

Inter-generational transition of equity – considering trusts in a succession context

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1 INTRODUCTION

The intention of this paper is to address issues arising in the inter-generational transition of equity and in particular considering trusts in a succession context. The paper is given in the context of a half day seminar series in which several of the other sessions address similar elements of the planning aspects of inter-generational transitions of equity. As such the majority of the paper addresses the more unique aspects of applying these principles in the context of trust structures and in particular the common discretionary trust.¹

As such the key topics can be divided as follows:

1. Planning

- Understanding the process of equity transition: Enhancing facilitation and communication.
- Getting it on the agenda: Why it is important to transition the equity of a family business ahead of the estate plan.
- Discussing the pitfalls and critical issues to cross: Tax, funding and achieving consensus between generations.

2. Implementation

- Considering trusts and how you deal with them in a succession context.

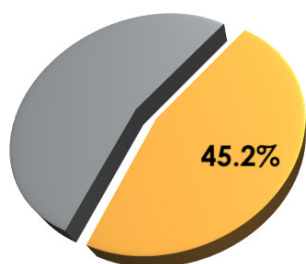
1.1 The landscape

It is sensible to first consider the current circumstances of family businesses in Australia in respect of which we are to consider these issues.

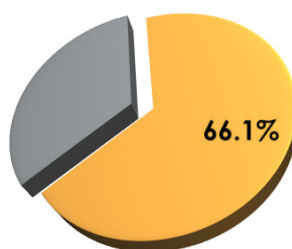
A useful publication to assist with that process is the MGI Australia Family and Private Business Survey 2010. This is the seventh such major survey of Australian businesses. The survey is conducted by Mr. Lucio E. Dana and Professor Kosmas X. Smyrniotis of RMIT, Melbourne in conjunction with MGI.

The survey involves a 113 item questionnaire and a random sample of 5,000 Australian family businesses. The sampling takes into account location by state, industry, number of employees and uses sales turnover to look at small-to-medium enterprises (SMEs).

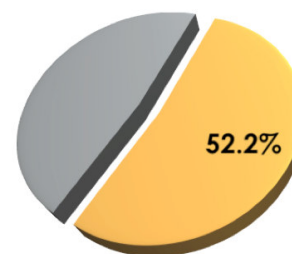
Importantly, for the purposes of issues of inter-generational transitions of equity, the following charts report key findings of the survey.²



Family business owners who see themselves working in the business beyond 65 years of age



Businesses were not exit or succession ready



Do not intend to do something about it in the next 12 months

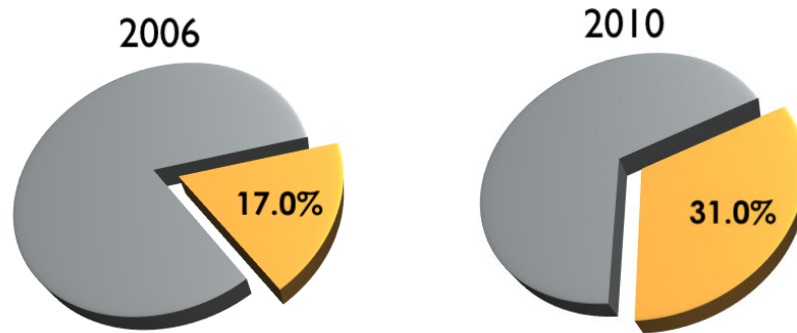
¹ Sometimes referred to as a family trust although as this has a very specific taxation meaning the term is avoided in this paper unless it is being discussed in a taxation context.

² The MGI Australian Family and Private Business Survey 2010



Further, in addition to the apparent poor state of succession planning in family businesses, the survey noted that there significant problems looming in the ability for current business owners to retire. When asked about whether they had an adequately funded retirement program, business owners answered as noted below, illustrating a marked increase on the affirmative response from prior to the Global Financial Crisis.

Business owners without an adequately funded retirement program.³



1.1.1 Critical issues and challenges

When asked about the critical issues and challenges facing business owners they replied as follows.⁴

Most critical issues/challenges confronted by family businesses	(%)
Communication between family members	39.7
Letting go of leadership/ownership control	39.7
Providing liquidity for family owners to exit	36.7
Securing adequate capital for growth and retirement	34.2
Choosing a suitable ownership structure for next generation	29.1
Selecting a leadership successor	25.3
Family conflict management and resolution	21.9
Developing effective processes for shared family control	13.9
Expectations of family owners not active in the business	7.6
Controlling factional orientation of family branches	2.1

Again, issues relevant to succession planning and the inter-generational transition of equity dominated the top responses.

³ *Ibid.*

⁴ *Ibid.*

1.2 Understanding the process of equity transition: Enhancing facilitation and communication

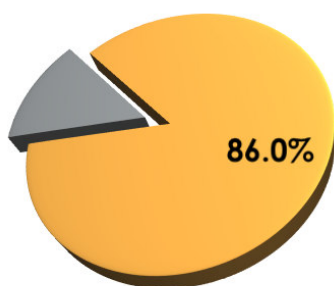
The process of equity transition is fundamentally linked to communication within the family. The process can involve:

- setting rules to strengthen interpersonal relationships and manage the expectations of family members;
- establishing policies to deal with predictable issues before the need arises; and
- holding regular family meetings to share information, build trust, avoid politics, and achieve consensus.

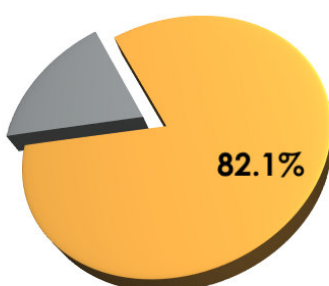
The objective is to achieve a harmonious and fair transition to the next generation whilst ensuring the continuity of the business.

However, again, Australian family businesses seem to fail to adopt such important measures if the results of the MGI Australian Family and Private Business Survey 2010 are an accurate guide.

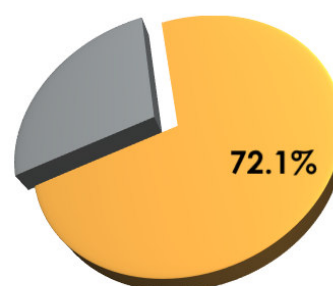
1.2.1 Survey response from family business owner managers



Have not set rules to strengthen interpersonal relationships and manage the expectations of family members



Have not established policies to deal with predictable family-in-business issues before the need arises



Do not hold regular family meetings to share information, build trust, avoid politics, and achieve consensus

1.3 Getting it on the agenda - Why it is important to transition the equity of a family business ahead of the estate plan

If a family business owner simply plans to transition equity by the will then they are placing both the continuity of the business and the future harmony of the family at significant risk.

By “getting it on the agenda” early, families can specifically put into action plans to ensure that these issues are adequately addressed.

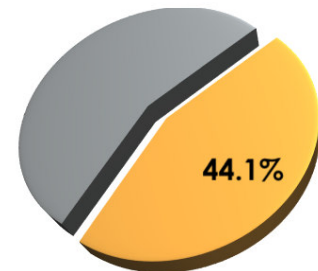
In respect of the objective of ensuring the continuity of the business, early planning may enable:

- the next generation to gain sufficient experience from being engaged in other businesses such as to allow them to introduce new ideas to the family business;
- the successful transition of operational control by ensuring that the next generation has established the respect and loyalty of current non-family member managers and staff; and
- the next generation to acquire sufficient experience in the business, its people, processes and operations - the “know how” of the business before such time that they are expected to put those skills and that knowledge into action.

In relation to the objective of maintaining or ensuring harmony within the family, transitioning equity ahead of the estate plan enables the family to:

- ensure that there is an appropriate balance of interests of beneficiaries of the estate actively involved in the business with those involved in other pursuits;
- plan how the various family entities are to be managed and administered;
- determine the ability of those involved in the business to “buy out” any interest of the others including adopting or formulating agreed valuation methodologies;
- address the separation of passive non-business assets from the risks of the business; and
- set a point in time to achieve an agreed valuation for the business interest.

However, despite those significant advantages, a significant majority of family business owners do not intend to transfer some equity in the business to younger generation family members during their lifetime.⁵



1.4 Discussing the pitfalls and critical issues to cross - Tax, funding and achieving consensus between generations

When the issue of inter-generational transition of equity does make it “onto the agenda”, then a series of critical issues must be addressed. They involve taxation, funding and also achieving consensus between the generations.

1.4.1 Tax

Taxation issues are specifically addressed elsewhere in this business succession program. However, in brief, the key issues to be addressed concern the ability to defer (by roll-overs) or apply concessions (such as the small business capital gains tax concessions) to any taxation event triggered by the succession plan.

Poor planning may trigger a significant liability to taxation that perhaps need not have been incurred at all if either the succession plan had been structured in such a way as to not trigger any taxation events or if taxation events needed to be triggered they were managed in such a way that either the taxation consequences of the event were deferred until an ultimate realisation event involving a sale to a third party (for example) or the taxation consequences of the event could be mitigated by the appropriate application of available concessions and exemptions from taxation.

1.4.2 Funding

Again, issues concerning funding are addressed in the session relating to buy/sell agreements. However families will also need to consider issues such as:

- the ability of the next generation to borrow to the same extent or on the same terms as the current generation given the lack of an existing “track record”, or insufficient assets for the purpose of guarantees; and
- the estate plan implications of capital growth assets vs. income producing business assets and how the entitlements to these assets as they pass to the next generation can

⁵ *Ibid.*



place some members of the next generation at disadvantage as compared to other members, particularly where capital growth assets are heavily geared making their viability as an investment even more precarious should there be fluctuations in the interest rate. The ability of the current generation to absorb such losses or financial stretch through the mix of both passive and active assets is not necessarily available to the next generation when those asset classes are split.

1.4.3 Achieving consensus between generations

A critical to issue to manage in addressing the inter-generational transition of equity is the challenge of achieving consensus between generations.

The active involvement of family members in the business itself is an issue, but this is further complicated when you consider who is likely to succeed the current manager of the business and then how these people relate to one another and then the members of the family who continue to have a passive interest in the business.

The involvement of family members in the business was addressed in the MGI Australian Family and Private Business Survey 2010. They found the results identified in the table below.⁶ This clearly presents a challenge both between generations but also between sexes.

In relation to generational conflict, consider the result that the spouse is the most actively involved family member in the business at the present time and yet the son is the most likely to succeed the CEO (27.4% as compared to 14.2%).⁷

In relation to conflict amongst the family members consider the disproportionate involvement of make members of the family whether they are sons vs. daughters or brothers vs. sisters. In both cases the male members of the family are involved in the business to a much greater extent today but also as expected in the future succession in the business.

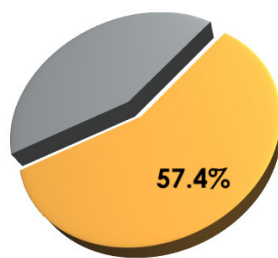
Family member	Most actively involved in the business(%)	Most likely to succeed the CEO (%)
Spouses	35.4%	14.2%
Sons	35%	27.4%
Brothers	8.8%	8.0%
Daughters	5.9%	5.3%
Sisters	1.6%	0.9%

And this takes place in an environment where the majority family business owners intend to keep the business in continuous family ownership and do not intend to differentiate between “active” and “passive” family members.⁸

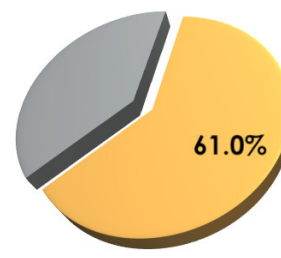
⁶ *Ibid.*

⁷ *Ibid.*

⁸ *Ibid.*



Intend to keep the business in continuous family ownership



Do not intend to differentiate between 'active' and 'passive' family members

There are no clear guidelines or template that can be simply rolled out and applied to every family business to allow them to address these issues. Indeed, such a process is fraught with danger. Awareness of the issues is the first important step. Another is the ability to learn from the experience of family businesses that have successfully achieved inter-generational transitions of equity and have continued to thrive whilst under the control of the second, third and later generations.

The approach of framing these items as “lessons learned” rather than “best practice” is supported and endorsed in the work of Lucio Dana and Kosmas Smyrniotis in their article “Family business best practices: Where from and where to?” in the *Journal of Family Business Strategy*.⁹ They make the following comments in their conclusion:¹⁰

The success and longevity of those businesses as performance outcomes were the result of an incredibly complex array of attributes and factors that operated simultaneously over long periods of time, making it virtually impossible to distinguish the effect that any one of them could have had on the final outcomes from any other. The factors at work would have been so many, and so varied as to make it extremely difficult to identify which ones actually led to their success and longevity without extensive, extended, and rigorous empirical investigation, if such investigation were possible. Accordingly, we have questioned whether, without further supporting and verifiable evidence, the retrospectives of current owner-managers of a minority of successful, long-lasting family businesses are a sufficient basis for the characterization as best practices of lessons they may have learned over time; evidence that would enable others to replicate and corroborate findings.

Based on those findings they conclude:¹¹

Given the problematic nature of, and difficulties with, the concept best, we conclude that when identifying practices designed to improve the performance of family businesses, it might be preferable to continue employing the expressions *insights*, *principles*, and *lessons* that are quite adequate for the purpose. Alternatively, the expressions *promising* or *proactive practices* might be appropriate, unless and until additional verifiable empirical evidence is obtained and presented that warrants referring to those practices as best practices.

The MGI Australian Family and Private Business Survey 2010 identifies 35 key “lessons learned” as distilled from various authors on the topic. Many of those are particularly useful in providing guidance as to how family businesses may initiate practices that may allow them to better manage the inter-generational transition of equity both in planning and implementation.

Although practitioners in the field should consider each of the 35 “lessons learned” some of the more directly relevant to succession issues are extracted here for consideration.

⁹ Dana, Lucio and Smyrniotis, Kosmas “*Family business best practices: Where from and where to?*” *Journal of Family Business Strategy* 1 (2010) 40.

¹⁰ *Ibid* 51.

¹¹ *Ibid* 52.



In relation to governance of the family business, some “lessons learned” from successful family businesses include the following practices:¹²

- Establish policies to deal with predictable family-in-business issues before the need arises.
- Define a unifying sense of purpose and mission in relation to the business.
- Identify a clear set of values the family wishes to perpetuate (i.e., the human face of family business).
- Establish processes to govern the family-business interaction for continued family ownership/control.
- Set rules to strengthen interpersonal relationships and manage the expectations of family members.
- Establish a formal dividend policy that pays out according to business profitability.

In relation to communication and conflict management, the report identifies the following lessons learned:¹³

- Hold regular family meetings to share information, build trust, avoid politics, and achieve consensus.
- Accept that family members will have different perspectives on family business issues.
- Establish conflict management processes.
- Get family members together regularly to have fun and pursue non-business activities.

Finally, from a range of other categories the following lessons appear to be particularly relevant in addressing issues of inter-generational transitions of equity:¹⁴

- Establish merit-based policies for the compensation and promotion of family members.
- Define clear family member roles, responsibilities, accountabilities and interpersonal boundaries.
- Gradually modify parent-offspring relationships into ones of “peers” at work.
- Establish processes for welcoming, educating, and inducting in-laws into the family.
- Designate a mandatory retirement age for all senior executives, especially owner-managers.
- Select a family (cf. business) leader to perform the role of holding the family together emotionally.
- Set a definite date for the transfer of leadership responsibility and control to the next generation.

2 ISSUES CONCERNING DISCRETIONARY TRUSTS IN SUCCESSION PLANNING – TIPS

The practical implementation of the types of issues identified above can be illustrated when considering the particular problems that arise when dealing with trusts and in particular discretionary trusts in a succession planning context.

2.1 Does a discretionary object have an interest in the trust for general law purposes?

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.¹⁵ This is because, regardless whether a trustee is required under the trust

¹² The MGI Australian Family and Private Business Survey 2010

¹³ *Ibid.*

¹⁴ *Ibid.*

¹⁵ 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.



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.¹⁶

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

2.1.1 Decision in *Richstar*

In *Re Richstar Enterprises Pty Ltd (ACN 099 071 968) And Others; Australian Securities And Investments Commission v Carey And Others*¹⁷ (**Richstar**), the Federal Court adopted a similar approach in considering whether a discretionary object has an interest in the trust to that of the Family Court.

In this case ASIC sought appointment under section 1323 of the *Corporations Act 2001* (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 by the defendants of assets and liabilities. ASIC subsequently sought to amend the receiver's orders in respect of the 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 section 9 CA and that the court could make the orders sought on the basis that a defendant who is a beneficiary of a discretionary trust has a contingent interest in the property of the trust which therefore constitutes property as defined in section 9 of the CA.

Section 1323(1)(h) of the 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 ...

Crucial to the court's consideration of the proposed orders is the definition of “property” in section 9 of the CA which 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.”

The question therefore became whether the property of the trusts of which the Individuals were beneficiaries can somehow 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:¹⁸

- 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 1323.¹⁹

¹⁶ 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.

¹⁷ [2006] FCA 814

¹⁸ 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.

¹⁹ [2006] FCA 814 at paragraph 29



- 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 which is akin to a proprietary interest in the beneficiary.²⁰
- 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.²¹ On the other hand, 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.²²
- 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 the ownership of the trust property.²³

2.1.2 General Law Context vs. Family Law Decisions and *Richstar*

In contrast to the approach adopted in recent family law decisions and *Richstar*, the decision in *Public Trustee v Smith* [2008] NSWSC 397 (**Smith**) which was decided by the Supreme Court of New South Wales after the *Richstar* and *Spry*²⁴ decisions is consistent with established trust and equity principles and emphasizes 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 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. The testatrix was not the sole beneficiary or beneficial owner of the property. White J denied that Ward as controller of the company, was beneficially entitled the trust’s assets.²⁵

“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.”

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

“In some of the cases, findings that property of the trust is to be treated as if it were the property of the husband has been supported by findings that the trustee was the “alter ego” or “puppet” or “creature” of the husband. It is not clear to me what the significance of such a finding is unless it is another way of saying that the husband controls, or is in a position to control, the exercise of the trustee’s powers; which in turn simply raises the question as to whether such control amounts to ownership, or should be treated as if it did amount to ownership....²⁶

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 trustee²⁷.”

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 section 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.²⁸

²⁰ [2006] FCA 814 at paragraph 29

²¹ *Ibid* at paragraph 36

²² *Ibid* at paragraph 36

²³ *Ibid* at paragraph 37

²⁴ *Kennon v Spry* [2008] HCA 56

²⁵ [2008] NSWSC 397 at paragraph 105

²⁶ *Ibid* at paragraph 118

²⁷ *Ibid* at paragraph 125

²⁸ *Ibid* at paragraph 138



“French J did not say that it followed from the defendants' positions as beneficiaries of discretionary trusts and their control of the trustees that this amounted to actual ownership as distinct from "effective ownership". As with the reference to "de facto ownership" I take the phrase "effective ownership" to mean that the defendants had such control of the affairs of the trust that they were in as good a position as if they were the beneficial owners, but not to mean that they were the beneficial owners of the trust property. **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 discretionary objects 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* which 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 CA²⁹:

“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 Court of Appeal in *Lygon Nominees Pty Ltd v Commissioner of State Revenue* [2007] VSCA 140.

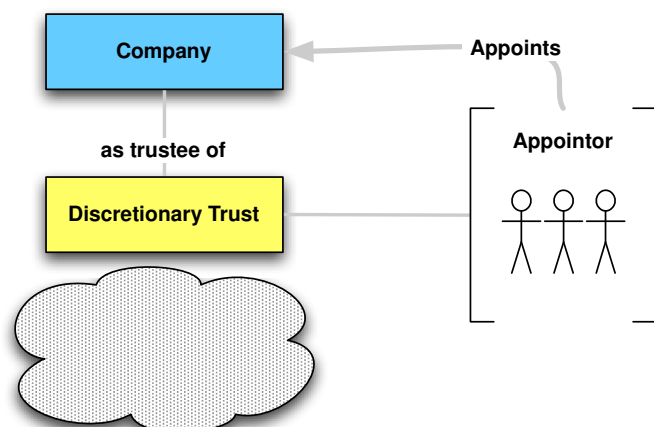
2.1.3 Requirement to consider the type of trust

Although case law supports the position that a discretionary object in a class of beneficiaries of a discretionary trust has no property interest in the trust itself, it is important to consider the nature of other types of trust structures. In some of those other types of trust structures there is an actual interest that must be specifically addressed in considering succession planning in order that control over the structure passes to the appropriate family member(s).

2.2 Appointor/guardian - identity, role and power.

Given the discussion above concerning property interests in discretionary trusts, the ability to pass control over the discretionary trust requires consideration of the identity of the trustee and the person who has the power to appoint the trustee.

The existence, terms and power of this role varies from trust to trust and is dependent upon the terms in the



²⁹ [2008] FCA 461 at paragraphs 74-75



relevant trust deed. Each trust deed may have a unique mechanism providing for how this role operates if it exists at all.

Issues that should be considered when reviewing the trust deed for the existence and scope of the power include whether the:

- Appointor/guardian must consent to distributions of capital;
- Appointor/guardian must consent to variation of trust deed;
- Appointor/guardian must consent to bringing forward the vesting date; and
- Appointor/guardian must consent to appointment of new trustee.

Other provisions that should be examined include those concerning:

- changing the appointor provisions;
- including an independent appointor;
- requiring unanimous decision making;
- providing a mechanism for resolving disputes; and
- providing for the succession of the appointors.

Appropriately drafted, the appointor provisions may be used to effectively pass control over the discretionary trust to the next generation including combinations of members of the next generation to ensure various interests are addressed as desired by the current generation.

2.3 Trustee, shareholding in corporate trustees, constitutions.

Although the appointor may be the ultimate controller of the discretionary trust through the ability to remove the existing trustee and appoint a new trustee, the manner in which the appointor provision is potentially drafted and the identity of the individuals comprising the appointor may mean that effective control still rests with the trustee where the appointor is unable to make an effective resolution to replace the trustee.

In order to assess the potential issues arising from the structuring of the trustee the following questions should be answered.

- Who owns the shares in the corporate trustee?
- What does the constitution provide for concerning governance of the trust deed and decision making?

After obtaining that information the combination of the following should be considered to determine the ability for effective decision making:

- shareholding in the corporate trustee;
- constitution of the corporate trustee;
- the role of appointor/guardian in the trust deed; and
- decision making where there are multiple persons in the role of appointor/guardian.

It is possible that the combination of these various factors may lead to a position where one member of the next generation could essentially stifle effective decision making by using a power of veto. Careful planning is required to ensure that this is not the case. This may require alterations in respect of each of the above items as part of the business succession planning process.

2.4 Challenges in relation to the nexus with estate planning

The inter-generational transition of equity in the business operations raises the following questions amongst others:



- Who is to be involved in the business?
- How are those not involved in the business to benefit from the estate?
- What proportion is the business of the total family assets?
- Is the business in one or several entities?
- Are there other passive non-business assets held by the entities conducting the business?
- Is it feasible to distribute those non-business assets (tax and stamp duty cost)?
- Can the passive non-business assets be sufficiently protected from the business activities?
- In dividing the estate should a risk factor be placed on the value of the business?
- How should the business be valued generally in allocating the pool?

2.4.1 Dealing with trusts

Where the relevant business is conducted via a trust the answers to those questions then need to be addressed by:

- **Careful structuring** of the role of the appointor both in terms of identity of persons undertaking the role, succession should any one of those persons die or be incapable of acting and decision making/dispute resolution.
- **Careful structuring** of the shareholding in the corporate trustee to ensure shares and voting rights are appropriately controlled including possibility of share split.
- **Careful drafting** of the constitution of the corporate trustee including the use of default management/distribution obligations should the next generation fail to agree on management.
- **Careful drafting** of a family constitution to govern the relationship between the parties, how the various family entities are to be managed and administered and the ability of those involved in the business to “buy out” any interest of the others including agreed valuation methodologies.

3 ISSUES CONCERNING DISCRETIONARY TRUSTS IN SUCCESSION PLANNING - TRAPS

Many traps may arise in succession planning matters that involve trusts. If these issues are not identified, addressed and resolved even the most sophisticated succession planning structure may fail to achieve its objectives.

Four key topics will be considered:

- Are the family members actually beneficiaries?
- Traps with multiple trusts.
- Implications of family trust elections.
- Variations of trust deeds.

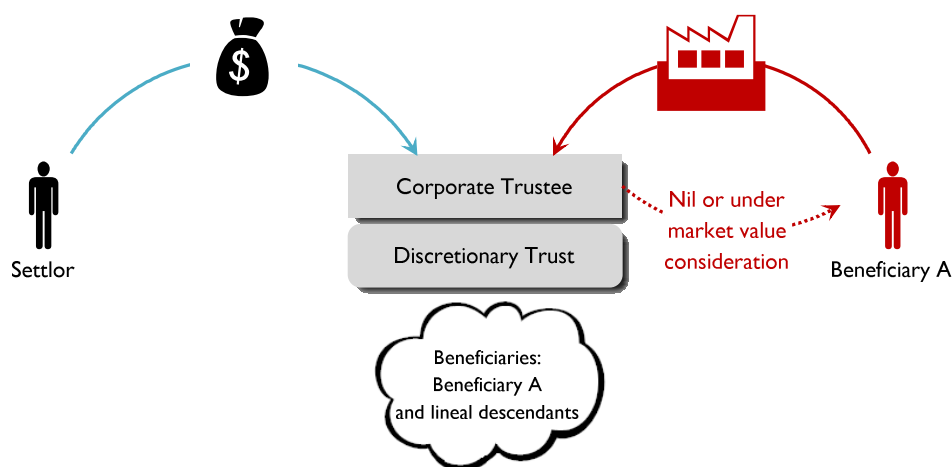
Legislative references are to the *Income Tax Assessment Act 1936* (Cth) (**ITAA 36**) and *Income Tax Assessment Act 1997* (Cth) (**ITAA 97**), unless otherwise stated.

3.1 Are the family members actually beneficiaries?

To properly and definitively determine the beneficiaries of a trust it is necessary to establish who may benefit from the trust and to what extent and how a particular benefit may be provided. Clearly these issues should be considered at the time a trust is established. Unfortunately in most instances they are not.

3.1.1 Notional settlor

When establishing trusts for asset protection purposes, key family members often transfer assets to the trust as gifts or at less than market value consideration. In this circumstance the provisions of the trust deed may have the effect of excluding those family members or entities related to them as beneficiaries of the trust.



In many trusts established today a notional settlor is excluded as a beneficiary. The notional settlor in these trusts is usually defined “as someone who has made any disposition of property in favour of the trustee other than for full consideration in money or moneys’ worth.”³⁰

The exclusion of the notional settlor usually only applies where that person is not named as a primary beneficiary. Accordingly in these circumstances, where a beneficiary of the trust (other than a primary beneficiary) gifts their present entitlement to the trust for asset protection reasons, that person would cease to be a beneficiary.



Trap

The operation of notional settlor provisions may result in persons who had been receiving distributions of income and capital from a trust not actually being included within the class of beneficiaries of the trust.



Warning

An appointment or distribution to a person or entity who is not a beneficiary would render the appointment ineffective³¹ and result in the income purportedly appointed being either assessable

³⁰ Neil Mathison “Discretionary Trusts – problems with beneficiaries” Taxation in Australia Issue 39 No. 4 October 2004.

³¹ *BRK (Bris) Pty Ltd v Commissioner of Taxation* [2001] FCA 164, 2001 ATC 4111.

to the trustee under section 99A of ITAA 36 or to the beneficiaries who, under the terms of the trust deed, take the income in default of an effective appointment.

3.1.2 *The trustee*

In some circumstances, provisions of the relevant trust deed may provide that the trustee is excluded from the class of beneficiaries unless the trustee is specifically named as a beneficiary. This is often overlooked.

If it is determined to appoint a potential beneficiary of a trust to be the trustee, any provision in the proposed trust deed which excludes the trustee from being a beneficiary should be removed from the deed. Provided that the settlor of the trust was not the trustee, removing the exclusion of the trustee as a beneficiary would not enable the Commissioner to invoke the provisions of sub-section 102(1) of ITAA 36. However, questions regarding the proper exercise of the trustee's fiduciary duties or the general anti-avoidance provisions of the income tax legislation still need to be considered prior to any such distribution. Further, any variation of the trust deed would need to be carefully drafted in order that the variation did not result in the creation of a new trust.

3.1.3 *Other related beneficiaries*

Some trust deeds may not specifically exclude the trustee as a beneficiary but include a provision to so exclude any company in which specific persons (for example the guardian) have any interest. In these circumstances if the guardian named in the trust deed is a shareholder in the trustee, the trustee would be disqualified from being a beneficiary. It would also present a difficulty where the trustee was empowered to nominate a company as beneficiary and in the purported exercise of that power the trustee did so even though its shareholders included the guardian of the trust.



Trap

Where the only named beneficiaries are the children of a person who has arranged for the establishment of a trust, that person, immediately or in the future, may be excluded as beneficiary.

This will occur if the person is named as any one or more of the trustee, guardian or appointor or becomes a notional settlor and the trust deed provides that unless specifically nominated as beneficiaries, persons who hold the position of trustee, guardian and/or appointor or become a notional settlor are excluded as beneficiaries of the trust.

3.1.4 *Addition of beneficiaries*

Although modern discretionary trust deeds are often drafted in such a manner that related entities of the key family members are automatically included within the class of beneficiaries, occasionally the trustee needs to exercise a power in the deed to appoint such related entities as beneficiaries of the trust. In that circumstance, it is critical to strictly follow the terms of the trust deed to ensure that the appointment is effective.

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 nominate a person as beneficiary. A resolution of director is may not be sufficient to appoint an additional beneficiary.

In addressing whether an entity had been effectively nominated as a beneficiary of a trust, Spender J in *Idlecroft* commented and found as follows:

47. Secondly, cl.6 of the trust deed gives power to the Principal to appoint a beneficiary, and cl.6 does not confer power on the trustee to make such an appointment. The Commissioner nonetheless contends that there was a mere irregularity in relation to the nomination of WCC in its capacity as Trustee of the unit trust as a beneficiary of the

trust. It was submitted for the Commissioner that where there is power to appoint a beneficiary, a mere irregularity in the qualification of the person as a beneficiary is not, in tax matters, a concern of the Court or the Commissioner.

48.

49. 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.³²

Spender, J continued in relation to his finding that the nomination of WCC as a beneficiary had been ineffective:

72. I proceed now on the basis that in each appeal the position is that the nomination of WCC as a beneficiary was ineffective, and that the appointment of income to it was therefore a nullity and liable to be set aside *ab initio* by the Court. Re: *Cavill Hotels Pty Ltd [1998] 1QDR 396 at 402; Turner v Turner [1984] Ch 100 at 111; and BRK at par 15.*³³

This clearly demonstrates that failure to comply with the terms of a trust deed when nominating beneficiaries may have dire, or at the very least, unintended consequences.



Tip

Prior to nominating a person to be a beneficiary of a trust the questions to be answered are:

- Is there any power included in the deed to nominate any persons as additional beneficiaries of the trust?
- If the answer to the first question is no, can the trust deed be varied to include the necessary power to nominate beneficiaries?
- If the answer is yes, who has the power to nominate beneficiaries?
- How is the power to nominate beneficiaries to be exercised? For example, by deed of variation or by a resolution passed by the trustee.
- Does the person whom it is proposed to nominate as a beneficiary qualify to be so nominated?
- Is the person to be nominated an excluded beneficiary?

Only after these questions have been answered should the nomination of additional beneficiary proceed.

3.1.5 Taxation implications

If the objective of a trustee of a trust is, at the trustee's discretion, to create enforceable entitlements to the income and capital of the trust then for any taxation liability attaching to the entitlements created to follow those entitlements it will be essential for the trustee to be satisfied that the persons in whose favour an entitlement is to be created are beneficiaries. The beneficiaries will include persons nominated by the trustee or some other person, for example the guardian, under and in accordance with an express power in the trust deed and who are not specifically excluded as beneficiaries.

If a person in whose favour the purported creation of an entitlement in the income of a trust has been exercised is not a beneficiary of the trust in whose favour income can be appointed, and this issue was placed before a court for consideration, a determination would necessarily be made as to where liability would fall for the tax payable in respect of the ineffective appointment.

If the trust deed of a trust provides that income not the subject of an effective determination or appointment by the trustee will be income to which specific or default beneficiaries will be entitled,

³² *Idlecroft* paras 47 and 49.

³³ *Ibid* para 72.



then those beneficiaries will be entitled to that income and it will be included in their assessable income in the proportions to which they are so entitled.³⁴

To the extent that a present entitlement in any part of the income of a trust has not been created in favour of beneficiaries, the trustee will be assessed to tax on that part of the income³⁵. The Commissioner will assess the trustee to tax under the provisions of section 99A of ITAA 36.

If it is intended that any part of the income of a trust in an income year which has not been the subject of an effective determination is to be taken to be the income of specific beneficiaries the trust deed must be clear in its terms to that effect.

3.2 Traps with multiple trusts

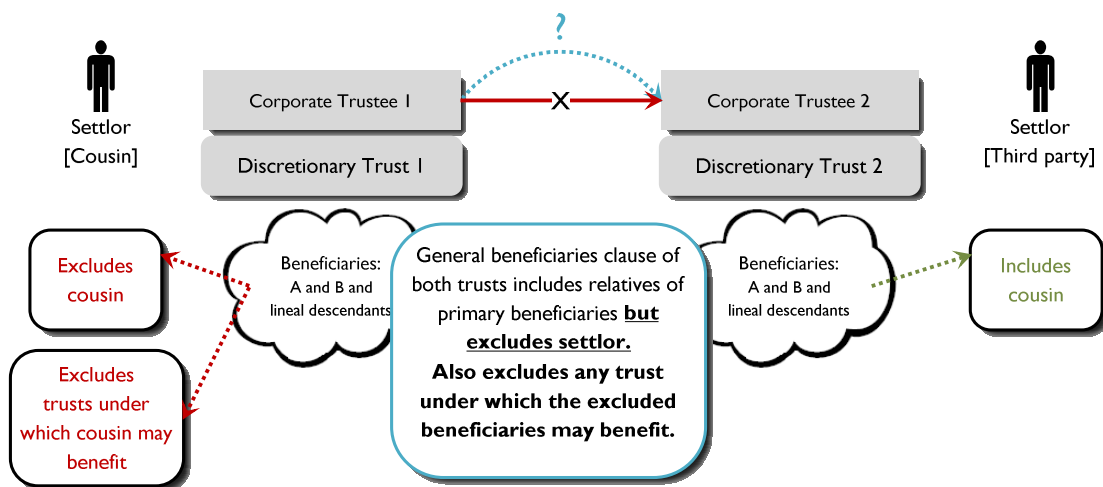
Identification of the beneficiaries of a trust is also relevant to the increasingly common occurrence of distributions of income and capital from one trust to another trust. With many family groups now holding assets through a number of separate trusts, the ability to appoint income or capital between those trusts needs to be carefully considered. Simply having the same primary beneficiaries named in the schedules to both trust deeds does not mean that the trustees of both trusts may make distributions between the two trusts. It is important to pay attention to the operation of any exclusions that apply to provisions of the trust deed that identify the class of beneficiaries.

Trap

The trust deed of a trust from which a distribution is to be made may only include trusts as beneficiaries, the vesting date of which is no later than the perpetuity period of the distributing trust.

Trap

The distributing trust will be likely to exclude the settlor as a beneficiary and possibly any trust of which that settlor is a beneficiary. If this is so, where the receiving trust has been established by another settlor and includes the settlor of the original trust as a beneficiary, the receiving trust would be excluded from being a beneficiary of the distributing trust.

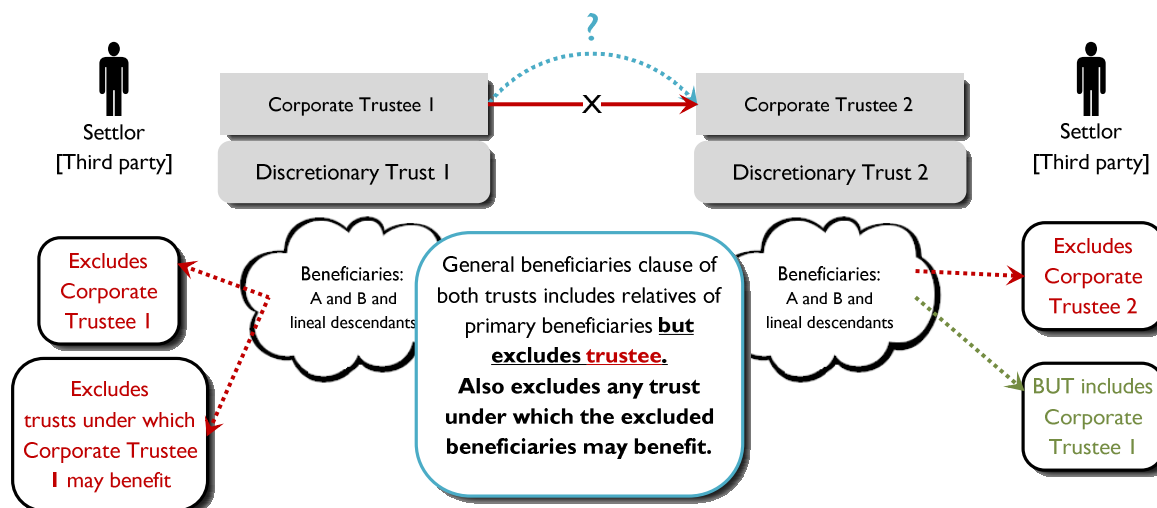


³⁴ Section 97 of ITAA 36.

³⁵ Sections 99 and 99A of ITAA 36.


Trap

Similarly, assume a distributing trust excludes its trustee as a beneficiary and any trust of which that trustee is a beneficiary. In that case a receiving trust that provides for a wide range of beneficiaries including companies in which related beneficiaries may hold shares may be excluded as a beneficiary of the distributing trust.



3.3 Implications of Family Trust Elections

Recent changes to the family trust election regime have highlighted issues that may arise for family groups with multiple trust structures. In particular, the inability to nominate a deceased person as the test individual for a family trust election is a potential limitation to the future flexibility of family groups that may wish to establish new trusts in the future and include those trusts within an existing family group.

3.3.1 Introduction

Schedule 2F of ITAA 36 contains the family trust regime and various trust loss and debt deduction measures.

A family trust is a trust in respect of which a family trust election is in force (section 272-75).

For the purposes of the trust loss measures, a family trust is an “excepted trust” and is exempt from having to satisfy certain tests in order to claim current and prior year tax losses and debt deductions.

3.3.2 What is a family trust election (FTE)?

The trustee of the trust may make an election (the family trust election) that the trust is a family trust for the purposes of the ITAA at all times after the beginning of a specified year.

The family trust election must nominate an individual (the test individual) as the individual whose family group is to be taken into account in relation to the family trust election. It must also contain such other information as the Commissioner requires.

For the purposes of the trust loss provisions, specific relatives and entities that have made an interposed entity election or a FTE nominating the same test individual will fall within the family group of the primary individual.



Trap

Subject to comments below regarding recent amendments, a FTE is generally irrevocable and therefore its implications will continue to apply while the trust exists.

3.3.3 *What is an interposed entity election (IEE)?*

If the trustee of a trust makes a family trust election, a company, the partners in any partnership or the trustee of any trust, may make an election (the interposed entity election) that the company, partnership or trust is to be included at all times after a specified day in a specified income year in the family group of the test individual specified in the family trust election (subsection 272-85(1)).



Trap

Subject to comments below regarding recent amendments, the IEE is generally irrevocable (section 272-85).

3.3.4 *When to make the elections - the 2004/2005 income year and following*

Tax Laws Amendment (2004 Measures No.7) Act 2005 commenced operation on 1 April 2005. Schedule 8 of the Act dealt with Family Trust Elections and brought about amendments to Schedule 2F of ITAA 36.

Elections must now always be made in writing in an approved form.

The Commissioner will also now allow a family trust or interposed entity election to be lodged with retrospective application but the earliest year this can apply to is the 2004/2005 income year. That is, the specified income year (not being a year earlier than the 2004/2005 income year) may be a year before the one in which the election is made if:

- the trust, company or partnership passes the family control test for that period, and
- any conferral of present entitlement or distributions of income or capital of the trust by the trustee during that period has been made to the test individual or a member of the test individual's family group.

The elections will have potential application for the purposes of the trust loss provisions, company loss measures and franking credit trading measures.

3.3.5 *The concept of a test individual*

A test individual is the person named in the family trust election and whose family group is taken into account for the purposes of determining whether distributions of income and capital made by family trusts or interposed entities will be subject to family trust distribution tax (FTDT). Accordingly, the selection of an appropriate test individual is very important.

3.3.6 *Test individual's family and family group*

The "family group" of the test individual includes members of that individual's "family", trusts in respect of which FTEs were made, trusts with the same test individual specified, entities which have



made an IEE to be a member of the test individual's family group and entities owned by members of the test individual's family (s.272-90).

The provisions that allow trusts that have made FTEs nominating the same test individual to be members of the one family group were introduced by the *Tax Laws Amendment (2007 Measures No 4) Act 2007 (TLAM4 2007)*. The new provisions mean that the prior practice of making numerous IEEs for trusts all nominating the same test individual can cease. Previously a group of three trusts with the same test individual would require nine elections to ensure that all of the trusts were members of each others family groups (one FTE and two IEEs in each case). Under the amendments the IEEs will not be required.

The definition of "family" has been expanded by amendments made by TLAM4 2007 with effect from 1 July 2007 and now includes the test individual, any parent, grandparent, brother, sister, nephew, niece, child, lineal descendants of any nephew, niece and child of the test individual, the test individual's spouse and a spouse of any of these persons (ss.272-95(1)).

The terms "child" includes a stepchild, adopted child or ex-nuptial child and "spouse" includes a de facto spouse (ss.995-1(1)).


Further, proposed amendments also now provide that former spouses, widows/widowers, and step children will remain members of the family group despite changes in the nature of the relationship between the parties, for example by marriage breakdown or remarriage (ss.272-90(2A)).

Finally, amendments provide that a person does not cease to be a member of the family as a result of the death of another member of the family (s.272-95(2)).

The following is a diagrammatic representation of a test individual's family under the **new** rules:

New definition of "family"

	Grandparent	Grandparent	
	Parent	Parent	
Brother/Sister	Test Individual	Spouse	Brother/Sister
Child	Child	Child	Child
Lineal descendants	Lineal descendants	Lineal descendants	Lineal descendants
And spouses, former spouses, widows, widowers and step-children of all above parties			

 **Trap**

The extension to the definition of the family still excludes some individuals which may ordinarily be considered to be family members. For example, cousins, uncles and aunts of the test individual are not members of the test individual's family group.

3.3.7 Selecting the appropriate test individual

Broadly, the concept of family extends up to include grandparents and down to include the lineal descendants of a test individual. Obviously the selection of a test individual must be made after significant consideration, particularly in light of the broad definition of the term "distribution". Distribution is defined to include payments, amounts credited, transfers in specie, amounts reinvested on behalf of the recipient and amounts applied for the benefit of the recipient.



The selection of an appropriate test individual will principally depend upon the particular circumstances and dynamic of a family, the income producing activities of the trust and the anticipated income and capital distribution patterns of the trust.

3.3.8 Family control test

In order to make the election, the trust must pass the family control test in section 272-87 at the end of the specified income year (section 272-80).

A trust passes the family control test if a group (generally defined as the test individual, one or more members of the test individual's family, defined in section 272-95, or the test individual and one or more members of their family):

- has the power to obtain, or is capable under a scheme of gaining, beneficial enjoyment (directly or indirectly) of the capital or income of the trust;
- is able to (directly or indirectly), or is capable under a scheme of gaining, control of the application of the capital or the income of the trust;
- is able to appoint or remove the trustee or the trustee of the trust is accustomed, under an obligation or might reasonably be expected to act in accordance with the directions, instructions or wishes of the group;
- has more than a 50% stake in the income or capital of the trust;
- includes the only persons who under the terms of the trust can obtain the beneficial enjoyment of the income and capital of the trust (section 272-87).

3.3.9 Variation to the test individual

Amendments made by TLAM4 2007 enable a once-off variation to the test individual specified in a FTE (ss.272-80(5B)).

The variation may be made for an income year that occurs before the end of the fourth income year after the income year specified in the FTE (ss.272-80(6B)(a)). For example, if a FTE was made in the 2006 income year, the election may be varied prior to 30 June 2010.

In the case of FTEs that were made prior to the 2003 income year, transitional measures enabled trustees to vary the test individual until 30 June 2009 (ss.272-80(6B)(b)).

The variation must be made in the trust's income tax return for the income year from which the variation is to be effective, or in the case of a retrospective variation, in writing and in the approved form specifying the income year from which the variation is to be effective (ss.272-80(8)).

3.3.10 Conditions for varying an election

The variation is only allowed where the new test individual was a member of original test individual's family at the election commencement time and where no conferrals of present entitlement to, and distributions of income or capital have been made by the trust or an interposed entity outside the new test individual's family group during the period in which the election has been in force (ss.272-80(5A)).

There are some additional circumstances relating to marriage breakdown in which the test individual may be varied. These provisions are not limited in time as the general variation power referred to above and do not contain qualifying restrictions regarding there being no distributions outside of the family group. The provisions only require that as a result of an order, agreement or award of the kind mentioned in the CGT marriage breakdown provisions the new individuals and members of the new individual's family have control of the trust (refer subsections 272-80(5C) and 95D of ITAA 36 and subsections 126-5(1)(a) – (f) of ITAA 97).

3.3.11 Challenges for succession planning

Fundamental aspects of the family trust regime being:

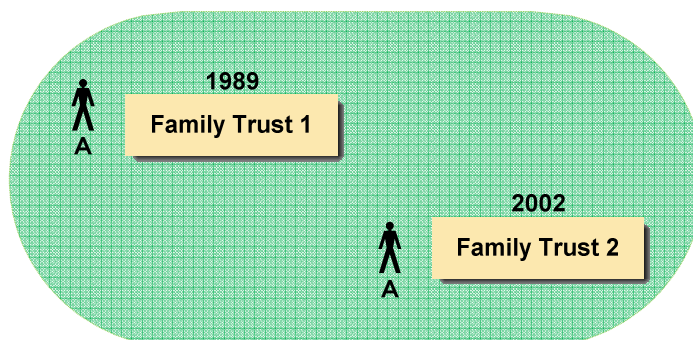
- elections are generally irrevocable;
- it is difficult to change the test individual for the purpose of the family group;
- death is not a trigger for allowing the change of a test individual;
- it is not possible to choose a deceased person as the test individual for a family trust election;
- and
- only one family trust election may be made for each trust;

present significant challenges where a family group comprises multiple trusts and the test individual for the relevant family trust election dies.

3.3.12 Case study

Consider the scenario where a family operates two trusts:

- Family Trust 1 established in 1989 with Individual A chosen as the test individual; and
- Family Trust 2 established in 2002 with Individual A chosen as the test individual.

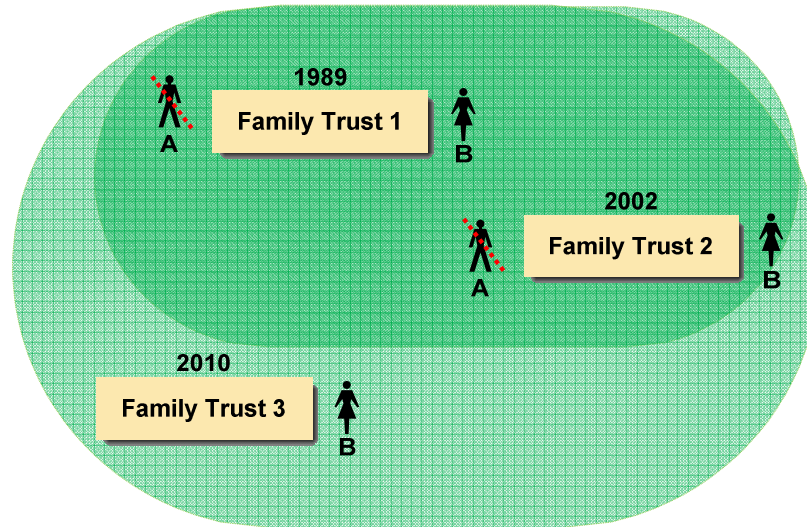


Individual A then dies leaving his daughter Individual B in control of the group.

In 2010 Individual B decides to establish a new business which will be conducted through a new discretionary trust – Family Trust 3. As the new business is likely to make tax losses in its first years of operation and the activities of Family Trust 1 and Family Trust 2 are likely to be profitable, Individual B wishes to include Family Trust 3 within the same family group as Family Trust 1 and Family Trust 2.

As Individual A has died it is no longer possible to make a FTE nominating Individual A as the test individual. Further, it is not possible to elect Individual B as the test individual for Family Trust 1 and Family Trust 2 unless those FTEs were made within the past four years or the transitional rules referred to above apply.

If Individual B had been chosen as the test individual for the FTEs at the outset then simply electing Individual B as the test individual for a FTE for Family Trust 3 would have automatically included Family Trust 3 within the family group comprising Family Trust 1 and Family Trust 2.



3.3.13 Interposed entity elections

It may still be possible to include Family Trust 3 within the family group of Family Trust 1 and Family Trust 2 by making an IEE.

Section 272-85(1) of ITAA 36 allows the trustee of a trust to make an election to be included within the family group of an individual specified in the FTE of a particular trust. Further, the restriction in section 272-85(7) on the making of multiple elections doesn't apply where the individual specified in each of the FTEs to which the trust is making the IEE is the same.

Therefore, Individual B could ensure that the trustee of Family Trust 3 makes an IEE to be included within the family group of each of Family Trust 1 and Family Trust 2 even though it may have otherwise made its own FTE nominating Individual B as the test individual. Similarly, the trustees of Family Trust 1 and Family Trust 2 will need to make IEEs in respect of Family Trust 3.

This issue was addressed in ATO Interpretative Decision 2005/174³⁶ in which the Commissioner confirmed that a trustee of a trust which had made a FTE (Trust 1) could make an IEE that enabled Trust 1 to be included in the family group of another trust (Trust 2) that had a different test individual to the individual elected in the FTE for Trust 1. This was possible as the primary individuals were brothers, resulting in the family control test being passed in relation to Trust 1 and Trust 2. This ATO ID has subsequently been withdrawn but only on the basis that it is "a straight application of the law and does not contain an interpretative decision"³⁷.



Tip

There are a number of important issues to be considered and addressed prior to adopting this course of action.

- It is critical that any IEEs that are redundant as a result of the recent amendments are revoked as they will by necessity nominate the same test individual that is already in the FTE therefore not allowing an IEE in respect of a different test individual due to the restrictions on multiple elections described above.
- It is essential that the family control test³⁸ is carefully considered as the making of FTEs and IEEs is only possible if the family control test has been satisfied.
- Families need to be acutely aware of which family members and related entities are within the

³⁶ See also Monahan, J. A Matter of Trusts: Trust elections –different primary individuals, *Taxation In Australia*, Vol 40, No.3 p.150.

³⁷ ATO ID 2005/174 (Withdrawn)

³⁸ Section 272-87 of ITAA 36

family groups of both any applicable FTEs and IEEs. A distribution outside of the family group of either one will result in a FTDT liability (see above).

3.4 Variations of trusts and the potential to create a new trust

One of the many dangers faced by practitioners when dealing with trust estates is the potential to inadvertently create a new trust by undertaking a variation or amendment to the trust deed or by entering into an arrangement concerning the trusts, beneficiaries or control over the trust estate. More recently, many practitioners have been concerned about the potential to "resettle"³⁹ a trust estate when varying the trust deed to modernise its provisions concerning income, capital and the manner in which amounts comprising either are distributed.

3.4.1 Consequences of the creation of a new trust

Practitioners have reason to be concerned. The consequences of inadvertently creating a new trust are great. A number of tax consequences may arise if the original trust is terminated and a new trust is created including triggering liabilities to stamp duty, the imposition of capital gains tax, income tax, or the loss of beneficial tax characteristics such as carried forward tax losses. Further, the taxation liabilities may be incurred at a time when the gain is only realised for tax purposes. As far as the parties are concerned the underlying assets and any inherent gain remains unrealised such that there are either insufficient funds available to meet the tax liability or the gain that is triggered for tax purposes is illusory and ultimately never truly realised.⁴⁰

3.4.2 Current state of the law

The state of the law is a principal difficulty for tax practitioners in advising clients as to whether certain activity is likely to trigger a resettlement of a trust.

As noted in the judgment of Edmonds and Gordon JJ in *FCT v Clark*⁴¹:

...In *Commercial Nominees* both the Full Court, at [49] of its reasons, and the High Court, at [35] of its reasons, pointed out that there was nothing in Pt IX, nor in the 1936 Act generally, which imposed some statutory requirement of continuity for determining when there is a sufficient identity of the trusts involved. With respect, the same applies in the case of Div 6 of Pt III of the 1936 Act.⁴²

As such practitioners have been faced with either considering older stamp duty case law, considering concepts such as the substratum of a trust,⁴³ following the approach adopted by the High Court in *Commercial Nominees*⁴⁴ or adopting the approach outlined by the Federal Commissioner of Taxation (the Commissioner) in his Statement of Principles.

3.4.3 ATO Statement of Principles

The Australian Taxation Office (ATO) originally released "*Statement of Principles Creation of a New Trust*" on 9 June 1999 setting out the Commissioner's views on resettlements as a guide for taxpayers, advisers and ATO officers (**the Statement of Principles**). The Statement of Principles was subsequently updated in light of the High Court's decision in *Commercial Nominees* in August

³⁹ Whilst this paper is focused on the income tax consequences relating to the creation of a new trust estate rather than the state duty implications concerning settlements of trusts, the common term "resettlement" will be used interchangeably throughout this article to describe the process of the creation of a new trust estate.

⁴⁰ For example, consider the circumstance where at the time of the eventual realisation of the asset by sale to an independent third party, the value of the asset has decreased from the valuation used in determining the taxation consequences of the earlier resettlement.

⁴¹ *FCT v Clark* [2011] FCAFC 5.

⁴² *Ibid* [88].

⁴³ *Kearns v Hill* (1990) 21 NSWLR 107.

⁴⁴ *FCT v Commercial Nominees* [2001] HCA 33.



of 2001⁴⁵. The Commissioner's view expressed in the Statement of Principles was that the decision in *Commercial Nominees* provided guidance in respect of changes made to superannuation entities only. He stated that:

"...nothing that the High Court said is contrary to the principles stated here and the Commissioner will continue to apply this Statement of Principles in relation to changes made to other categories of trust estates."⁴⁶

In the Statement of Principles the Commissioner outlines his view that reference to "trust estate" in Division 6 of the ITAA 36 is not limited to the trust property. In considering the issues the Commissioner states:

"Court authorities suggest that 'trust estate' may mean the trust property, but the structure of the legislation indicates that if so, it must be the property which is the subject matter of a particular trust relationship or 'trust'."⁴⁷

On the basis of that argument the Commissioner considers that if the changes are such that a new trust relationship arises, then there is also a new trust estate for the purposes of Division 6 of the ITAA 36. In effect the trustee is considered to have disposed of the trust property on behalf of one trust estate and reacquired it as trustee of another trust estate.

In support of the Commissioner's position he refers to a number of stamp duty cases (*Davidson v. Armytage*⁴⁸, *Davidson v. Chirnside*⁴⁹, *CSD (NSW) v. Perpetual Trustee Company Ltd* (Quigley's case)⁵⁰, *Wedge v. CS (Vic)*⁵¹, *Buzza v. CS (Vic)*⁵² and *CSD (NSW) v. Buckle*)⁵³ and uses those decisions as authority for the proposition that:

"a new settlement arises when the changes amount to a 'new charter of rights and obligations', or there are 'created in the trust fund as a whole different equitable interests to those which had existed under the pre-existing trust'."⁵⁴

The Commissioner also draws support from United Kingdom capital gains tax cases, but to the extent of any discrepancy between those cases and the Commissioner's findings he distinguishes those cases as relating to settlements not to funds held on distinct trusts.

However in so doing, the Commissioner also outlines his view that it is generally funds held on distinct trusts that constitute trusts pursuant to Division 6 of the ITAA 36 in any event. He considers that settlements may comprise more than one trust estate therefore making them more fluid than a reference to a single trust estate.

The Commissioner's view is that a new trust arises when there is a 'fundamental change to the trust relationship'.⁵⁵ It is a change in 'the essential nature and character of the original trust relationship that creates a new trust'.⁵⁶ It may mean that the original trust ceases to exist and a new trust arises, or a new trust may arise that exists independently of the original trust.

The Commissioner considers that the changes that could trigger the creation of a new trust need not arise solely as a result of variations under a power in the deed but could also be made by agreement among the beneficiaries.

The Commissioner lists some of the changes which may raise the question as to whether a new trust has been created, including:

- any change in beneficial interests in trust property;
- a new class of beneficial interest (whether introduced or altered);

⁴⁵ In this decision the High Court found that changes made in respect of a superannuation fund did not amount to the creation of a new trust estate. This is explained further in this article.

⁴⁶ <http://www.ato.gov.au/businesses/content.asp?doc=/content/14283.htm>

⁴⁷ *Ibid.*

⁴⁸ (1906) 4 CLR 205.

⁴⁹ (1908) 7 CLR 325.

⁵⁰ (1926) 38 CLR 272.

⁵¹ (1940) 64 CLR 75.

⁵² (1951) 83 CLR 286.

⁵³ 98 ATC 4097.

⁵⁴ Above n 8.

⁵⁵ *Ibid.*

⁵⁶ *Ibid.*



- a possible redefinition of the beneficiary class;
- changes in the terms of the trust or the rights or obligations of the trustee;
- changes in the nature or features of trust property;
- additions of property which could amount to a new and separate settlement;
- depletion of the trust property;
- a change in the termination date of the trust;
- a change to the trust that is not contemplated by the terms of the original trust;
- a change in the essential nature and purpose of the trust; and/or
- a merger of two or more trusts or a splitting of a trust into two or more trusts.⁵⁷

The Commissioner concedes that the changes of the kind outlined above “may amount to the mere variation of a continuing trust”⁵⁸. In addressing the list the Commissioner states:

“Whether a new trust is created will depend, among other things, on the terms of the original trust, and on the powers of the trustee. The original intentions of the settlor must be considered in determining whether a new trust has been created. There may be different trigger points/tests for different types of trusts.

The answer to whether alterations to trusts, taken together, result in terminations and creations of trust estates will generally flow from establishing whether the essential nature and character of the original trust relationship has fundamentally changed...”⁵⁹

The position adopted by the Commissioner in the Statement of Principles has been the subject of a significant criticism by commentators.⁶⁰ By the extent of the criticism of the Statement of Principles it is clear that a strong alternative view to that outlined by the Commissioner may be possible. In addition to the narrow interpretation of the decision of the High Court in *Commercial Nominees* and the disregard for the broader statements made by the Full Court in that case, another of the difficulties with the Statement of Principles is its reliance on stamp duty cases for authority of the propositions espoused.⁶¹

3.4.4 Significance of *FCT v Clark*

As compared to the confusing selection of trust law concepts adopted by the Commissioner in the Statement of Principles, the decision of the Full Court in *FCT v Clark* has provided significant assistance to tax practitioners in the following respects:

1. The judgment applies the principles outlined in the High Court’s decision in *Commercial Nominees* to trust estates other than mere superannuation funds.⁶²
2. Contrary to the position adopted by the Commissioner, the majority decision of Edmonds and Gordon JJ stated that the reasons of the High Court in *Commercial Nominees* clearly endorsed the framing of the criteria to be used in determining continuity of a trust estate outlined in the reasons of the Full Court.⁶³
3. Although disagreeing on the application of the indicia of continuity of trust property,⁶⁴ both the majority and dissenting judgment in *FCT v Clark* considered and analysed how the general principles from *Commercial Nominees* could be applied to the particular fact scenario in that case.

⁵⁷ *Ibid.*

⁵⁸ *Ibid.*

⁵⁹ *Ibid.*

⁶⁰ See Raphael, David ‘Settlements at common law and for certain statutory purposes’ Taxation Institute of Australia (TIA) paper presented on 7 April 2004, page 21, paragraph 63, Robertson, Mark ‘Changes to trusts leading to the creation of a new trust estate: principles to be applied by the ATO’ TIA Trusts Intensive Seminar paper presented on 6 December 2006, 27, Moshinsky QC, Ada ‘Trust Resettlements’ (1999) 3(3) *The Tax Specialist* 130 and Harrison QC, Lister ‘Trust Resettlements’ TIA seminar paper presented on 26 August 1999, 24.

⁶¹ See comments in Moshinsky QC, Ada ‘Trust Resettlements’ (1999) 3(3) *The Tax Specialist* 130.

⁶² See the comments in *FCT v Clark* [2011] FCAFC 5 of Dowsett J at [36] and [44] and Edmonds and Gordon JJ at [79] and [88] which follow the decision at first instance of Greenwood J *Clark v FCT* [2009] FCA 1401 at [103].

⁶³ *FCT v Clark* [2011] FCAFC 5 at [79] and *Clark v FCT* [2009] FCA 1401 at [97] to [103].

⁶⁴ Dowsett J finding that there was no continuity of the property of the trust estate [45] and Edmonds and Gordon JJ finding that there was such continuity [87].



At the time of writing this paper the Commissioner has sought leave to appeal the decision to the High Court. At this time we are unaware as to whether the High Court will grant the Commissioner leave to appeal the decision. Similarly, the Commissioner has not as yet issued a Decision Impact Statement in relation to the decision.

Modern Australian case law has provided us with a consistent approach to the determination of the relevant principles to be considered when addressing issues concerning the creation of a new trust. We now have a High Court decision, two Full Court of the Federal Court decisions and the judgment of the Federal Court at first instance in this case adopting a similar approach to identification of the fundamental principles to be examined.

It is hoped that the Commissioner takes the opportunity to afford practitioners greater clarity as to the manner in which ATO officers will approach these issues by revising the Statement of Principles to reflect the criteria to be used in determining continuity of a trust estate as outlined in the reasons of the Full Court in *Commercial Nominees*.

4 CONCLUSION

There are many issues that should be addressed when assisting our clients in addressing succession planning and asset protection matters involving trusts. If these issues are not identified, attended to and resolved even the most complicated or sophisticated succession planning and asset protection structure may fail to achieve its objectives.

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