

Asset protection and trusts



THE EFFECTIVENESS OF DISCRETIONARY TRUSTS AS AN ASSET PROTECTION MECHANISM HAS BEEN ERODED IN RECENT YEARS.

INTRODUCTION

The modern discretionary trust is a relationship between a trustee and a beneficiary pursuant to which the trustee holds property for the benefit of a class of beneficiaries, with a necessary element of the relationship being the separation of the legal and beneficial ownership of the property.

Traditional trust law has long established that the interest of a beneficiary of a discretionary trust in the trust property is neither a proprietary interest nor a mere expectancy in a proprietary interest, nor a contingent interest.¹ This is because regardless whether a trustee is required under the trust deed to fully distribute the trust's income (depending on whether the trustee's power of appointment is a trust power of mere power), a particular member of a class of beneficiaries may not receive any appointment of income.²

As a consequence of these features trusts have historically enjoyed a largely inviolate position in the formulation of tax planning and asset protection strategies.

In the context of Family Law property settlements however, the traditional approach to the sanctity of trusts has been largely disregarded in recent years by the "trust busting" approach adopted by the Family Court of treating trust property as the property of the parties to the marriage (**Parties**) or either of them (**Party**) and making settlement orders accordingly. Whilst this approach has been motivated by the Family Court's desire to achieve an equitable distribution of property amongst the Parties by evaluating the degree of control exercised by a Party over a trust's property,³ it has caused unforeseen asset protection and taxation consequences.

The Family Court's approach has also been adopted in recent years by the Federal Court in assessing receivers' orders⁴ and has the potential to also be applied in the context of bankruptcy hearings.

This article discusses discretionary trusts (sometimes referred to as family trusts) only.

Legislative references are to the *Family Law Act 1975* (Cth) (**FLA**), *Corporations Act 2001* (Cth) (**CA**) and *Bankruptcy Act 1966* (Cth) (**BA**) unless otherwise stated.

THE FAMILY COURT'S APPROACH

Powers in property settlement proceedings

1 Section 79(1)(a) of the FLA – Altering the interests of the parties

Section 79(1)(a) of the FLA empowers the Family Court to make various orders altering the interests of the Parties in property settlement proceedings:

"79(1) In **property settlement proceedings, the court may make such order as it considers appropriate:**

- (a) in the case of proceedings **with respect to the property of the parties to the marriage or either of them— altering the interests of the parties to the marriage in the property;** or

....

including:

- (c) **an order for a settlement** of property in substitution for any interest in the property; and
- (d) **an order requiring:**
- (i) either or both of the parties to the marriage; or

....

to make, for the benefit of either or both of the parties to the marriage or a child of the marriage, **such settlement or transfer of property** as the court determines."

- (2) The court shall not make an order under this section unless it is satisfied that, in all the circumstances, it is just and equitable to make the order...." [emphasis added]

In *Kennon v Spry* [2008] HCA 56 (**Spry**), Gummow and Hayne JJ observed that the reference in s 79 to "the parties to the marriage or either of them" includes a reference to the parties to a marriage terminated by divorce at a time before the court makes its order.⁵

In *Spry*, French CJ made the following observations:

- The word "property" in s 79 is to be read as part of the collocation "property of the parties to the marriage". It is to be read widely and conformably with the purposes of the FLA.⁶
- Dr Spry's retention of the legal title to the trust fund (as trustee) coupled with his power to appoint the whole of the fund to Mrs Spry and her equitable right, resulted in the trust fund remaining property of the Parties for the purposes of s 79.⁷

2 Section 106B of the FLA – Setting aside transactions

Section 106B of the FLA empowers the Family Court to set aside transactions which would have the effect of defeating claims under the FLA.

"106B Transactions to defeat claims

(1) In proceedings under this Act, **the court may set aside** or restrain the making of **an instrument or disposition** by or on behalf of, or by direction or in the interest of, a party, which is **made or proposed to be made to defeat an existing or anticipated order** in those proceedings or which, irrespective of intention, is likely to defeat any such order.

...

3) The court must have regard to the interests of, and shall make any order proper for the protection of, a bona fide purchaser or other person interested..." [emphasis added]

The s 106B powers are exercised where a Party has deliberately attempted to undermine the "trust busting" powers of the Family Court for example, by removing the control that that Party exerts over the trust, effecting a change of trustee, removing beneficiaries or distributing trust assets to other beneficiaries.

In *Spry* the High Court upheld the Family Court's orders pursuant to s 106B to set aside instruments that effectively disposed of Mrs Spry's equitable right to be considered in the application of the trust fund, and which also disposed of trust assets to the children's trusts.

3 Section 90AE of the FLA – Property of third parties

The Family Court is empowered under s 90AE of the FLA (which is contained in Part VIIIAA of the FLA) to alter the ownership of the property of a third party and direct that third party to transfer property to a Party.

"90AE(2) [Other orders court may make]

In proceedings under section 79, the court may make any other order that:

- (a) **directs a third party to do a thing in relation to the property** of a party to the marriage; or
- (b) **alters the rights, liabilities or property interests of a third party** in relation to the marriage." [emphasis added]

In *B Pty Ltd and Others & K and Anor* [2008] FamCAFC 113 (**B Pty Ltd**), the Full Court of the Family Court emphasised that all that s 90AE(2)(b) does is enable the court to adjust the property interests of a third party for the purpose of effecting a division of the property of the Parties, between those Parties.⁸

WHAT IS "PROPERTY OF" THE PARTIES TO THE MARRIAGE OR EITHER OF THEM?

"Property" is defined in s 4(1) FLA in relation to the parties to a marriage or either of them as:

"property to which those parties are, or that party is, as the case may be, entitled, whether in possession or reversion".

In determining what constitutes the "property of" the Parties to the marriage or either of them, the Family Court considers the following matters:⁹

- the assets, liabilities and financial resources of the Parties and their values at the time of the hearing;
- the financial and non-financial contributions made directly or indirectly by or on behalf of each Party;
- the effect of any proposed order upon the earning capacity of each Party;
- matters referred to in subs 75(2) FLA;¹⁰
- other orders affecting a child or either Party;
- whether child support is payable or likely to be payable in the future; and
- whether it is just and equitable to make the actual orders.

The Family Court's approach is motivated by the need to resolve property settlements in an equitable manner between the Parties.

Case Law

In *Simmons and Anor v Simmons* [2008] FamCA 1088 (**Simmons**), Watt J stated that the Full Court has previously emphasised the need to determine such issues in light of contemporary trends and referred to *In the Marriage of Davidson (No 2)* where the Full Court observed that regardless of the position one hundred years ago, Australian courts today have to look at "the reality of the situation and the purpose which family trusts serve today".¹¹

In *Spry*, French CJ considered whether the parties had prior to the 1998 instrument interests in or in relation to the assets of the trust that could answer the description of "property of the parties to the marriage" and made the following observations:¹²

■ The beneficiary of a non-exhaustive discretionary trust who does not control the trustee directly or indirectly has a right to due consideration and to due administration of the trust; it is difficult to value those rights when the beneficiary has no present entitlement and may never have any entitlement to any part of the income or capital of the trust.¹³

■ His Honour agreed with Gummow and Hayne JJ that prior to the 1998 Instrument the equitable rights to due administration of the trust fund and due consideration in relation to the application of the income and capital could be taken into account as part of the property of Mrs Spry as a party to the marriage.¹⁴

■ Dr Spry's power as trustee to apply assets or income of the trust to Mrs Spry prior to the 1998 Instrument could be treated for the purposes of the FLA as a species of property held by him as a Party even though it may not be property according to the general law.¹⁵

■ Although Dr Spry could not apply the assets for his own benefit that did not take them out of the realm of property of a Party for the purposes of s 79.¹⁶

■ The assets of the trust, coupled with Dr Spry's power to appoint them to Mrs Spry and her right to due consideration, were, until the 1998 Instrument, the property of the Parties for the purposes of s 79. The fact that Dr Spry removed himself as a beneficiary by the 1983 Deed did not affect that conclusion. Because the 1998 Instrument effectively disposed of Mrs Spry's equitable right to be considered in the application of the trust fund, and having regard to the trial judge's conclusions about the purpose of the instrument, the order setting it aside was an appropriate exercise of the Family Court's power under s 106B. Mrs Spry's equitable right could then be considered as part of the property of the parties to the marriage.¹⁷

Stephens & Stephens and Anor (Enforcement) [2009] FamCAFC 240 (**Stephens**) concerned an appeal in enforcing the Family Court orders

following the High Court's decision in *Spry*. Dr Spry had an obligation to pay Mrs Spry \$2.182 million. It was reported in the decision that Dr Spry had indicated to the children that he intended to abscond with approximately \$900,000 that he had cashed from the three children's trusts, cash proceeds from the sale of the house and his personal assets in cash; and had further threatened to "burn the money" as a last resort, and had stated that if he was caught by the authorities he would "go to jail rather than see [Mrs Spry] get anything". In the enforcement proceedings, Dr Spry contended that the maximum payment possible was \$1.790 million being the value of *his* net assets. Mrs Spry contended that her entitlement could be satisfied from the assets of the family trust. The Full Court (May, Boland and O'Ryan JJ) in upholding Coleman J's orders attaching to assets of the trust, stated:¹⁸

“ The trial Judge could make an order that granted to one Party an entitlement that exceeded the net individual property interests of the Parties. ”

- The trial Judge could make an order that granted to one Party an entitlement that exceeded the net individual property interests of the Parties.¹⁹
- In circumstances such as in this case, an order could be made by the Family Court for the payment of an amount on the basis that the assets of the trust are within the disposition of the Party who has power to appoint the assets of the trust, even if at the date when the property settlement power is exhausted, the other Party to the marriage by reason of a divorce no longer remains within the class of objects.²⁰
- If it is necessary for the assets of the trust to be attached to satisfy the property settlement entitlement of a Party, such an order could be part of the s 79 order in any subsequent enforcement proceedings.²¹

■ In the event that the assets of the trust are to be used for the purpose of satisfying an entitlement pursuant to the property settlement order, then before making such an order the Court would have "regard to the interests of any third parties who may also fall within the defined class of 'beneficiaries'". If such third parties are children of the marriage and the "origins of the greater part" of the assets of the trust were contributions made by the Parties during the marriage, then the interests of the children may be put aside. However, where persons other than the Parties and the children of the marriage are discretionary objects, such third parties would have standing to oppose the order and it would be for the Court to determine whether it was just and equitable to make the order having regard to the interests of such third parties.²²

Factors relevant to determining what is "property of" a Party

1 Connection between the Party and the Trust

The Family Court treats the assets of a family trust as the property of the Parties or either of them, where the Court can establish a connection between the trust and the relevant Party.

The Courts have found a connection to exist where a Party is the appointor or controller of the trust, where trust property consists of assets accrued during the marriage from the efforts of one or both Parties, and where the Parties are able to directly or indirectly benefit of the trust. These factors are considered below.

2 Control over the Trust

The element of control was a decisive factor in the following decisions:

- In *In the Marriage of Ashton* (1986) 11 Fam LR 457, the husband replaced himself as trustee with a corporate trustee and was sole appointor. He received trust income although he was not a beneficiary of the Trust. He was deemed to be "in full control of the assets of the trust" as he applied the assets and income from them as he wished and for his own benefit.²³
- In *In the Marriage of Goodwin* (1990) 14 Fam LR 801, the husband was the sole appointor and was a beneficiary to whom the trustee could make payments exclusively.
- In *Ascot Investments Pty Ltd v Harper* (1981) 148 CLR 337, although the High Court accepted the submission of the appellant company that as a consequence of restrictions imposed by the memorandum and articles of association of the company, the husband could not compel the registration of the transfer of his shareholding to the wife and the appellant and its directors could not be ordered to register the transfer of shares, Gibbs J made the following observation:²⁴

"20 ... if a company is completely controlled by one party to a marriage, so that in reality an order against the company is an order against the party, the fact that in form the order appears to affect the rights of the company may not necessarily invalidate it.

21. Except in the case of shams, and companies that are mere puppets of a party to the marriage, the Family Court must take the property of a party to the marriage as it finds it. The Family Court cannot ignore the interests of third parties in the property, nor the existence of conditions or covenants that limit the rights of the party who owns it... Thus, in the present case, the Court must deal with the husband's shares in Ascot Investments as they in fact are, that is, as shares in a company whose memorandum and articles contain a restriction on transfer."[emphasis added].

3 Accumulation of trust assets during the marriage

The accumulation of trust assets during the course of a marriage from the efforts of one or both Parties and their ability to benefit from the trust was a key factor in the recent High Court decision of *Spry*, where French CJ stated:²⁵

[65] Where property is held under a non-exhaustive discretionary trust with an open class of beneficiaries by a party to a marriage and the property has been acquired by or through the efforts of that party or his or her spouse, whether **before or during the marriage**, it does not, in my opinion, necessarily lose its character as “property of the parties to the marriage” because the party has declared a trust of which he or she is trustee and can, under the terms of that trust, give the property away to other family or extended family members at his or her discretion.

...

[70] The characterisation of the assets of the trust, coupled with Dr Spry’s power to appoint them to his wife and her equitable right to due consideration, as property of the parties to the marriage is supported by particular factors. It is supported by his legal title to the assets, **the origins of their greater part as property acquired during the marriage**, the absence of any equitable interest in them in any other party, the absence of any obligation on his part to apply all or any of the assets to any beneficiary and the contingent character of the interests of those who might be entitled to take upon a default distribution at the distribution date.”

In this case Keifel J stated that “property” is to be read as including those assets to which the parties have contributed throughout the course of their marriage and which are held for their use and benefit and found that the trust’s assets constituted property, much of which was obtained by way of the parties’ contributions to the marriage.²⁶

4. Potential to benefit from trust assets

The use of trust assets for the benefit of one or both of the Parties was also a factor in *In the Marriage of Goodwin*²⁷ discussed above.

The recent decision of the Full Court of the Family Court in *Essex v Essex* [2009] FamCAFC 236 (**Essex**), illustrates that the *possibility* of benefitting from a trust even in the absence of receiving actual distributions, may suffice to include a trust’s assets as part of the financial resources of a party. This case concerned an appeal by the wife seeking orders that the assets be divided 70%:30% in her favour and that the assets of two family trusts (the N Trust and the S Trust) be treated as a financial resource of the husband. The trust funds were constituted by gifts from the husband’s parents and

established to provide for the husband’s mother’s living expenses after the Parties separated. The husband had not received any distributions from either trust and only managed the day-to-day affairs of the corporate trustee of one of the trusts in his brother’s absence. The Family Court found that it was possible but unlikely that income from the N Trust would be available for distribution to the husband and the wife as the trust was primarily set up to provide the capital for the benefit of the parties’ children; and that it was unlikely that either party would receive any capital from the S Trust, that neither party had a legal or equitable right to the S Trust’s capital or income, and that the inclusion of the husband as a general beneficiary did not give the husband any interest in the property contained within the trust and that the trusts did not constitute a financial resource of the husband.²⁸ On appeal to the Full Court, Bryant CJ and Boland J found that the assets of the S Trust should have been treated as a financial resource of the husband’s as there was compelling evidence that the husband would receive distributions from the S Trust at the conclusion of the proceedings.²⁹

- The purpose of providing the husband’s mother with an aged pension and preventing her making imprudent investment decisions could have been achieved by the settling of one trust only.

- The difference in the provisions of the two trust deeds was relevant. The beneficiaries named in the N Trust deed evinced a clear intention in the drafting of that trust to benefit the husband’s brother and his wife. As they did not have children, the wide class of general beneficiaries (who were not named) was readily appreciable. The S Trust deed evinced a clear intention that the capital of that trust be distributed on vesting, or at such earlier time as the trustee may determine, to the two children of the marriage, the grandchildren of the husband’s mother. It also disclosed a clear intent that the husband, as one of the three named income beneficiaries, was entitled to be considered to receive distributions of income until the vesting of the trust.

- The husband had the effective day-to-day operation of the trusts for

a period of approximately 18 months and was well aware of the assets of the trusts.

- The husband’s brother’s evidence did not demonstrate that the husband would never receive income, or even that he was unlikely to receive income from the trusts.

- When the husband’s brother chose to borrow approximately \$135,000 from trust assets he did so from the assets of the N Trust, implying that the assets of S Trust were to remain intact for the income and capital beneficiaries of that trust.

- As the sole director of the corporate trustee of the S Trust the husband’s brother had control of that trust and was only obliged to consider the husband as one of the three income beneficiaries entitled to the income of the trust, and conceded that, but for the property proceedings the husband should have the benefit of assets in the trusts.

As a consequence of these decisions, it would seem that very few family trusts would be protected from the reach of the Family Court.

5 Lack of connection between a Party and the Trust

The trust property will **not** be treated as the property of the Parties or one of them where there is no connection between the trust and the relevant Party.

Such situations include where a Party is not the settlor, appointor or beneficiary and cannot assert any legal or equitable right in respect of the trust property.³⁰ However, as the case of *Essex* illustrates, trust property may still be taken into account as a financial resource of the parties and so have some effect on the final division of property.³¹

A lack of connection was also relevant in the context of third party property rights in the case of *B Pty Ltd* where the Full Court found that there was no nexus between the husband’s chose-in-action as a beneficiary and the trust assets which gave the husband any proprietary interest in those assets.³²

6 Trusts established by parents of a Party

If the Family Court's emphasis is on assets accumulated by the trust *during the course of a marriage*³³ then arguably a trust's property is not that of the Parties where the trust was established and its assets accumulated, by the parents of one Party *prior* to the marriage.³⁴

However, the decisions in *Simmons, Coventry v Coventry & Smith* [2004] 181 FLR 220 (**Coventry**) and *Milankov and Milankov* (2002) 28 Fam LR 514 (**Milankov**) have challenged this notion in situations where there is a connection between the trust's assets and a Party and where the element of control is present. Further, where the requisite degree of control is present, property held under trust by a Party that has been acquired *before* a marriage would also be included within the ambit of "property of" the Parties following French CJ's judgment in *Spry*.³⁵

Simmons concerned an application by the trustee company for summary dismissal of the wife's amended application for final orders under Pt VIII A of the FLA. The trust was established by the husband's father and the beneficiaries included the husband's mother, the husband and his siblings, their spouses and their children. The husband was not a director of the trustee company nor an appointor. The Court considered whether the husband's interest as a beneficiary of the trust was property for the purposes of s 79 FLA. Watt J held determined that there was a connection between the trust's assets and the husband as although the genesis of the trust's assets could be attributed to the husband's father, the original corporate structure included the husband as a substantial shareholder and his shares had been converted into interest free loans to the trust that did not require repayment until 35 years after they were advanced, thus representing a significant investment in the trust by the husband.³⁶ Accordingly there was a sufficient nexus between the assets of the trust and the property of the Parties for the Court to find that Part VIII A applied and was available to enable orders binding third parties to be made.³⁷

In *Coventry*³⁸ the trust was established by the husband's father for the benefit of the husband and his family (including

the wife). The husband's mother was sole trustee following the father's death. Although the husband had received no trust distributions, the assets of the trust were included in the property settlement as the husband was perceived to control the assets of the trust by virtue of his position as appointor.

In *Milankov*³⁹ the Court found that whilst the husband did not at the time of the hearing control the trust established by his father, under the terms of the trust he would control of the trust's assets following his father's death and would therefore have the ability to distribute the assets to himself.

WHAT IS "PROPERTY" IN THE CONTEXT OF RECEIVERS' ORDERS?

In *Re Richstar Enterprises Pty Ltd (ACN 099 071 968) And Others; Australian Securities And Investments Commission v Carey And Others*⁴⁰ (**Richstar**), the Federal Court adopted a similar approach to that of the Family Court.

In this case ASIC sought appointment under s 1323 CA of receivers to the property of certain officers and former officers of companies in the Westpoint Property and Finance Group. In April 2006, orders were made appointing receivers and also for the disclosure of assets and liabilities. ASIC subsequently sought to amend the receivers' orders in respect of certain defendants to include property held by a third party as trustee for any trust of which a defendant was a beneficiary, including a superannuation fund.

ASIC submitted that the beneficiary under a discretionary trust has a contingent interest within s 9 CA and that the court could make the orders sought on this basis.

Section 1323(1)(h) CA provides that:

"The Court may, upon application by ASIC or by the aggrieved person, make one or more of the following orders:

...

(h) an order appointing:

(i) if the relevant person [in this case each of the Individuals] is a natural person – a receiver or

trustee, having such powers as the Court orders, of the property or of part of the property of that person ..."

The definition of "property" in s 9 CA reads:

"Property means any legal, equitable estate or interest (whether present or future and whether vested or contingent) in real or personal property of any description and includes a thing in action."

At issue was whether the property of the trusts of which the individuals were beneficiaries could be classed as property of the individuals themselves, or whether the beneficiaries had an interest in the assets of those trusts sufficient to constitute property so that those interests could be the subject of the appointment of receivers.

French J (as his Honour was then) departing from traditional trust law concepts made the following comments:⁴¹

- In the ordinary case, the beneficiary of a discretionary trust other than the beneficiary of an exhaustive trust, does not have an equitable interest in the trust income or property which would fall within the definition of property in s 9 and be amenable to control by receivers under s 1323.⁴²
- The "ordinary case" is to be distinguished from the case in which the beneficiary effectively controls the trustee's power of selection – then there is something akin to a proprietary interest in the beneficiary.⁴³
- A beneficiary of a discretionary trust at arm's length from the trustee does not have a contingent interest but rather an expectancy or mere possibility of a distribution.⁴⁴
- Where a discretionary trust is controlled by a trustee who is the alter ego of a beneficiary, a contingent interest may be identified as it is as good as certain that the beneficiary will receive the benefits of distributions.⁴⁵
- A beneficiary who effectively controls the trustee's power of selection because he is the trustee or one of them and/or has the power to appoint a new trustee has something approaching a general power and ownership of the trust property.⁴⁶

WHAT IS "PROPERTY" IN THE CONTEXT OF BANKRUPTCY?

The trustee in bankruptcy is entitled to claim the debtor's property owned at or acquired after the commencement of bankruptcy.

“Property” is defined in s 5(1) *BA* as:

“**property** means real or personal property of every description, whether situate in Australia or elsewhere, and includes any estate, interest or profit, whether present or future, vested or contingent, arising out of or incident to any such real or personal property.”

This definition is similar to that in the *CA* and both definitions refer to contingent interests. The effect of the decision in *Richstar* (and subsequently that of *Spry*) could represent a considerable expansion of the property amenable to distribution by the Bankruptcy Trustee.⁴⁷

GENERAL LAW CONTEXT VS FAMILY LAW DECISIONS AND RICHSTAR

In contrast to the approach adopted in *Richstar* and *Spry*, the subsequent decision of the Supreme Court of New South Wales in *Public Trustee v Smith* [2008] NSWSC 397 (**Smith**) is consistent with established trust and equity principles, and emphasises that the appointor or controller of a trust is not the beneficial owner of the trust’s property.

In this case a gift by the testatrix Dr Ward, of a house she described in her will as “my property” was held to be ineffective because the property was owned by the corporate trustee of a family trust, even though the testatrix was the sole shareholder and director of the trustee company and controlled the trust. Dr Ward was not the sole beneficiary or beneficial owner of the property. White J denied that Dr Ward as controller of the company was beneficially entitled to the trust’s assets:

“Indeed, to say that a person who controls a trustee which holds property on trust for others, rather than the beneficiary of the trust, is beneficially entitled to the trust property, is inconsistent with the very notion of a trust.”⁴⁸

His Honour distinguished between the general law context and the family law decisions, observing:

“It is perfectly understandable that in the context of s 79 the expression “property of the parties to the marriage or either of them” should be read as extending not only to property owned by a party to the marriage but also property controlled by a party to the marriage where the control is such as to put the party in the same position as if he or she were the owner of the property. That is how I understand the

family law cases to have proceeded. . . . This is the context in which the family law cases must be read. In my view, **they do not support the wider proposition that as a matter of general law an object of a discretionary trust can be described as the beneficial owner of the property held by the trustee, merely by virtue of his or her being a discretionary object and also controlling the trustee.**⁴⁹”
[emphasis added]

His Honour also accepted that in the context of receiver orders, the notion of property could be extended to **property effectively owned by a person for the same reasons as discussed in the family law cases concerning s 79 of the FLA**, but observed that *Richstar* did not establish that because a discretionary beneficiary controls the appointment or removal of the trustee, or controls the exercise of the trustee’s powers, that person is the beneficial owner of the trust property, irrespective of the terms of the trust deed.⁵⁰

“[138]. . . . **In my view, there is very sound reason for construing the expression in s 1323(1)(h)(i) “an order appointing a receiver or trustee of the property of [the relevant person]” as extending not only to property actually owned by the relevant person but property effectively owned by him or her, for the same reasons as discussed in the family law cases concerning s 79 of the Family Law Act.** However, I do not understand *ASIC v Carey (No 6)* to establish that because a beneficiary of a discretionary trust controls the appointment or removal of the trustee, or controls the exercise of the trustee’s powers and can appoint trust property to himself or herself, that the holder of such a power is the beneficial owner of the trust property irrespective of the terms of the trust deed.” [emphasis added]

Any concerns that *Richstar* may have broader implications in determining whether beneficiaries of a discretionary trust have an interest in the trust have been somewhat alleviated by Goldberg J of the Federal Court in *Kawasaki (Australia) Pty Ltd v Arc Strang Pty Ltd* [2008] FCA 461 (**Kawasaki**). *Kawasaki* concerned a pre-emption procedure in a Shareholders Agreement in relation to a transfer of shares in a joint venture company. His Honour commented on the impact of the decision in *Richstar* and confined its effect to the CA:⁵¹

“74. The relevant principle was recently re-stated by Hollingworth J in *Lygon Nominees Pty Ltd v Commissioner of State Revenue* (2005) 60 ATR 135 at [58]:

“Neither the right to due administration of the trust nor the fiduciary obligations owed by the trustee is capable of making the object of a power of appointment into a ‘beneficial owner’ of the subject matter of the trust. The right of an object to take legal proceedings to prevent a disposal of income or capital by the trustee to persons outside the designated object does not involve the assertion of a proprietary right by the object and does not require the conclusion that the object has a proprietary interest in particular assets within the fund or is a ‘beneficial owner’ of such assets”.

75. There is nothing in the reasoning of French J in *Australian Securities and Investments Commission v Carey (No. 6)* (2006) 153 FCR 509 which doubts these principles in relation to the nature of interests in or under a discretionary trust. French J was concerned with the content and extent of a contingent interest for the purposes of s 9 of the Corporations Act 2001 (Cth).”

The decision in *Lygon Nominees* was affirmed by the Victorian Supreme Court of Appeal in *Lygon Nominees Pty Ltd v Commissioner of State Revenue* [2007] VSCA 140.

CONSEQUENCES FOR ASSET PROTECTION

Whilst the decisions in *Smith* and *Lygon Nominees* reinforce traditional trust law principles they do not preclude the continual erosion of the asset protection afforded by discretionary trusts. In *Smith* White J commented that s 79 FLA and s 1323(1)(h)(i) CA provided an exception to the general law position.⁵²

Following the decisions in *Richstar* and *Spry*, it would seem that where an individual exerts a considerable degree of control over a trust (for example, as the appointor of the trust, or as the sole director and shareholder of a corporate trustee, and of relevance in the context of receivers orders and bankruptcy, as the spouse of such a person⁵³), they have a greater capacity to benefit from the trust and therefore it is more likely that the Court would construe the trust’s assets as “property of” that individual.

1 Independent appointor

One strategy to consider is to have an independent individual (such as a trusted business adviser, accountant or lawyer) assume the role of appointor of the trust.

The extent of the trustee's control of the trust property may be restricted by expanding the role of the appointor to include a requirement for the trustee to obtain the appointor's consent for significant distributions of capital, variations or amendments to the trust deed, bringing forward the vesting date and obtaining asset protection advice from a lawyer or accountant with expertise in that area prior to winding up the trust prior to the vesting date.⁵⁴

If the trust has an independent appointor and a corporate trustee, of which the bankrupt's spouse is the sole shareholder and director and the bankrupt is an excluded beneficiary it may be difficult to argue in the context of bankruptcy proceedings and receivers' orders that on *Richstar* principles, the trust's assets are the "property of" the bankrupt.⁵⁵

However, it may be arguable that the bankrupt does benefit from the trust if, the trust has previously distributed income and/or capital to a second family trust in which the bankrupt is a beneficiary, and that second trust has made distributions to the bankrupt.⁵⁶

Also, the operation of Part VIIIAA of the FLA has perhaps diminished the effectiveness of using an independent appointor in the Family Law context.

2 Property acquired by the parties to the marriage during the marriage

The majority of the High Court in *Spry* considered it relevant that the trust property was acquired by the Parties during the marriage.

Subject to the comments below, the decision in *Spry* and the subsequent decision of the Full Court of the Family Court in *Stephens* enhance the importance of testamentary trusts in protecting assets from FLA property settlement orders. Where a testamentary trust has been established by a parent of one of the Parties for the benefit of that child and their family, the assets of the testamentary trust should be protected to a greater degree from FLA orders as those assets were not

contributed by the Party (cf. traditional inter vivos discretionary family trust).

■ Where there is a high degree of similarity between a testamentary trust and a traditional inter vivos discretionary family trust and the discretionary trust has been in existence for a long time, the Family Court may treat its assets as part of the pool, especially where a separate testamentary trust has been established for each adult child and their family.⁵⁷

“*Spry* and the subsequent decision in *Stephens* enhance the importance of testamentary trusts in protecting assets from FLA property settlement orders.”

■ The assets of a testamentary trust may be exposed where an adult child contributed to the growth in the assets of the trust.⁵⁸

Consequently, there is potential for a testator to prefer to establish a single testamentary trust for all of his or her children and to provide for more than one child to control the trust so as to limit the exposure to family law claims that could otherwise result where each child is the primary beneficiary of his or her own testamentary trust. However, this practice could result in increased pressure on an individual the subject of family law property settlement proceedings from his or her siblings (who are also the primary beneficiaries of the testamentary trust) to settle family law property claims out-of-court.

Ultimately testators will need to balance objectives of asset protection, flexibility and ease of administration. If they elect to use a single testamentary trust they need to consider the implications of all the assets of a second generation being potentially exposed to the risks of a Family Court action if one member of the second generation were to suffer relationship difficulties.

3 Inheritances, gifts, bequests and loans

Inheritances, informal loans and gifts and bequests made to a Party during the marriage may be construed by the Family Court as having been made for the benefit of that Party's family generally and could thereby be treated as property acquired by the Parties during the marriage or alternatively as a financial resource of one of the Parties.

Consideration should be given to the adoption of the following strategies:

■ the gift giver or testator documenting their intention that the gift or bequest be for the sole benefit of the recipient and for the recipient to isolate the gift/bequest by retaining it in their sole name and/or in a separate bank account. Whilst this strategy could be effective in a Family Law context (although query whether the gift or bequest could not still be treated as a financial resource of the relevant Party), it would have limited use in the context of bankruptcy proceedings as the assets would then be clearly the assets of the debtor.

■ loans from family members being documented in written loan agreements, repayments being made pursuant to the agreement and the lender registering a mortgage or charge over the borrower's real or personal property so as to emphasise formality.

CONCLUSION

Recent Family Law decisions such as *Spry*, *Stephens* and *Essex* and the Federal Court decision in *Richstar* have the potential to limit the effectiveness of trusts as effective tax planning and asset protection mechanisms.

There has been some concern that these decisions may have broader implications in determining whether discretionary objects of a discretionary trust have an interest in the trust. Those concerns appear to have been somewhat alleviated by the Federal Court in *Kawasaki*, the Victorian Supreme Court in *Lygon Nominees*, and the New South Wales Supreme Court in *Smith*, in each of which traditional trust law principles were applied and the case of *Richstar* confined to its facts and the CA context.

However, the threat remains a cause for concern. The law in this area is dynamic and courts are not limited to traditional trust law principles when considering equity, as is evident in both the *Richstar* and *Spry* decisions. Going forward, professional advisers need to be more vigilant when formulating strategies to address unforeseen taxation and asset protection consequences.

*Renuka Somers, FTIA, Lawyer
Harwood Andrews Lawyers*

Reference notes

- 1 Refer *Gartside v IRC* [1968] AC 553 at 617-618, *In re Weir's Settlement Trusts* [1971] 1 Ch 145, *Sainsbury v IRC* [1970] 1 Ch 712 and *In re Beckett's Settlement* [1940] 1 Ch 279.
- 2 See *Jorgensen R, and Somers R, Trust practices under threat! Discretionary trust interests: the Westpoint litigation*, Taxation Institute of Australia, 13 September 2006, p 8.
- 3 Refer *Simmons and Anor v Simmons* [2008] FamCA 1088 at paras 115-123; *In the Marriage of Davidson (No 2)* (1990) 101 FLR 373
- 4 *In Re Richstar Enterprises Pty Ltd (ACN 099 071 968) and Others; Australian Securities And Investments Commission v Carey And Others (No 6)* [2006] FCA 814.
- 5 *Kennon v Spry* [2008] HCA 56 at para 128.
- 6 [2008] HCA 56 at para 64.
- 7 [2008] HCA 56 at para 66.
- 8 [2008] FamCAFC 113 at para 39 referring to the decision in *Hunt v Hunt and Others* (2007) 36 FamLR 64.
- 9 Refer *In the Marriage of Lee Steere* (1985) FLC 91-626; *In the Marriage of Ferraro* (1993) FLC 92-335; *In the Marriage of Clauson* (1995) FLC 92-595; *BH & PH* [2006] FMCAFAM 167 at para 7.
- 10 Section 75(2) FLA lists the matters that the Family Court must take into account, including amongst other factors, the Parties' age, state of health, income, property and financial resources, financial commitments, child custody arrangements, standard of living, maintenance payments, arrangements for payment of creditors and receipts of pensions, allowances and benefits.
- 11 [2008] FamCA 1088 at paras 115-116; *In the Marriage of Davidson (No 2)* (1990) 101 FLR 373 at 382.
- 12 *Kennon v Spry* [2008] HCA 56 at paras 77-80.
- 13 *Kennon v Spry* [2008] HCA 56 at para 77.
- 14 *Kennon v Spry* [2008] HCA 56 at para 78.
- 15 *Kennon v Spry* [2008] HCA 56 at para 79.
- 16 *Kennon v Spry* [2008] HCA 56 at para 79.
- 17 *Kennon v Spry* [2008] HCA 56 at para 81.
- 18 [2009] FamCAFC 240 at paras 348-361.
- 19 [2009] FamCAFC 240 at para 350.
- 20 [2009] FamCAFC 240 at para 350.
- 21 [2009] FamCAFC 240 at para 352.
- 22 [2009] FamCAFC 240 at para 361.
- 23 (1986) 11 Fam LR 457 at 461.
- 24 (1981) 148 CLR 337 at 354-355.
- 25 [2008] HCA 56 at 274-275.
- 26 [2008] HCA 56 at 317.
- 27 (1990) 14 Fam LR 801.
- 28 *Essex & Essex (No. 2)* [2007] FamCA 639 at paras 99-101.
- 29 *Essex v Essex* [2009] FamCAFC 236 at paras 168-174.
- 30 *In the Marriage of Kelly (No 2)* (1981) 7 Fam LR 762.
- 31 See also *In the Marriage of Kelly (No 2)* (1981) 7 Fam LR 762 and *McDonald. A., Trust Busting (Including Bamford): Unscrambling the egg: current tax and trust issues in family law*, Taxation Institute of Australia, 4 August 2009 at p.4.
- 32 [2008] FamCAFC 113.
- 33 *Kennon v Spry* 2008] HCA 56 at p.274.
- 34 *McDonald, op. cit.* p.15.
- 35 *Kennon v Spry* 2008] HCA 56 at para 64.
- 36 [2008] FamCA 1088 at paras 119-121.
- 37 [2008] FamCA 1088 at para 123.
- 38 [2004] 181 FLR 220; FAMCA 249.
- 39 (2002) 28 Fam LR 514 ; FLC 93-095.
- 40 [2006] FCA 814.
- 41 Referring to the decisions in *R & I Bank of Western Australia Ltd v Anchorage Investments Pty Ltd* (1992) 10 WAR 59 and *Gartside v Inland Revenue Commissioner*; [1968] AC 553 and the family law cases of *Ascot Investments Pty Ltd v Harper* (1981) 148 CLR 337, *In the Marriage of Ashton* (1986) 11 Fam LR 457, and *In the Marriage of Goodwin* (1990) 101 FLR 386.
- 42 [2006] FCA 814 at para 29.
- 43 [2006] FCA 814 at para 29.
- 44 [2006] FCA 814 at para 36.
- 45 [2006] FCA 814 at para 36.
- 46 [2006] FCA 814 at para 37.
- 47 A more detailed discussion of this aspect of the decision is included in *Jorgensen. R, and Somers. R, op. cit., p 17.*
- 48 [2008] NSWSC 397 at para 105.
- 49 [2008] NSWSC 397 at para 125.
- 50 [2008] NSWSC 397 at para 138.
- 51 [2008] FCA 461 at paras 74-75.
- 52 [2008] NSWSC 397 at para 125.
- 53 As was the case in *Richstar* where the defendants' various roles as directors and secretaries of the trustee companies, appointors and as spouses of appointors gave them the requisite contingent interests in the assets of the trusts.
- 54 *Morton, A. A Matter of trusts: Family Court third party powers*, Taxation in Australia, Vol 43, No.11, p.654.
- 55 See *Butler, M. Trust Busting (including Bamford): Protecting discretionary trusts following Richstar, Cummins and Spry*, Taxation Institute of Australia, 4 August 2009, p 12.
- 56 *ibid.* p 13.
- 57 *McDonald, op. cit.* p 16.
- 58 *Coventry v Coventry* [2004] Fam CA 249.