to execute the documents to record the retirement and appointment should be incorporated as part of the family law orders.

The position of appointor (sometimes described as guardians or supervisors) is arguably the most important position in relation to the control of a trust, as the appointor often has the ability to remove the trustee. The appointors of a trust will usually be individuals, and commonly a husband and wife jointly. Therefore, control of this position needs to be transferred to the continuing party. In making this change it is important to consider the risk profile of the continuing party. If the risk profile is unacceptable then the appointment of an independent person to act jointly with the continuing party may be appropriate.

When changing the appointor it is again necessary to review the provisions of the trust deed in relation to how this change can be made. Some trust deeds contain provisions that only allow an appointor to nominate a replacement that will act in substitution for the original appointor, but not confer a right of survivorship. This means that the new appointor cannot nominate a replacement, even upon his or her death. If a trust deed contains such a restriction then it is important that it is identified and taken into account in the succession plans for the trust.

UNPAID BENEFICIARY ENTITLEMENTS AND LOAN ACCOUNTS

Loan accounts with credit balances and unpaid beneficiary entitlements (credit trust entitlements) can be addressed in two ways. If a cash payment to one party from the trust is required pursuant to the terms of settlement this can be made by paying the credit trust entitlement to the entitled party, or if the credit trust entitlement is in favour of the other party, then payment can be made to that party who can then make a gift of that amount. Alternatively, if



a payment is not required from the trust, an assignment of the credit trust entitlement to the continuing party (or an entity nominated by him or her) should be made. The assignment should not only be reflected in the financial statements of the trust but also recorded in a written documents signed by both parties. Further, before the assignment is effected, asset protection should be considered and if the continuing party is exposed to risk the assignment should be made to a protected entity.

If the credit trust entitlement is an unpaid beneficiary entitlement, then it will be important to review the provisions of the trust deed to determine how these amounts are characterised for trust purposes. Commonly, trust deeds will provide that these amounts are held on separate trusts for the beneficiary. If this is the case, then it is the beneficial interest in this separate trust that is being assigned and this should be reflected in the written document recording the assignment.

The task of dealing with the loan account of an outgoing party is more difficult if it has a debit balance. The tax implications that arise under Div 7A of the Income Tax Assessment Act 1936 are beyond the scope of this article, however, it is imperative that they are considered in the family law context. The forgiveness of a loan owed by an outgoing party may give rise to a deemed dividend. The assignment of the liability to the continuing party may also give rise to adverse tax implications if a reasonable person may conclude that the loan will never be called up and the assignment has merely "parked" the debt. An assignment may also

increase the repayment obligations of the continuing party to an unsatisfactory level. If there are sufficient funds to repay the loan this is the preferred option. Whether the loan is assigned or repaid it should be recorded in writing.

CHANGES TO BENEFICIARIES

A trust will generally have two classes of beneficiaries, primary or specified beneficiaries who are often the takers in default in relation to undistributed trust income, and general beneficiaries which usually consist of a wide range of individuals, companies and trusts. No single beneficiary of the trust has an ownership interest or an entitlement to the trust fund.

In making the decision to continue to control the trust the continuing party must ensure that they are a beneficiary of the trust. Some trusts exclude the settlor, the trustee and individuals that have made capital contributions to the trust. It is important to review the trust deed to determine whether it provides for such exclusions.

Whilst a beneficiary of a trust does not have an entitlement to the trust fund, if they are a primary beneficiary they may receive a distribution if there has not been an effective distribution of income or if the trust reaches its termination date without being vested earlier. Therefore, if the outgoing party remains as a primary beneficiary, a distribution to them may arise through the operation of the provisions of the trust deed.

To avoid the unintended consequences of a distribution being made to an outgoing party, the outgoing party's interest as a beneficiary should be renounced. The trust deed should be reviewed to determine whether there is a process set out for the exclusion of a beneficiary. In the absence of a provision being contained in the trust deed, the execution of a deed by the outgoing party will operate as an effective renunciation of the beneficiary's interest. Care should be taken to ensure that the outgoing party has received all distributions from the trust which were contemplated as part of the family law settlement before his or her interest is renounced.

Whether the removal of a primary beneficiary from a trust is a variation to a trust deed that creates a resettlement of the trust is unclear and will depend on the beneficiary provisions contained in the trust deed. This is a matter that should be considered prior to the interest being renounced.

The issues discussed in this article highlight the importance of reviewing the control of the trust, the beneficiaries, the loans or entitlements that exist in relation to the trust and the trust deed before any final settlement is reached in relation to family law proceedings.

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