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Let's chat

Succession Planning and Discretionary Trusts – March, 2021

With:

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Information provided is general in nature; precise application depends on specific circumstances



Overview

- Discretionary trusts and succession planning
- Multiple trust assets and multiple recipients
- Restructuring trust assets to fit the succession plan
- When the discretionary trust succession plan fails
- Tax issues in relation to discretionary trust succession planning



Discretionary trust roles

- Relationship
- Trustee
- Appointor/Principal/Guardian (referred to as Appointor)
- Beneficiaries:
 - Discretionary beneficiaries
 - Default beneficiaries
- Terms governing above relationship subject to a trust deed

The issue (and key advantage) with discretionary trusts



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*“[n]o object of a discretionary trust has, as such, any legal right to or in the capital. His sole interest, if it be an “interest” within the scope of these provisions is with regard to the income: **he can require the trustee to exercise, in bona fide, their discretion as to how it shall be distributed, and he can take and enjoy whatever part of the income the trustee choose to give him”***

- *Gartside v Inland Revenue Commissioners* (1986) AC 553 at 606



Painting the deed - beneficiaries

- **Primary Beneficiary:** John Smith and Jane Smith
- **Beneficiaries:**
 - Primary Beneficiary;
 - Direct family members of the primary beneficiary (spouses, children, siblings, parents);
 - Wider family members of primary beneficiary (nieces, nephews, uncles, aunties);
 - Related structures (trusts and companies in which any of the above persons have an interest or control in); and
 - Charities



Painting the deed - income

- **4.1** The Trustee holds the Income of a Financial Year which is available for Distribution upon trust to pay, apply, or set aside the Income, or any part of the Income, to or for the benefit of the beneficiaries, or any one or more of them exclusive of the other or others who are living or which are in existence at the time of the Distribution of the Income is made in such shares or proportions and from such Category of Income as the Trustee may in its discretion determine.
- **4.3** If the Trustee fails to effectively distribute the whole of the Income of a Financial Year as provided in clause 4.1 or to effectively resolve to accumulate the Income as provided in clause 4.2, the Trustee must set aside the Income which has not been distributed or accumulated on Trust absolutely:
 - for the Default Beneficiaries named or described in clause 14.2(d)(i); and
 - if there are no such Persons, for the Default Beneficiaries described in clause 14.2(d)(ii)



Painting the deed – default beneficiaries

- **14.2(d)** hold the remainder of the trust fund on trust for the following Default Beneficiaries:
 - (i) such of John Smith and Jane Smith as are living on the Termination Date and if more than one in equal shares as tenants in common and if a Default Beneficiary dies before the Termination Date leaving issue living on that date:
 - such issue will take equally among themselves the share to which their parent would otherwise have been entitled had that parent been living on the Termination Date; and
 - Such issue are not to be taken to to be, or be capable of becoming, a Default Beneficiary until the death of the parent of that Person and unless at the time such issue is a beneficiary by reason of clause 3.1; and
 - (ii) if the whole or any part of the trust fund fails to so vest in any one or more of the Default Beneficiaries set out in clause 14.2(d)(i), for such of the following persons...*[include either other named persons; charities; or persons defined in relation to John and Jane Smith]*

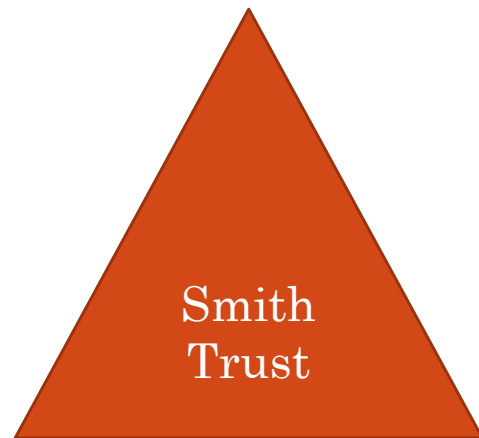


Discretionary trust succession

- Who is the Trustee?
- Who is the Appointor?
- One or more?
- Who are the successors?
- If multiple, then how do they act?
- How are the successors appointed?
- Can the intended successors act together?
- Should the successor be individuals or a corporate entity?



The 'nuclear' family



Owns:

- Investment property
- Investment shares

Trustee: John and Jane Smith

Appointor: John and Jane Smith

Primary beneficiary: John and Jane Smith

Beneficiary class: Usual wider family

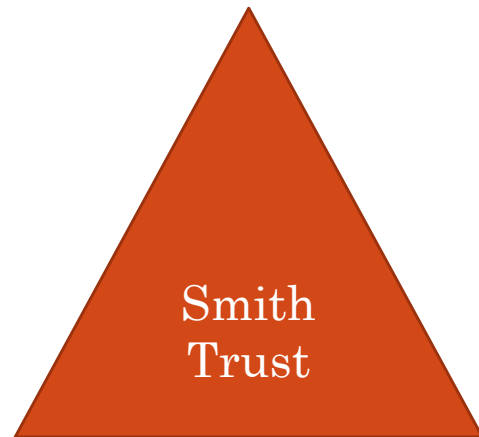
Default beneficiary: John and Jane Smith

provided that if a 'Default Beneficiary' is deceased,
then their children

John and Jane have two children. Adam and Bob.



The simple succession



Owns:

- Investment property
- Investment shares

Trustee: Adam and Bob

Appointor: Adam and Bob

Primary beneficiary: John and Jane Smith

Beneficiary class: Usual wider family

Default beneficiary: John and Jane Smith

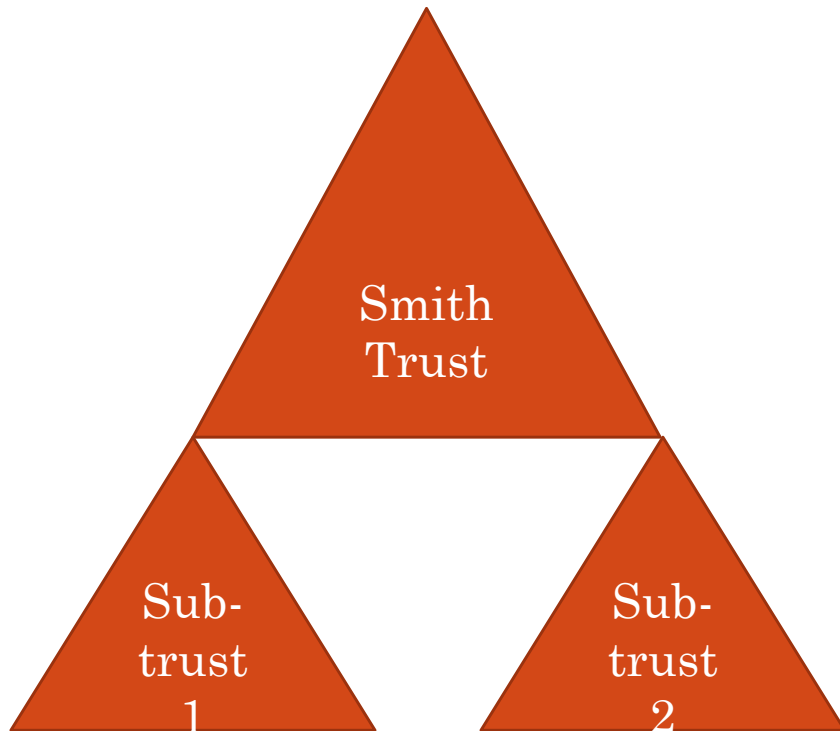
provided that if a 'Default Beneficiary' is deceased,
then their children

RISK: Adam and Bob cannot agree in the
management of the trust.

RISK: If Adam or Bob passes away, their spouse
may not have any say in the management of the
trust.



Splitting the assets – trust split



Trustee: Adam and Bob

Appointor: Adam and Bob

Primary beneficiary: John and Jane Smith

Beneficiary class: Usual wider family

Default beneficiary: John and Jane Smith

provided that if a 'Default Beneficiary' is deceased, then their children

- Investment property

Trustee and Appointor
of sub-trust#1: Adam

- Investment shares

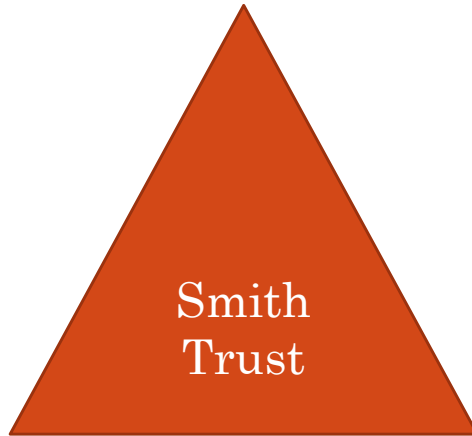
Trustee and Appointor
of sub-trust#1: Bob

RISK: Dispute at the Smith Trust level

RISK: ATO has flagged this arrangement as at risk of capital gains tax consequences if not properly implemented



Splitting the assets – trust clone



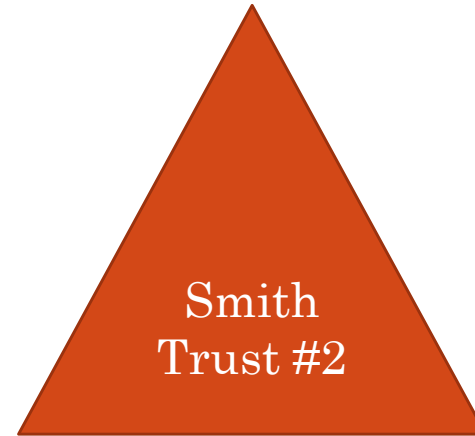
Owns:

- Investment property

Trustee: Adam

Appointor: Adam

Same beneficiaries



Owns:

- Investment shares

Trustee: Bob

Appointor: Bob

Same beneficiaries

RISK: Tax issues to
effect arrangement



Splitting the assets – other alternatives

- Call option agreements:
 - Conditions
 - Stamp duty
 - **RISK:** Dispute arises whether the call option is in the best interest of beneficiaries
- Trusted and independent persons in control?
 - Corporate trustees/appointors
 - Bespoke constitutions
 - Memo of directions
 - **RISK:** Corporations law concerns if constitution not appropriately drafted, officeholder duties not adhered to or oppression of minority shareholders exist
 - **RISK:** Memo of directions not formally binding



Dispute risk with discretionary trusts

- Stems from inability for the trust to be managed appropriately or in agreement
- Avenues of dispute:
 - Persons not acting 'bona fide'
 - Amendments to trust deed not effective



Mercanti v Mercanti

- Michael Mercanti established a shoe repair business
- Tyrone, son, was positioned to succeed Michael
- Trust deeds were varied in 2004 to appoint Tyrone as Appointor of relevant trusts, as well as director of the corporate trustees
- Father and son fell out and Michael took steps to remove Tyrone from the directorship roles
- Tyrone responded by changing the trustee of the trusts
- The trusts referred are:
 - M Mercanti Family Trust (MMF Trust)
 - Footwear Wholesale Trust (FW Trust)



Variation power – MMF Trust

28 Subject to clause 10 hereof the Trustees for the time being may at any time and from time to time by deeds revocable or irrevocable **revoke add to or vary all or any of the trusts terms and conditions hereinbefore contained or the trusts terms and conditions contained in any variation or alteration or addition** made thereto from time to time and may in like manner declare any new or other trusts terms and conditions concerning the Trust Fund or any part or parts thereof the trusts whereof shall have been so revoked added to or varied provided that the rule known as the Rule against Perpetuities is not thereby infringed and provided that such new or other trust powers discretion alterations or variations -

- (1) insofar as the beneficial interests created by this Deed are revoked added to or varied shall be for the benefit of all or any one or more of the General Beneficiaries or any one or more persons born or unborn being lineal descendants of whatever degree (or the spouse of any lineal descendant) of any grandparent of any General Beneficiary; but
- (2) shall not be in favour of or result in any benefit to any member of the excluded class;
- (3) shall not affect the beneficial entitlement to any amount set aside for any beneficiary prior to the date of the variation alteration or addition; and
- (4) shall not (save as provided in paragraph (1) of this clause) enlarge the number of persons capable of falling within the description 'beneficiary' hereinbefore contained.

Save as provided in this clause these presents shall not be capable of being revoked added to or varied.



Variation power – FW Trust

14.1 The Trustee may at any time and from time to time (but whilst there shall be an Appointor only after having given not less than 30 days written notice to the Appointor of his intention so to do) by deeds **revoke add to or vary all or any of the trusts hereinbefore** provided or the trusts provided by any variation alteration or addition made thereto from time to time **and may by the same or any other deed declare any new or other trusts or powers concerning the Trust Fund or any part thereof the trusts** whereof shall have been so revoked added to or varied.

14.2 The powers specified in clause 13.1 shall not be exercised so that:

14.2.1 any interest under the trusts as so revoked added to or varied may vest after the expiry of the perpetuity period;

14.2.2 any member of the Excluded Class is becomes or may become entitled to any interest or benefit under the trusts as so revoked added to or varied; or

14.2.3 the beneficial entitlement to any amount set aside for any Beneficiary prior to the date of the variation alteration or addition is affected.

14.3 Save as provided in clauses 14.1 and 14.2 these presents shall not be capable of being revoked added to or varied.



Mercanti v Mercanti

- Analysis of MMF Trust deed variation power:
 - Possible to amend provisions of trust deed including items in the Schedule
- Analysis of FW Trust deed variation power:
 - Variation only referred to varying 'trusts' and not provisions, terms or conditions



Mercanti v Mercanti (on appeal)

- Michael appealed the initial decision claiming:
 - Ground 1: MMF Trust deed does not empower the trustee to amend the deed by removing the appointor and appointing a new appointor
 - Ground 2: alternatively, the deed did not allow the trustee to amend the schedule
 - Ground 3: the deed of variation was not binding on the trustee because it was not properly executed.
 - Ground 4: the variation constituted a fraud on the power to amend the deed and so a breach of Slondia's fiduciary duty as trustee
 - Ground 5: that Michael's agreement to enter into the deed of variation both as a director of Slondia and as guardian/appointor amounted to equitable fraud by the undue influence of Tyrone
 - Ground 6: Tyrone's actions of retiring Slondia and appointing Parradele amounted to a fraud on the power of the appointor and so a breach of duty
 - Ground 7: the appointment of Tyrone as appointor/guardian was void but alternatively that Tyrone held such powers on constructive trust for Michael



Mercanti v Mercanti (on appeal)

- Grounds 1 and 2:
 - Variation power broad enough
 - By having definitions of 'appointor' and 'guardian' in clause 1 of the deed referring to the Schedule, the words 'hereinbefore contained' did not limit the changes made to the Schedule
- Ground 3:
 - Deed of variation properly executed as evidenced by file note of the lawyers present
- Ground 4:
 - Trustee obligation is to act honestly and in good faith; and to exercise the power for the purposes for which it was conferred and not for any extraneous or ulterior purpose



Mercanti v Mercanti (on appeal)

- Ground 5:
 - No undue influence found
 - Noted that Michael was properly advised of the role of the appointor
- Ground 6:
 - Not all powers in a trust deed are fiduciary in nature
 - Noted that if holders of a power can exercise a power in their own benefit then the power will be personal as distinct from fiduciary
 - Note distinction between trustee role and an appointor role
- Ground 7:
 - Not relevant



Ying Mui & Ors V Frank Kiang Ngan Hoh & Ors

- In contrast to *Mercanti* and picking up on the points made in Ground 6 of the appeal around an appointor acting dishonestly or in bad faith, in this case the Victorian Supreme Court found an appointor had acted for the improper purpose of advancing his own interests when he removed existing trustees and appointed a new trustee to 2 trusts. After appointment, the new trustee distributed income from the trust to the appointor's family at the expense of his siblings' families. The Court looked to the broader purpose of the trusts, i.e. to benefit the extended family, rather than one family member and his children.



Callus v KB Investments

- This case is example whereby a disgruntled beneficiary could not establish the fact that the trustee 'was not in a position to give real and genuine consideration to the interests of the beneficiaries, or that it did not give real and genuine consideration of those interests'
- This was notwithstanding that the trustee of the trust in that case transferred a property to one of the beneficiaries over another, and left no written reasons or record for making such a decision
- In that case, a disgruntled family member challenged the trustee's discretion to transfer trust property to one of four named beneficiaries in a discretionary trust deed
- The Court undertook to consider, not whether the final outcome was fair, but rather whether the trustee at the time had proper consideration as part of the process of making a decision



McCarthy v Saltwood

- Saltwood Pty Ltd was the trustee of the JD McCarthy Family Trust ('the Trust'). The Trust had carried on farming operations since 1 October 1977. The land on which the farming operations was carried on was owned by the Trust. John McCarthy (deceased) was the controlling mind of the Trust and until his death, was primarily responsible for, and in charge of the family's farming operations. John was married to Eunice McCarthy.
- The couple had 6 children. Andrew, a son, had worked on the family farm since 1987 and claimed he had an agreement with his father that on John's death, Andrew would take over the farming operations and would receive part of the farming property.
- It was this agreement that was the catalyst for the dispute between Andrew, as replacement appointor of the Trust and his mother, Eunice.



McCarthy v Saltwood

- Over the life of the farming operations, John took responsibility for dealing with the family accountant in relation to the preparation of tax returns and financial statements for the Trust.
- On the facts, it appears it was an adopted practice between John and the accountant that each year the net income of the Trust was distributed equally between John and Eunice resulting in a joint 'loan' account owing to the parents being recorded in the Trust financials.
- Drawings were offset against the loan, however the remaining 'profits' appear to have been reinvested in the Trust farming operations.



McCarthy v Saltwood

- On John's death, Eunice claimed that John's share of the loan passed to her under principles of succession and claimed on the Trust for the amounts owing to her.
- The Trust rejected Eunice's claim and disputed the 'loan' balance as represented on the financial statements claiming among other things, that income distributions made to John and Eunice were invalid because the meetings did not satisfy the requirements under the Trustee company's constitution.



McCarthy v Saltwood

- Of particular interest in this dispute were journal entries made by the accountant who attended to the preparation of the Trust financials and income tax returns subsequent to John's death.
- **One key transaction highlighted by the Court was a journal entry for \$791,698 applied to reduce Eunice's 'loan' balance which the accountant had claimed was required to record the transfer of farmland from the Trust to Andrew as part of the administration of John's estate.**
- Noting that trust property does not form part of a deceased estate in most Australian States.
- **The decision also drew attention to journal entries processed by the accountant that had the effect of making loan accounts to other beneficiaries 'disappear and seem to be absorbed into the joint loan account of [Eunice] and John'. The Court highlighted there was no apparent explanation or legal basis for such transactions.**



McCarthy v Saltwood

- The Court ultimately held that despite the claimed family arrangement, the trust income distributions were in the most part valid, and the Trust had an obligation to pay the 'loan' amount owing to Eunice.
- This was an outcome apparently not contemplated by Andrew, who was under the assumption he would inherit the farming operations on this father's death.



Tax issues for trust succession

- Resettlements – challenging trust amendments made as a tax risk
- Vesting – triggering of capital gains tax event E5
- Family trust elections – distributing to beneficiaries outside the family group
- Family reimbursement agreements – discretionary trusts having large unpaid present entitlements forgiven

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