

The all important trust deed

COMPLIANCE WITH THE TRUST DEED IS ONE OF THE MOST IMPORTANT DUTIES OF THE TRUSTEE IN ADMINISTERING A TRUST.



INTRODUCTION

The need to administer an express trust in accordance with the terms and conditions of the governing trust deed cannot be understated. Trust deeds establish and define the trust and set out the terms and conditions upon which the trust must be operated and managed. The implications of failure to comply with the terms and conditions of a trust deed vary depending on the particular circumstances but can result in unintended taxation or other consequences being triggered. This article identifies and considers some of the principal areas in which failure to comply with the terms of a trust deed can arise along with analysing the potential implications.

THE IMPORTANCE OF TRUST DEED

The trust deed is essential to every aspect of the trust relationship, including the establishment of a trust, the day to day conduct of a trust, specific activities to be undertaken in respect of the trust and the winding up of the trust. Most trusts are established on the condition that they are conducted in accordance with the terms and conditions of a trust deed. For example, a discretionary trust is established by the settlor gifting property to be held on trust for the beneficiaries on the terms and conditions of the trust deed. Alternatively, a unit trust is established by persons or entities subscribing for units that are subject to the terms and conditions of the trust deed.

On the establishment of a trust it is the trust deed that defines the terms of the trust. The trust deed defines the beneficiaries, the vesting date of the

trust and the conditions upon which the trustee holds the trust property for the beneficiaries. This includes activities in respect of the trust and trust property which the trustee is permitted or alternatively prohibited from undertaking.

Despite the importance of the trust deed, once a trust has been established the trust deed is regularly filed at the back of a cupboard or the bottom of a draw. Thereafter the trust is often administered without further reference to the trust deed.

Actions which are not in accordance with the provisions of the trust deed may be null and void. Importantly, the implications of an act being null and void can reach further than the act simply being treated as if it did not occur. Instead, an invalid act of a trustee in respect of a trust can result in unwanted taxation implications for the trustee, a breach of the trustee's duties or alternatively unwanted consequences for beneficiaries.

TRUSTEE'S OBLIGATIONS

Jacobs' Law of Trusts¹ (**Jacobs'**) makes it clear that "...trustees who depart from the strict terms of the trust do so at their peril."² Jacobs' identifies in respect of the trustee's duty to observe and comply with the terms of a trust deed that:

"It is the duty – '[p]erhaps the most important duty'³ – of a trustee to adhere rigidly to the terms of the trust."^{4,5}

Not only can a failure to comply with the terms of a trust deed result in unintended taxation consequences, the trustee may, although not in all cases, be held liable for a breach of its duty to comply with the terms of the trust deed save for where it

can be shown that the deviation from the terms of the trust deed was necessary.⁶

In *Turner v Turner*⁷ the duty of the trustee in respect of compliance with the trust deed was considered in detail. The trustees in this case did not understand or contemplate the terms and conditions of the trust deed. Instead, any actions to be taken in respect of the trust were completed by an advisor preparing resolutions and the settlor of the trust procuring the signatures of the trustee in respect of the resolution and where applicable associated documents. The issue that therefore arose was whether the trustees were under a duty to consider the terms of the trust deed and the proposed actions. Ultimately, Davies J concluded as follows:

"...the trustees exercising a power come under a duty to consider. It is plain on the evidence here the trustees did not in any way 'consider' in the course of signing the three deeds in question... They merely signed when requested. The trustees therefore made the appointments in breach of their duty..."⁸

The implications of such a breach of duty by the trustees can be as far reaching as those acts of the trustees being set aside. This was ultimately the determination of Davies J in *Turner v Turner*.⁹

PARTICULAR PROVISIONS OF THE TRUST DEED THAT REQUIRE STRICT COMPLIANCE

Although all terms and conditions of the trust deed are important and require strict compliance, there are particular terms and conditions of a trust deed that if not complied with can result in dire or at the very least unintended consequences.

The following considers some of these specific areas. In considering these key areas, this article focuses on discretionary trusts unless otherwise stated. However, similar considerations arise in respect of all types of trusts which are governed by a trust deed.

Definition of beneficiaries and appointing new beneficiaries

The definition of beneficiaries in a discretionary trust is generally very broad. However, it would be a grave mistake to assume, without reference to the trust deed, that a particular person or entity falls within the definition of beneficiaries.

the trustee may not be liable to be assessed to tax on the income. However, this is not always the case.

Likewise, in adding a new person or entity to the class of beneficiaries, strict compliance with the trust deed is essential. Failure to comply with the terms of the trust deed will result in an ineffective nomination of a beneficiary and therefore any subsequent acts in respect of that person or entity will be invalid. This particular scenario was considered by Spender J of the Federal Court of Australia in *Idlecroft v Commissioner of Taxation*,¹⁰ the decision in which was affirmed by the Full Federal Court of Australia in *Idlecroft Pty Ltd v Commissioner of Taxation*¹¹ (**Idlecroft**).

and therefore it was not a matter which required determination by the Court.¹²

However, the assertion of the Commissioner was not accepted by Spender J. Instead, Spender J found that the nomination of WCC as a beneficiary did not comply with the terms and conditions of the trust deed. He stated:

“The fact that Mr McGowan signed the document “Nomination of General Beneficiary” over the stamp of Downville and as a director of Downville does not, in my judgment, constitute an appointment by him as Principal, nor does the document constitute a notice in writing by the Principal to the Trustee appointing WCC to be a beneficiary for the purposes of the McGowan Trust Deed. I reject the contention of the Commissioner that WCC was nominated as a beneficiary of the McGowan Family Trust.”¹³

“ The only approach in dealing with a trust is to treat every trust deed as unique, reviewing provisions carefully prior to taking any action. ”

In considering whether the nomination of a person or entity as beneficiary was effective, it was determined by the Court that a literal interpretation of the trust deed must be employed.¹⁴

In this particular case, the consequence of the ineffective nomination of WCC as a beneficiary of the trust was that any appointment of income to WCC was null and void. This was confirmed by Spender J:

“...the appointment of income to it was therefore a nullity and liable to be set aside *ab initio* by the Court.”¹⁵

To determine the full extent of the consequences of this failure to comply with the terms and conditions of the trust deed, it is necessary to consider the default provisions in relation to the appointment and distribution of income. In the event that there are default beneficiary provisions included in the trust deed, it is those beneficiaries that may be entitled to the income that was incorrectly appointed. In *Idlecroft*, it was determined that the default provisions applied in respect of the McGowan Family Trust (defined as “Downville” by Spender J). However, in *Idlecroft* it was further determined that s 100A of the ITAA36 was also applicable to the appointment of income to the default beneficiaries and therefore s 99A of the ITAA36 applied. The court held that s 100A of the ITAA36 applied on the basis that the present entitlement of the default beneficiaries arose in connection with

The definition of beneficiaries is particularly relevant to distributions of income and/or capital of the trust to beneficiaries. For example, a distribution of income to a person or entity by the trustee of a trust will only be valid if the entity to whom the income is distributed is a beneficiary.

In the event that income of a trust is distributed to a person or entity other than a beneficiary, the operation of s 99A of the *Income Tax Assessment Act* (Cth) 1936 (**ITAA36**) may be triggered. If s 99A of the ITAA36 applies, the trustee may be liable to be taxed on the income of the trust that was invalidly appointed at the highest marginal tax rate (plus the Medicare levy). To determine whether s 99A of the ITAA36 applies, it will always be necessary to consider whether a present entitlement in favour of a beneficiary has been created. This will usually require consideration of the default provisions of the trust deed. In the event that a beneficiary was entitled to that income, for example if the default provisions apply and provide for the appointment of income to default beneficiaries,

In addition to considering the application of s 100A of the ITAA36, it was necessary for the Court to consider the issue of compliance with the trust deed. In this case five discretionary trusts entered into a joint venture agreement with Westside Commerce Centre Pty Ltd as trustee for the Hendon Unit Trust (**WCC**) in relation to the development of land. It was agreed between the parties that the method of funding the property development was to nominate WCC as a beneficiary of each of the five discretionary trusts.

One of the issues that arose in relation to the arrangement was whether WCC was validly nominated as a beneficiary of each of the five discretionary trusts. In considering this issue, Spender J considered the provisions of each of the trust deeds in relation to the terms and conditions upon which a person can be added as a beneficiary of the trust. In relation to one of the trusts, the Commissioner of Taxation (**Commissioner**) contended that there was a mere irregularity in the appointment of WCC as a beneficiary of the trust

the reimbursement agreement, being the purported appointment of trust income to a company which was contemplated to be a beneficiary.¹⁶ (A detailed analysis of the basis upon which s 100A of the ITAA36 applied to the distribution of income to the default beneficiaries is not however within the scope of this article.)

The obligations of the trustee in respect of the appointment of income will vary from trust deed to trust deed. Further, the implications of the trustee not exercising its powers and obligations in respect of the income of the trust, or alternatively exercising powers in a non compliant manner, will also vary from trust deed to trust deed.

to trigger the operation of the default provisions had not arisen. The consequence of this determination was that no present entitlement of a beneficiary to the income had been created and ultimately the trustee was liable to be assessed to tax pursuant to s 99A of the ITAA36.

Power to appoint new trustee or appointor

Most trust deeds are inclusive of provisions that permit the appointment of a new trustee and nomination of a new appointor or principal. As with all powers in a trust deed, in order for an exercise of power to be valid, the power must be exercised in accordance with the terms and conditions specified in the trust deed. Further to this issue, consideration must also be given to the distinction between the power to appoint a trustee or to nominate an appointor from the general power of variation which is often included in trust deeds. That is, does the power of variation allow the variation of the trust deed to remove or change the appointor of the trust.

*Jenkins v Ellett*²⁰ involved an invalid nomination of a principal as a result of the trustee's exercise of the general power of variation in the trust deed. In considering the general power of variation and the breadth of power it conferred upon the trustee, Douglas J stated:

"The essential issue seems to me to whether the power given to the trustee to vary the trusts declared can extend to the removal of the Principal especially where it is the Principal who alone, in the trust deed as originally drafted, has the power to appoint and remove the trustee...."²¹

In light of the power of the principal to remove the trustee being fundamental to the structure of the trust deed, Douglas J found that it was not permissible to allow the trustee to undermine the power of the principal by using the general powers of variation to amend the trust deed.²²

The risk in undertaking an ineffective appointment of trustee or nomination of appointor is that along with the appointment being invalid, any subsequent acts of the trustee or appointor ineffectively appointed will also have no effect. The implications of this can be far reaching and result in numerous other breaches of the trust deed or trigger unintended taxation consequences, for example by the

“ ... failure to comply with the terms and conditions of the governing trust deed may result in significant taxation implications to the trustee or alternatively default beneficiaries. ”

Alternatively, to the extent that a present entitlement has not been created to any part of the income, for example where the default income provisions provide for the accumulation of the income or alternatively where the default provisions have not been triggered, the trustee will be assessed to tax on that part of the income pursuant to s 99A of the ITAA36 at the top marginal income tax rate (plus the Medicare levy).

This case illustrates that failure to comply with the terms and conditions of the governing trust deed may result in significant taxation implications to the trustee or alternatively default beneficiaries.

Appointment and distribution of income of the trust

Inadvertent repercussions may result from failure to comply with the trust deed in respect of the appointment and distribution of income. Often appointments of income are made to persons as beneficiaries without any reference to the trust deed, or alternatively, there is simply a resolution of directors of a corporate trustee purporting to appoint income to a beneficiary when that action will not be sufficient to achieve the desired outcome. Similar to the appointment of income to a person or entity who is not a beneficiary, an appointment of income which is not in accordance with the terms of the trust deed may trigger unintended taxation consequences.

The case of *BRK (Bris) Pty Ltd v Commissioner of Taxation*¹⁷ considered the obligations of the trustee pursuant to the trust deed in respect of the appointment of income. The determination of this matter involved an analysis of the trust deed by the Court. Clauses 4 and 5 of the trust deed were particularly relevant to the issue of appointment of income. Clause 4 of the trust deed conferred on the trustee the discretion to determine whether to accumulate part or all of the income. Clause 5 of the trust deed dealt with that income not accumulated pursuant to clause 4 and included default provisions. The default provisions defined default beneficiaries however an entitlement to income by those default beneficiaries was only triggered where the trustee failed to exercise its discretion to accumulate part or all of the income or a reasonable time had expired without the trustee exercising this discretion.¹⁸ In considering the terms and conditions of the particular trust deed Cooper J noted:

"The effect of cl4 and cl5 of the Deed, in my judgment, is that the trustee is bound by obligatory discretionary powers, to accumulate such income, if any, as the trustee thinks fit and to apply the income not accumulated in any income year in accordance with the terms of the discretionary power to the objects of the power in default of which the income for that income year is to be distributed in accordance with the default proviso..."¹⁹

In this case it was ultimately determined by Cooper J that the circumstances necessary

failure to create a present entitlement in a beneficiary to income of the trust.

Power to vary the trust

The determination of Douglas J in *Jenkins v Ellett*²³ illustrates that in order to comply with the terms of a trust deed, it is also necessary to consider what the particular provisions of the trust deed permit. This issue arises particularly in respect of the general power of variation included in most trust deeds.

Although a general power of variation is included in most trust deeds, this power of variation may differ from trust deed to trust deed and is often subject to a number of restrictions. Failure to comply with any restrictions in respect of the variation power or alternatively acting outside the variation power granted may result in such act being null and void.

Numerous consequences can flow from a variation to the trust deed being held invalid. Of particular concern is the consequence that any subsequent reliance on an invalid provision of the trust deed created by the variation in question will have no effect.

Powers of the trustee in relation to the trust

Most trust deeds include numerous powers that allow for the day to day conduct of the trust. Continual reference to the powers prior to taking any action is essential in order to ensure compliance with the trust deed.

Related to this issue, it is not uncommon for banks to require the amendment of trust deeds prior to the provision of finance to the trustee of a trust. The usual premise for requiring such variations is in order to ensure that any security the bank requires is enforceable against the trust.

In complying with any request of the bank it is necessary to ensure that such a request is permitted pursuant to the terms and conditions of the trust deed. The case of *Cavill Hotels Pty Ltd as trustee of the Greg Cavill Family Trust and Anor v Cavill Hotels Pty Ltd and Ors*²⁴ considered this particular issue. In addition to determining that the purported variation was in breach of the terms of the trust deed Williams J noted:

"...neither Gregory Cavill nor Jenny Cavill, who were directors responsible for the passing the necessary resolutions and executing the Deed of Variation in question on behalf of the trustee, believed that it was in the best interests of The Greg Cavill Family Trust that the grandchildren and others in question be excluded from the class of beneficiaries. They acted as they did because they could not see any other practical alternative; they simply accepted the ANZ proposal."²⁵

Ultimately the deed of variation was determined to be invalid and was set aside.

CONCLUSION

It is a dangerous assumption to think that all trust deeds are inclusive of the same terms and conditions. The only approach in dealing with a trust is to treat every trust deed as unique, reviewing provisions carefully prior to taking any action. Care must be taken to ensure strict compliance with the terms and conditions of the trust deed. This is an essential element in ensuring that all acts undertaken in relation to the trust are valid. Taking such an approach is the only way to ensure that unintended and potentially disastrous consequences are avoided as a result of failure to comply with the trust deed.

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Reference notes:

- 1 J Heydon, M Leeming, *Jacobs' Law of Trusts in Australia*, (7th ed,2006)
- 2 Paragraph [1704] J Heydon, M Leeming, *Jacobs' Law of Trusts in Australia*, (7th ed,2006)
- 3 *Youyang Pty Ltd v Minter Ellison Morris Fletcher* (2003) 212 CLR 484 at [32]
- 4 A-G Downing (1767) *Wilm* 1 at 23; *Raby Ridehalgh* (1855) 7 De G M & G 104 at 108
- 5 Paragraph [1704] J Heydon, M Leeming, *Jacobs' Law of Trusts in Australia*, (7th ed,2006)
- 6 *Harrison v Randall* (1852) 9 Hare 387 at 467
- 7 [1983] 2 All ER 745
- 8 *Turner v Turner* [1983] 2 All ER at 752
- 9 [1983] 2 All ER 745
- 10 [2004] FCA 1087
- 11 [2005] FCAFC 141
- 12 Paragraph 47 *Idlecroft v Commissioner of Taxation* [2004] FCA 1087
- 13 Paragraph 49 *Idlecroft v Commissioner of Taxation* [2004] FCA 1087
- 14 Paragraphs 47 and 49 *Idlecroft v Commissioner of Taxation* [2004] FCA 1087; *BRK (Bris) Pty Ltd v Commissioner of Taxation* [2001] FCA 164 para 14; *Gulbenkian's Settlements* [1970] AC 508 at para 518; *In re Hays Settlement Trusts* [1982] 1 WLR 202 at para 210
- 15 Paragraph 72 *Idlecroft v Commissioner of Taxation* [2004] FCA 1087

- 16 Paragraphs 106 and 107 *Idlecroft v Commissioner of Taxation* [2004] FCA 1087
- 17 [2001] FCA 164
- 18 Paragraphs 34 and 35 *BRK (Bris) Pty Ltd v Commissioner of Taxation* [2001] FCA 164
- 19 Paragraph 36 *BRK (Bris) Pty Ltd v Commissioner of Taxation* [2001] FCA 164
- 20 [2007] QSC 154
- 21 Paragraph 14 *Jenkins v Ellett* [2007] QSC 154
- 22 Paragraph 19 *Jenkins v Ellett* [2007] QSC 154
- 23 [2007] QSC 154
- 24 [1998] 1 Qd R 396
- 25 Paragraph 7 *Cavill Hotels Pty Ltd as trustee of the Greg Cavill Family Trust and Anor v Cavill Hotels Pty Ltd and Ors* [1998] 1 Qd R 396.