

Trusts in the family law arena – Part 2

THE IMPLEMENTATION OF FAMILY LAW ORDERS RELATING TO TRUSTS REQUIRES A CAREFUL ANALYSIS OF TRUST ISSUES SUCH AS CONTROL, LOANS, DISTRIBUTIONS AND BENEFICIARIES.



This article is the second in a two part series exploring issues relating to trusts in the family law arena. In this article the implementation of family law orders is considered. It follows the introduction in last month's edition to the general trust issues that arise in the family law context.

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.

HOW ARE FAMILY LAW ORDERS MADE?

To understand family law orders and their application to trusts it is important to consider the context in which they are made. Approximately 95 per cent of family law disputes resolve by negotiation, without a determination of the Family Court, either before or after Family Court proceedings are issued.

Property orders to deal with the distribution of the property of the marriage can either be made as a consequence of an application made by the parties for consent orders or alternatively to resolve an application brought by the parties for the Family Court to make a determination. In both cases the orders reached by agreement must be approved by the Family Court. Prior to the orders being approved by the Family Court it is necessary for full financial disclosure to be made by both parties. In addition a judicial officer of the Family Court must be satisfied that the orders result in an outcome that is in the range of a reasonable settlement.

As an alternative to property orders approved by the Family Court parties now have the opportunity to enter into a binding

financial agreement to effect a distribution of the property of the marriage. To be valid the agreement must be certified by an independent lawyer for each party.

As a separate step to making orders relating to the property of the marriage, a divorce order can be made by the Family Court. Under the *Family Law Act 1975* "divorce" means the termination of the marriage other than by the death of a party to the marriage. One party to a marriage can make an application to the Family Court requesting that a divorce order is made. In most family law matters a property settlement will occur before an application for a divorce is made.

Where trusts are involved, property orders for the distribution of the assets will frequently contain the following provisions:

- An obligation that the party that will retain control of a trust (the continuing spouse) pay or cause to be paid an amount of money to the spouse who will no longer benefit from the trust (the exiting spouse).
- Contemporaneously with the payment of the monetary sum, the exiting spouse:
 - Resign as a trustee or a director of a corporate trustee of the trust and transfer any shares held in the corporate trustee.
 - Resign as an appointor of the trust.
 - Assign to the continuing spouse any beneficial entitlement he or she may have in the trust, including any credit beneficiary entitlement and any credit loan account.
- The exiting spouse renounce or relinquish any interest in the trust.

- The continuing spouse assume any liability of the exiting spouse to repay a loan to the trust.
- The continuing spouse indemnify the exiting spouse in relation to any liability that may arise out of the exiting spouse's position as a trustee (or director of a corporate trustee), appointor or beneficiary.

HOW ARE THE ORDERS IMPLEMENTED AND WHAT ARE THE CONSEQUENCES?

Payment of money from the trust

Although the Family Court has power to make orders in relation to third parties, property orders will in most cases require the continuing spouse to source the funds from a trust instead of requiring a trustee to make a payment. If a distribution is to be made from a trust directly to an exiting spouse it will be important to ensure that the exiting spouse remains a beneficiary of the trust, as defined by the trust deed.

In addition to determining whether the trust deed allows a distribution to be made to the exiting spouse, it will be important to determine whether a family trust election¹ (FTE) has been made in relation to the trust and to identify the primary individual for the purpose of the FTE. This will be crucial where a divorce order has been made.

The existence of a FTE in relation to a trust does not prohibit a distribution being made to an exiting spouse. However, the tax cost will often make a distribution undesirable. If a divorce order has not been made, despite the separation of the parties, the exiting spouse will still fall within the

“family group”² and a distribution to the exiting spouse will not give rise to family trust distribution tax (FTDT). If a divorce order has been granted, as the legislation currently stands the exiting spouse would no longer form part of the family group and FTDT will become payable.

In the Federal budget released in May this year it was announced that the definition of “family group” would be amended to include former spouses. At this stage the operative date for the implementation of this change is unknown. In the meantime consideration should be given to distributing property from the trust to the continuing spouse and thereafter a gift being made from the continuing spouse to the exiting spouse to satisfy the requirements of the property order and ensure that the distribution from the trust is to a beneficiary within the family group.

Change in control of the trust

When implementing property orders emphasis should be placed on transferring control of a trust contemporaneously with a requirement to transfer property to the exiting spouse. To achieve this the following steps should be considered:

- If the trust has a corporate trustee and the exiting spouse was a director the exiting spouse must resign. If the exiting spouse held shares in the corporate trustee these must be transferred to the continuing spouse or an entity associated with him or her. It is important that the appropriate minutes, notices and Australian Securities and Investment Commission forms are completed and lodged.
- If the exiting spouse is a trustee of the trust then he or she must be removed from this position. The trust deed will prescribe the process for this to occur. It must be strictly followed. After the removal of the exiting spouse as trustee a review should be undertaken of the trust property. Any property that records the exiting spouse as a registered owner must be transferred to the new continuing trustee(s). This is particularly important where the trust owns real property.
- The removal of the exiting spouse from the position of appointor is crucial. The trust deed should be

reviewed to determine the process for removing the appointor. Again this must be strictly followed to ensure that the removal has been effective.

Relinquishing entitlements, satisfying obligations and indemnities

The existence of a credit beneficiary entitlement owing to an exiting spouse or a loan with a credit balance in favour of an exiting spouse can be resolved by recording the assignment or relinquishment in writing. The trust deed should be reviewed to determine the nature of the entitlement to ensure that it is accurately described and effectively assigned or relinquished.

A debt owed by an exiting spouse to a trust may cause difficulties. The extinguishment of the debt must be treated cautiously where the trust has an unpaid beneficiary entitlement to a company. The forgiveness of a debt in these circumstances may give rise to a deemed dividend under the provisions contained in Div 7A of the *Income Tax Assessment Act 1936 (ITAA36)*. The assignment of the debt to the continuing spouse may avoid this problem but may increase the continuing spouse's repayment obligations.

To forgive or assign the debt a written instrument should be entered into between the trustee of the trust, the continuing spouse and the exiting spouse. This change in financial position in relation to this amount must then be reflected in the financial records of the trust.

The property orders will commonly include an indemnity by the continuing spouse for any liabilities that arise in relation to the trust that are the subject of a claim made against the exiting spouse. The exiting spouse will simply be able to rely on the property orders to enforce the indemnity. An exiting spouse who was previously a trustee of the trust may also have a right of indemnity against the trust assets under the trust deed if such a claim arises.

Tax considerations in calculating a family law settlement

Distributing assets from trusts or liquidating assets held by trusts in order to satisfy obligations under property orders will often have tax consequences. These consequences and the tax cost are taken into account in the family law context in determining the value of the property

available for distribution. Therefore, the cost of any capital gains tax or income tax resulting from the trust distributions and payable by beneficiaries will be taken into account in determining the net value of the property being dealt with in the property orders and the amounts distributed to each party.

CONCLUSION

The implementation of property orders arising from family law disputes is complicated where trusts are involved. A thorough analysis of the control of the trust, the assets held by the trust and the provisions of the trust deed must be undertaken. This will enable both the family law and trust issues to be resolved contemporaneously which is commonly a high priority for the parties involved.

Joanna Monahan
Director, Harwood Andrews Lawyers

Georgina Thomson
Lawyer, Harwood Andrews Lawyers

Reference notes

- 1 Family trust elections are made in accordance with section 272-80 contained in Schedule 2F of the *Income Tax Assessment Act 1936 (ITAA36)*. Similar issues to those in relation to an FTE arise where an interposed entity election has been made in accordance with section 272-85 of Schedule 2F of ITAA36.
- 2 'Family group' is defined in section 272-90 of Schedule 2F of the ITAA36.
- 3 *Rosati v. Rosati [1998] FamC38*