LexisNexis™ Butterworths

RETIREMENT & ESTATE PLANNING BULLETIN

Print Post Approved 244371/00048

Volume 9 Number 9

Do beneficiaries have an 'as of right entitlement' to inspect trust documents?

Tina Cockburn
QUEENSLAND UNIVERSITY OF TECHNOLOGY

Information contained in this newsletter is current as at April 2007

contents

Trustees are under a duty to keep and render to the beneficiaries a full and candid record of their stewardship, including all appropriate financial accounts. In *Armitage v Nurse*,[1] Lord Justice Millett said that there are irreducible trust obligations,[2] and indicated that the result of one such obligation is that every beneficiary is entitled to trust accounts.[3]

The traditional approach to the determination of the question as to whether a beneficiary is entitled to inspect documents concerning the trust has been to allow inspection of trust documents, as discussed in *Re Londonderry's Settlements*,[4] subject to various qualifications on this 'right'. Examples include cases where disclosure would reveal the reasons for discretionary decisions, where the trust deed contains secrecy provisions, or the document is considered to be confidential, or where confidentiality may be in the best interests of the beneficiaries.[5]

In *Schmidt v Rosewood Trust Ltd*,[6] the Privy Council rejected the traditional approach to the entitlement of beneficiaries to information concerning the trust as being based on a proprietary right and the classification of documents as trust documents or otherwise, and affirmed the trustee's right to assert confidentiality on broad grounds relating to the due administration of the trust. In that case their Lordships said:

> … But the Board cannot regard it as a reasoned or binding decision that a beneficiary's right or claim to disclosure of trust documents or information must always have the proprietary basis of a transmissible interest in trust property.
>
> … [T]he more principled and correct approach is to regard the right to seek disclosure of trust documents as one aspect of the court's inherent jurisdiction to supervise, and if necessary to intervene in, the administration of trusts. The right to seek the court's intervention does not depend on entitlement to a fixed and transmissible beneficial interest. The object of a discretion (including a mere power) may also be entitled to protection from a court of equity, although the circumstances in which he may seek protection, and the nature of the protection he may expect to obtain, will depend on the court's discretion …[7]

As to whether a beneficiary has an as of right entitlement to disclosure, they came to the following conclusion:

> … [N]o beneficiary (and least of all a discretionary object) has any entitlement as of right to disclosure of anything which can plausibly be described as a trust document. Especially when there are issues as to personal or commercial confidentiality, the court may have to balance the competing interests of different beneficiaries, the trustees themselves, and third parties. …[8]

Recently, in *Avanes v Marshall*,[9] Gzell J of the NSW Supreme Court took the opportunity to review and clarify the law in this area.

Proceedings

In *Avanes v Marshall*, the plaintiff brought proceedings against the trustees of a testamentary settlement alleging breach of trust. In the course of discovery, the defendant trustees claimed client legal privilege with respect to certain documents. The plaintiff challenged the claim on the principal basis that the documents were trust documents in which the plaintiff had a proprietary interest, relying on *Re Londonderry's Settlement*.[10] As aspects of that case were overruled by the Privy Council in *Schmidt v Rosewood Trust Ltd*,[11] Gzell J invited further submissions on the impact of that decision.

Relevant law

After hearing and considering the submissions, Gzell J summarised the relevant law.[12] He noted that the general rule has been that a beneficiary (including a discretionary beneficiary)[13] has a right at all reasonable times to inspect trust documents,[14] although not documents which concern the reasons for the exercise of a trustee's discretion.[15]

Next, his Honour drew attention to the debate as to the theoretical basis of the beneficiary's entitlement to information concerning the trust, highlighting the different approaches taken in *Hartigan Nominees Pty Ltd v Rydge*.[16] In that case Mahoney JA relied on the proprietary theory,[17] an approach which was rejected by both Kirby P[18] and Sheller JA,[19] Kirby P adopting the view that a trustee's duty of disclosure arose from the fiduciary duty to keep a beneficiary informed and to render accounts.[20] This debate was not resolved in *Rouse v IOOF Australia Trustees Ltd*,[21] as the Full Court found it unnecessary to determine the basis upon which disclosure was available and whether the beneficiary's right to access was founded upon a proprietary right or a fiduciary duty, because the court considered that this 'right' was not unqualified and confidentiality or legal professional privilege were circumstances in which a discretion to refuse inspection might arise. However, in *Schmidt*, the Privy Council rejected the proprietary interest theory, adopted the approach that the right to seek disclosure of trust documents was an aspect of the court's inherent jurisdiction to supervise and, if necessary, to intervene in the administration of trusts[22] and expressed general agreement with Kirby P and Sheller JA's approach in *Hartigan*.[23] In *Schmidt*, Lord Walker of Gestingthorpe said that beneficiaries do not have an 'as of right' entitlement to disclosure of trust documents and that the court is required to 'balance the competing interests of different beneficiaries, the trustees themselves, and third parties'.[24]

As to the impact and status of *Schmidt* in Australian law, Gzell J concluded:

> The consequence is that according to *Schmidt*, there is no longer a general rule that a beneficiary has a right to inspect trust documents that is subject to exceptions, notably concerning the reasons for the exercise of the trustee's discretion and confidentiality in third parties. In each case it is a matter for the Court to exercise its discretion by balancing competing interests …[25]
>
> …
>
> In my view, the approach in *Schmidt* should be adopted by Australian courts. The decision should not be regarded as abrogating the trustee's duty to keep accounts and to be ready to have them passed, nor the trustee's obligation to grant a beneficiary access to trust accounts. But when it comes to inspection of other documents there should no longer be an entitlement as of right to disclosure of any document. It should be for the court to determine to what extent information should be disclosed. I propose to adopt that approach in determining this application.[26]

Decision

In this case there were two categories of documents in question — correspondence between the trustees' solicitors and barrister, and

correspondence between the trustees' solicitors and accountants.

The plaintiff, the life tenant under the settlement, submitted that the balancing exercise required by *Schmidt* favoured disclosure to her.

The plaintiff submitted:[27]

- the documents should be made available for inspection because she was required to overcome a defence of acquiescence or consent in her proceedings for breach of trust;
- there was no evidence of personal or commercial confidentiality;
- there was no evidence of a conflict between the exercise of discretion in favour of the life tenant to the prejudice of the remainderman (the infant daughter of the defendant) and the remainderman had adopted a submitting role to the plaintiff, who was suing for her benefit;
- there was no evidence that documents to three and five to 10 were other than accounting documents for which the estate appeared to have paid fees;
- the balancing process should be determined on the merits and not by reference to procedural matters such as the *Evidence Act 1995* (Cth) requirements; and
- only documents that indicate the reasoning process of the trustees were to be withheld and documents upon which that reasoning process is based should be made available for inspection.

The trustees submitted:[28]

- the court should, in its inherent jurisdiction of supervision of the administration of trusts, protect the trustees' confidential dealings with the legal and accounting advisers;
- there was no evidence that the plaintiff was suing for the benefit of the remainderman, who was separately represented and whose interests were adverse to those of her mother; and
- the documents were confidential and came into existence for the benefit of the trustees for making determinations about the due administration of the estate and the creation of documents that may ultimately become trust documents.[29]

The trustees provided copies of the documents to the court for its inspection under the *Uniform Civil Procedure Rules 2005* (NSW), r 1.8. They submitted that the court should make its own determination based upon its perusal of the documents.

After perusing the documents, his Honour came to the following conclusions.

- *Item 1*: The first document was regarded as a 'confidential communication by barrister to solicitor for the personal guidance of the trustees and should not be disclosed'.[30] The other document accompanied the opinion of counsel and as it was for the personal guidance of the solicitors and should not be disclosed even though it did not relate to the exercise of any discretion or power the trustees possess under the settlement as 'the interests of the trustees in keeping confidential communications between their solicitors and counsel outweigh any requirement of openness between the trustees and the life tenant'.[31]
- *Documents two to three and five to nine*: These documents were regarded as preparatory to the trust accounts and comprise requests for advice by the solicitors' accountants on matters of law and advice by the accountants on accounting matters affecting the presentation of the accounts, including presentation of draft accounts, explanations as to how they were compiled and reconciliation of work undertaken for consideration by the trustees in arriving at a decision as to what fees should be paid. These documents went to the trustees' deliberations.

Justice Gzell concluded:

> Since deliberations by the trustees precede their determination to have trust accounts drawn up, I see the balancing process as coming down in favour of protecting the trustees from scrutiny of their deliberations leading up to the drawing up of the accounts. That part of their administration should not become the subject of a fishing expedition by beneficiaries.
>
> In my view, none of the documents is discoverable under the principle in *Londonderry* excluding from inspection the reasoning process of the trustees or under the balancing process enunciated in *Schmidt*.[32]

The plaintiff, the life tenant under the settlement, submitted that the balancing exercise required by *Schmidt* favoured disclosure to her.

Justice Gzell dismissed the notice of motion, ordering the plaintiff to pay the defendants' costs, and found that the defendants were entitled to reimbursement from the estate income of any difference between their costs and the costs recovered from the plaintiff.[33]

Concluding comments

As noted by Dal Pont, 'the beneficiaries' entitlement is to be *reasonably* informed, which imports a limitation, given that a trustee's main task:

> … is to administer the trust estate for the benefit of the beneficiaries as a whole, rather than to respond to voluminous and lengthy queries from a particular beneficiary. Informing the decision in each case is the basic tenet that 'beneficiaries are entitled to receive information which will enable them to ensure the accountability of the trustees in terms of the trust deed'.[34]

In exercising its supervisory jurisdiction over trusts to ensure trustees meet their core obligations and act in best interests of all beneficiaries the courts need to balance the policy of transparency against these core obligations.

Relevant factors and considerations to be balanced in the determination as to whether documents should be disclosed include the competing interests of beneficiaries of the same and different classes, for example, successive beneficiaries, the interests of third parties, whether the documents reveal the reasons or the reasoning process as to the exercise of trustee's discretion, whether the document is expressly or impliedly classified as secret or confidential, and whether the document is a 'trust document'. ●

Tina Cockburn,
Senior Lecturer,
QUT Faculty of Law,
Brisbane,
<*t.cockburn@qut.edu.au*>.

Endnotes

1. [1998] Ch 241; [1997] 2 All ER 705.
2. At 253–254.
3. At 261.
4. In *Re Londonderry's Settlements* [1965] Ch 918 at 938; [1964] 3 All ER 855 Salmon LJ noted the following features of trust documents: they are documents in the possession of trustee qua trustee; they contain information about the trust which the beneficiaries are entitled to know; and the beneficiaries have a proprietary interest in the document and are accordingly entitled to see them.
5. For an overview of the law in this area see Cockburn T 'Trustee duties: disclosure of information' (2005) 12 (1&2) *E Law — Murdoch University Electronic Journal of Law*, available online at <www.murdoch.edu.au/elaw/issues/v12n1_2/Cockburn12_1.html>, viewed 31 March 2007. See also Dal Pont G E and Chalmers D R C *Equity and Trusts in Australia* (4th edn) 2007 at [20.30]–[20.60].
6. [2003] 2 AC 709; [2003] 3 All ER 76; [2003] UKPC 26.
7. At [50]–[51].
8. At [67].
9. [2007] NSWSC 191; BC200701448.
10. [1965] Ch 918.
11. [2003] 2 AC 709; [2003] 3 All ER 76; [2003] UKPC 26.
12. At [3]–[15].
13. *Spellson v George* (1987) 11 NSWLR 300, compare *O'Rourke v Darbishire* [1920] AC 581 at 626–627; [1920] All ER Rep 1 (Lord Wrenbury).
14. At [3] citing in *Re Cowin; Cowin v Gravett* (1886) 33 Ch D 179.
15. *Re Londonderry's Settlement* [1965] Ch 918; [1964] 3 All ER 855.
16. (1992) 29 NSWLR 405; BC9203940.
17. At 47.
18. At 421–422.
19. At 444
20. At 421–422.
21. (1999) 73 SASR 484; [1999] SASC 181; BC9902313.
22. At 729.
23. At 729–730.
24. At 734–735.
25. *Avanes* at [11].
26. At [15].
27. See [17]–[18].
28. See [19]–[20].
29. The legal opinion of counsel was accepted to be a trust document and made available for inspection.
30. *Avanes* at [21]. A claim for disclosure of this document under the exception to lawyer client privilege contained in s 122(1) *Evidence Act 1995* failed: [27]–[34].
31. At [21].
32. At [25]–[26].
33. At [35].
34. Dal Pont G E and Chalmers D R C *Equity and Trusts in Australia* (4th edn), 2007 at [20.35].

Dealing with residuary beneficiaries

John Dymond
DYMOND FOULDS & VAUGHAN

What is residuary estate?

Residuary estate is that part of the estate which is left after all funeral and testamentary expenses, such as funeral expenses, accounting expenses, legal expenses, medical expenses, and so on, have been paid. Assuming a solvent estate, legacies and bequests are paid in priority to estate expenses and liabilities.

Therefore, the valuation of residuary beneficiary entitlement in an estate should normally be undertaken once the final value of all assets and liabilities in the estate are known. Distributions undertaken before the final value of assets and liabilities are known are normally known as interim distributions and should be made on the condition that they can be adjusted on final distributions and any claw back of over distributions can be made on final distribution if required.

Trustee rights and responsibilities and obligations of advisers

Tax Ruling IT 2622 sets out the views of the Australian Taxation Office (ATO) on the normal manner of administration of a deceased estate. In this ruling, at para 5, the following summary of the role of the trustee is given:

> Even where a will does not envisage the creation of a testamentary trust, the executor must assume a trustee's fiduciary capacity for some period after death. The responsibilities of the executor are similar to, though legally separate and distinct from, those of a testamentary trustee. The estate represents a legal entity or relationship quite separate from the testamentary trust. In practice it is only in rare cases that two different persons assume the roles of executor and testamentary trustee and, for income tax purposes, the estate and the testamentary trust are treated as one and the same. In fact, the term 'trustee' is defined in subs 6(1) of the *Income Tax Assessment Act 1936* [(Cth)] (the Act) to include persons acting as executors or administrators.

Executors and trustees will often be given a power to determine the value of assets in the estate. Executors have a responsibility to deal with creditors in the estate and negotiate and settle the value of liabilities and give receipts and give discharges of liabilities that conclusively bind the estate. In addition, executors and trustees are personally liable to the ATO for the tax liability of the estate, in addition to their other role and responsibilities under the will.

Normally, the rights of residuary beneficiaries to the capital of the estate determined when all estate liabilities are discharged. IT 2622 at para 13 also provides the following summary:

> Until the estate of a testator has been fully administered and the net residue ascertained, a residuary beneficiary has no proprietary interest in any specific investment forming part of the estate or in the income from any such investment. Both corpus and income are the property of the executors or administrators: *Lord Sudeley v Attorney*-General [1897] AC 11; *Dr Barnardo's Homes National Incorporated Association v Commissioners for Special Purposes* [1921] 2 AC 1. See also *Pajels v MacDonald* (1936) 54 CLR 519 at 526; *Corbett v IRC* (1937) 4 All ER 700 at 707 and *CSD (Qld) v Livingston* (1964) 112 CLR 12.

Where an executor or trustee proposes to use their trust power to determine a liability in the estate for the purpose of fixing the value of the estate for a beneficiary distribution, this valuation may well be conclusive on a beneficiary for trust law and estate administration purposes but will NOT be conclusive against the ATO if an alternative tax liability is determined by the Commissioner of Taxation other than that which is allowed by the trustee.

A trustee who uses his trust power of valuation to determine a tax liability in the estate will remain at risk personally if the ATO assessment is different from the valuation. Other beneficiaries in the estate may allege a breach of trust if the trustee finalises a distribution entitlement on the basis of an erroneous valuation and then seeks to use the remaining trust property to satisfy the liability.

Professional advisers may also be at risk if they do not warn the trustee that the course of action proposed may result in a personal liability to meet the unbudgeted liability which may not be able to be recouped from the remaining trust property.

Valuations of a residuary estate will normally need to be approached on the basis that until a final tax assessment is given for a period, the interests of beneficiaries cannot be fixed or determined, otherwise trustees may attract unreasonable personal liability. That is to say, the tax liability of an estate is by definition not settled until such time as the ATO issues an income tax assessment for the relevant period (that is, the period in which the residual beneficiary distribution was made).

When are beneficiary rights normally determined for tax purposes?

IT 2622 at para 19 provides the following guidance on this matter:

> The 'net income of the trust estate' and whether any beneficiary is presently entitled to a share of income of the estate are determined on the last day of the financial year. As Chief Justice Barwick said in *Union Fidelity Trustee Co of Australia v FC of T* (1969) 119 CLR 177 at 182; 69 ATC 4084 at 4087; 1 ATR 200 at 202:
> 'The time as at which to determine the assessable income of a taxpayer is in general the concluding day of the taxation year. There is no provision which takes the calculation under s 95 in that respect out of the general scheme of the Act.'

This approach is also supported by the decision in *FC of T v Galland* 86 ATC 4885; (1986) 18 ATR 33.

Distributing residuary estate — the normal case

Normally, where an estate has reached the point of administration where the trustee may make distributions, such distributions will always be in two parts. First, there will be an interim distribution, which distributes the majority of the residual share owing to the beneficiary, but allows for unpaid income tax and unpaid professional fees. You see, even if a distribution were to be made on 30 June, and accruals for professional fees and provision for income tax had been made, the estate bank account would still be open to either pay the income tax owing or receive the income tax refund. At best, the income tax assessment would be received on or about 14 July, and then the cheque would need several days to be presented and cleared, or the refund would need to be banked and again allowed several days to clear. Only then would bank fees be capable of calculation, only then would the precise amount of income tax paid or refunded be known, and only then could the precise amount of the residual be calculated and a final distribution be paid.

Where the estate has minor beneficiaries, then the bank account is clearly not closed until the last minor beneficiary has come of age. In all other respects, however, the mechanism is the same, in that those beneficiaries who are not minors will receive an interim distribution, and then once the income tax return for the year in which they received the interim distribution is lodged, they will receive the final distribution.

As the bank account will continue to operate and due to the presence of minor beneficiaries not all moneys of the estate will be distributed at that time, the trustee will be required to calculate the after tax income derived by the fund from the date of the interim distribution to the date of the final distribution. As the final distribution will be made in a financial year following the financial year in which the interim distribution was made, the after-tax income calculation will include an estimate of the after-tax income of that part of the financial year up to the date of the final distribution. This estimate in turn will not be verified until the assessment of the income tax return for that financial year.

> … those beneficiaries who are not minors will receive an interim distribution, and then once the income tax return for the year in which they received the interim distribution is lodged, they will receive the final distribution.

Therefore, where a significant estate is concerned, the difference between the estimated final distribution and the actual after-tax income share of a residual beneficiary may be material, such that an adjustment to the final distribution is required.

Once the final (second) distribution has been made, in all but the largest estates, for practical purposes, the ledger account for the paid out beneficiary(ies) may be closed. In any case, general ledger accounts for all residual shares due to all residual beneficiaries should be maintained for accounting purposes so that subsequent

amendments arising from audits, re-evaluations of facts and so on, may be recognised and accounted for.

Issues in more complex estates

The administration of an estate is not complete until the last beneficiary has come of age, that beneficiary has been paid out and the final return has been lodged, such lodgment necessarily occurring after all liabilities are paid and the closure of all bank accounts.

It is normal for trustees to make provision for these final administration expenses in the valuation of estate interests in which beneficiaries come of age at differing times. In such a case, the trustee may well use his trust power to determine the amount of a contingency fund which will be applied against all trust interests in the estate. These contingencies should be disclosed to all beneficiaries and a decision taken by the trustee as to whether in the final administration of the estate, all residuary beneficiaries should participate in the final distribution of this fund, if any.

In appropriate circumstances, the rule in *Saunders v Vautier* (1841) 49 ER 282 gives the trustee the means to establish a scheme for the administration of the estate to which all beneficiaries are bound. If this is not practical, the court may assist in binding the beneficiaries to the scheme of administration of the estate.

It is important to remember that professional trustee companies are able to take a measure of financial risks in the policies they pursue in the administration of estates that are not practical for personal trustees. It may be appropriate for a personal trustee concerned about liability and management of long term beneficiary interests to seek the appointment of a trustee company in his place in order that the personal risk issues set out above are negated.

A point for reflection

Wills are increasingly more than merely dispositive documents that break up and distribute the ownership of property on the death of a person. For many people, their will is in part or whole the constitution of an investment business that will be formed on their death and which may operate for many years. Trustees of deceased estates need to carefully consider their duties in operating these investment enterprises which form part of a deceased estate administration. For estates of limited value, it may be prudent to use beneficiary agreements (where all beneficiaries are of age) and valuation powers to bring certainty to the administration of the estate.

Trustees need to be certain that in the exercise of their trust powers that they do not expose themselves unnecessarily to liabilities (such as tax assessments) from which their trust power cannot absolve them for personal liability if they make an error in administering the liability. ●

John Dymond,
Partner,
Dymond Foulds & Vaughan,
<*john@dfv.net.au*>.

legislation update

Anti-money laundering Rules finalised

The Australian Transaction Reports and Analysis Centre (AUSTRAC) last month finalised a series of Rules that set out the requirements with which industry must comply under the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth) (AML/CTF Act).

Developed following consultation with industry, the Office of the Federal Privacy Commissioner and the Attorney-General's Department, the Rules include requirements for customer identification and verification procedures, and anti-money laundering and counter-terrorism financing (AML/CTF) programs.

AUSTRAC Chief Executive Officer Neil Jensen said that, in line with the risk-based approach integral to the AML/CTF Act, businesses themselves will determine the way in which they meet their obligations.

'Importantly, now that these Rules are made, it is critical that businesses do not wait until December to put their plans into action. Industry needs to start work now in applying resources to the areas of their operations which they consider put them at greatest risk of exposure to money laundering,' said Mr Jensen.

The AML/CTF Act and Rules set out obligations relating to the financial sector, the gambling sector, bullion dealers and other professions who provide services covered under the Act.

The Act will come into effect during a staggered implementation timeframe with the final provisions effective in December 2008. Mr Jensen said all of the remaining Rules will be finalised before the implementation dates for each relevant section of the Act.

This release of Rules follows the registration in December 2006 of Rules for movements of bearer negotiable instruments; register of providers of designated remittance services; movements of physical currency into or out of Australia; and receipts of physical currency from outside Australia.

Copies of the Rules are available on AUSTRAC's website <www.austrac.gov.au>.

<www.austrac.gov.au>

AML legislation passes the Senate with government amendments

The Anti-Money Laundering and Counter-Terrorism Financing Amendment Bill 2007 passed the remaining stages in the Senate on 22 March 2007. The Bill was passed with government amendments. ●

REP in practice

In search of a 100-year family support strategy

Michael Perkins
CUTLER HUGHES & HARRIS

We were approached recently by a client who, on reviewing the wealth he had accumulated, was interested in establishing a stable platform for the management of his capital through the next four generations of his family.

This was not an exercise in 'ruling from the grave' or locking up his children's inheritances. Our client was driven by the simple realisation that the best long-term financial return for the family would come from the consistent management of his estate for stable long-term returns of both capital gain and income. He was seeking to establish the best method to discharge his long-term accountability to his family for their ongoing support.

As a result of our discussions, we agreed with our client upon a restatement of his strategic objectives as:

> ... to establish a family investment management business which would survive our clients' death or incapacity and be focussed on delivering stable long-term income streams to him and his family. This business would ensure that he and his family are also supported by appropriately timed capital distributions or capital loans as the needs in life of the family for housing, educational, health support and business investment emerged.

As we discussed the management plan to implement this strategy, a number of salutary challenges emerged.

Longevity of family members

Our client is 72 years old and in good health. His estate planning horizon is therefore in our experience best set at 15–20 years. His children are all in their 40s and his grandchildren are teenagers.

The planning horizon of generation two and three is therefore 50–80 years. If the capital benefits of the structure are to succeed generation three, ideally, you do not want to trigger a compulsory vesting of the trust fund during the retirement years of generation three if this can be avoided.

While a company could be selected as a business vehicle as it has perpetual succession, the shares in a company will be testamentary assets of a shareholder and bound up in the estate of the shareholder who could die at any time. The wealth of the company being attached to the value of the shares would then be dealt with primarily in the wills of each shareholder. No assured longevity of strategy and wealth management could be made.

If a discretionary trust with a corporate trustee is selected and that trust is established in NSW, the life of the trust is limited to 80 years. While the trust property will stand outside the testamentary estate of a beneficiary during the life of the trust, the shares in the corporate beneficiary will not. Having regard to the principles set out in *Richstar No 6*,[1] the control shares of the trustee company may provide a path for attack of the trust property by creditors of the shareholders, depending on the governance model and operational processes of the trust.

Asset protection and offshore entities

Protecting the accumulated asset base of the family from third party attack was certainly a substantial objective of our client. He accepted that on the basis of the *Richstar* principles that his control of the trust may put the trust property at the exposure of his creditors during his life. He was prepared to accept this as a reasonable risk for his life as he believed his risk

profile was minimal. The concern then turned to assuring reasonable protection for trust property in generation two and three.

In cruising the internet our client had come across references to foundations as asset management vehicles.[2] We were asked to consider foundations as an alternative to trusts in approaching the construction of the family's long-term investment business.

Foundations are civil law structures which have been created as the response of that legal system to the operation of trusts under common law. A foundation is neither a trust nor a company but has its own unique identity under civil law. At first blush, there seems a prospect that such a structure may sit outside the Australian CFC, FIF and transferor trust regimes[3] because of the inherent legal distinctions between civil and common law structures.

The fundamental tax accountability of Australian residents for foreign sourced income is summarised by the Australian Taxation Office (ATO) as:

> Broadly, income may be attributed to you, and you need to declare it, if you have:
>
> 1. an interest in a non-resident company or non-resident trust (known as a foreign investment fund — FIF) or a foreign life assurance policy (FLP),
> 2. a direct or indirect interest in a foreign company controlled by Australians (known as a controlled foreign company — CFC) or a foreign trust controlled by Australians (known as a controlled foreign trust — CFT) or you effectively controlled the CFC or CFT,
>
> or at any time, directly or indirectly caused the transfer of property (including money) or services to a non-resident trust.

The key risk for the client is being taxed in Australia on income and gains that accrue in the offshore structure, irrespective of the payment of those gains to an Australian resident.

We then had to consider, for Australian tax law purposes, could foreign foundations be treated as foreign trusts? The ATO has recently released ATO ID 2007/42 which, while applying directly to a Netherlands-based Stichtung (a civil law structure akin to a company limited by guarantee in that it has a corporate existence but no shareholders), provides a useful summary of relevant principles the ATO considers relevant to this issue:

> Is there a 'trust estate' for the purposes of Division 6AAA?
>
> 'Trust estate' is not defined in the [*Income Tax Assessment Act 1936* (Cth)] ITAA 1936 or *Income Tax Assessment Act 1997* (ITAA 1997). French J in *Harmer & Ors v Federal Commissioner of Taxation* (1989) 20 ATR 1461; 89 ATC 5180 stated that a trust 'is notably a definition of a relationship by reference to obligations'. He went on to state that the four essential elements of a trust are:
>
> 1. the trustee who holds a legal or equitable interest in the trust property
> 2. the trust property which must be property capable of being held on trust and which includes a chose in action
> 3. one or more beneficiaries other than the trustee; and
> 4. a personal obligation on the trustee to deal with the trust property for the benefit of the beneficiaries, which obligation is also annexed to the property.
>
> Having regard to the Agreement, all four elements are present so as to give rise to a trust relationship between the Stichting and the employees entitled to benefits from the Fund.

In considering both *Richstar No 6* and *Harmers* case, it seems clear that the following principles emerge for Australian tax law purposes.

1. A trust is found in the relationship of identified parties with respect to defined property. It is the compellability of those rights with respect to defined property that is a trigger for the trust relationship.
2. There is nothing that precludes a civil law structure from being a party to enforceable trust obligations.
3. Trusts may be found in the arrangement that a party enters into, not just a formal 'trust deed'. These arrangements may or may not be in writing.

While a civil law foundation may appear attractive as a perpetual vehicle through which the shares in a trustee company may be held in perpetual ownership outside the testamentary estates of family members, this approach carries a risk that the establishment of side arrangements to give comfort to beneficiaries of their expected entitlements could give rise to a trust obligations which would bring the whole structure back into the transferor trust regime.

A foundation is neither a trust nor a company but has its own unique identity under civil law.

Asset protection and family accountability

In the discussion paper on amendments to the *Bankruptcy Act 1966* (Cth) (the Act), released by the federal government on 8 February 2005,[4] the government was canvassing support for amendments that will make it more difficult for business proprietors to transfer money out of their businesses into 'safe harbours' such as the hands of spouses and third parties. In this paper, however, the legitimacy of needing to protect capital accumulations is recognised. The paper states:

> Any amendments to the Act would continue to support recognition of the legitimacy of asset protection arrangements; and the focus of any amendments to the Act would be on the debtor's/bankrupt's purpose in transferring property rather than on the effect this has on their substantive wealth.

Notwithstanding these statements, the paper also states:

> Bankruptcy was never intended to allow bankrupts to protect their wealth from creditors. The purpose of ss 120 and 121 of the Act is to ensure property

> transferred prior to bankruptcy can, in certain circumstances, be recovered by the trustee for the benefit of creditors.

These two extracts highlight the fact that the effectiveness of asset protection strategies now turns on the provable purpose of the transfer of funds from the proprietor to the other party. We seem to be moving away from a broad brush 'tainted purpose' regime where a transfer was deemed to be improper unless the bankrupt proved otherwise, to a regime where transactions of recognised probity would be given safe harbour. Government policy is now summarised in the paper as:

> The Government remains determined to ensure bankrupts who actively seek to avoid paying their debts are brought to task without causing unintended consequences for legitimate asset protection arrangements …

In assisting our client to protect his assets from future depredations, a balance needs to be struck between establishing strict accountability between the structure and the beneficiary which maximises exposure of property and economic rights to third parties and fully discretionary structures in which the property transferred to the structure or custodian may well be proof from attack from third parties but fully exposed to the errant and prejudicial decisions of the custodian.

Striking a balance in decision-making

A final decision has yet to be reached. We are currently evaluating the following matters.

1. The risks to family members of moving to an offshore foundation as a holding company for the corporate trustee in view of the effect of centralising decision making power in the foundation's controllers. This centralising power is necessary having regard to ATO ID 2007/42 if our client is to have any chance of avoiding the current Australian transferor trust regime.
2. The risk of the Australian international tax regime being amended to directly include foundations during the life of the family arrangements.
3. The risk of the international features of the foundation led structure bringing a heightened audit risk by the ATO to the family.
4. The attractiveness of the SA trust regime as providing a trust jurisdiction with no particular perpetuity period without involvement of foreign jurisdictions.
5. The attractiveness of using a professional trustee company as a long-term fiduciary for the family in which the family can have influence but not ownership of the trustee.
6. The wisdom of adopting a private trustee management scheme supported by appropriate shareholders deeds in the private trustee company in which the family members who pursue duties as long-term investment capital managers of the family are not those members who pursue or attract commercial and corporate or professional negligence risk.

It is clearly possible for a 100-year family accountability strategy to be established. It is a matter for each client to evaluate the compromises in the structuring of their affairs that such a strategy imposes on their operations and the freedom to access and use capital that is restricted in subsequent generations. ●

Michael Perkins,
Special Counsel,
Cutler Hughes &Harris,
<*michael.perkins@cutlers.com.au*>.

Endnotes

1. *Australian Securities and Investments Commission, Re Richstar Enterprises Pty Ltd (ACN 099 071 968) v Carey (No 6)* (2006) 153 FCR 509.

2. See, for example, <www.and-offshore.info/panama_private_interest_foundation.html>.

3. For more information please see <www.ato.gov.au/taxprofessionals/content.asp?doc=/content/64063.htm>.

4. See <www.itsa.gov.au/dir228/itsaweb.nsf/docindex/reform-> law+reform?opendocument>.

Special disability trusts

Suhanya Ponniah
MOORESLEGAL

In September 2006, the federal government introduced changes which will allow some people to plan for the future and provide for people with significant disabilities via a trust, without affecting their entitlements to the means tested Disability Support Pension. This represents a significant departure from the way most trusts are treated by Centrelink.

When advising clients in relation to their estate planning, a key issue for consideration is determining what the circumstances of the clients' intended beneficiaries are. Where an intended beneficiary has a disability, this entails further exploration to identify the clients' objectives, the beneficiary's ability to manage finances, their perceived level of 'vulnerability' and the means testing implications of an inheritance.

Beneficiaries with disabilities

The disabilities sustained by the intended beneficiaries may be intellectual, physical, psychological, or a combination of these. In addition, some disabilities do not affect the beneficiary's capacity to manage finances, whereas others will impact to a significant degree. Some disabilities will affect the beneficiary's social skills or ability to manage finances in a manner that makes them very vulnerable to suggestion from newly found 'friends'. Some will be fully able to manage finances. Others will be capable of managing small amounts of money, while others are unlikely to ever have the capacity to do so. Some beneficiaries will qualify for the disability support pension (DSP) via Centrelink, whereas others will not.

Protective trusts

When providing for beneficiaries who are perceived to be vulnerable, a willmaker will often set out instructions in their will for the establishment of a 'protective trust'. A protective trust is so named because the funds are administered by trustees who are directed to expend them for the benefit of the vulnerable beneficiary, thus protecting them from 'predatory' persons. Therefore the funds are not held by the beneficiary directly, and cannot be gifted or otherwise spent by them.

Disability support pension

An issue that often arises concerns beneficiaries who are in receipt of, or may in the future become entitled to receive, the DSP. The DSP is means-tested, and thus the applicant is subject to an assets test and an income test. The applicable thresholds for the tests depend on factors such as whether the person is partnered or single, whether they have dependant/s and whether they own their home.

The [disability support pension] is means-tested, and thus the applicant is subject to an assets test and an income test.

If a beneficiary who is in receipt of the DSP receives an inheritance, the inheritance will count for the purposes of the assets test, and the income generated from the funds will count under the income test.

'Deeming' of trusts

Before 2002, this rule did not apply if inherited funds were held for the benefit of the beneficiary in a protective trust, or if they were held in any other type of trust. However from 2002, legislation was passed, empowering Centrelink to deem all assets of a trust in which the person was a beneficiary to be theirs for the purposes of the means test. This provided and continues to provide an impetus to prepare Deeds of Exclusion to exclude such persons as beneficiaries of discretionary and other trusts.

Importantly, thus far Centrelink has also had the power to deem that assets held in a protective trust of which the person is a beneficiary can count for the purposes of the assets test. This would often have the result of either reducing the beneficiary's DSP entitlement, or disentitling them to the payment in its entirety.

For many families, the income stream represented by the DSP is not the major concern. It is the Health Care Card and resultant eligibility for various government-funded programs and initiatives that are of significant benefit. The experience of some families is that outside of the government system, there are no private providers who can step into the gap and provide the support services required, regardless of the resources of the family.

This scenario created problems for families that were seeking to make provision for their child after their death. During the lifetimes of the parents, the funds could be held by them and administered on behalf of the child, but upon their death the position regarding the child's care and the availability of finances was often uncertain.

Indeed this is an issue which has largely arisen in recent times. In the past, persons with significant disabilities often did not survive their parents or guardians. However, with more understanding of disabilities and better support facilities

available, we are now finding that people with disabilities often outlive their parents.

Introduction of special disability trusts

From 20 September 2006, a new type of trust became available to address, in part, this situation. The federal government enacted legislation giving people the ability to establish a 'Special Disability Trust' for persons with a 'severe disability'. The main advantage of the trust, and a departure from the way other trusts are treated, is that there are certain Centrelink exemptions provided.

The trusts can be established during the lifetime of someone, that is by deed, or upon their death, via their will. The relevant beneficiary is referred to as the 'principal beneficiary'.

Exemptions

The exemptions are two-fold, first, for the principal beneficiary themselves, and second, for certain donors to the trust.

1. Up to $500,000, in addition to a principal place of residence, can be held in the trust, without the assets or income generated counting for the purposes of the means test. The $500,000 threshold will be indexed on an annual basis.
2. If a parent, guardian, grandparent or sibling of the principal beneficiary gifts up to $500,000 to the trust, those funds will not count for the purposes of the deprivation rules if the donor is seeking to qualify for:
   - a social security payment and is of age pension age;
   - a service pension and has reached veterans' pension age; or
   - a veteran's income support supplement and has reached the qualifying age for payment.

Parameters of the special disability trust

Severe disability

A Special Disability Trust can only be established in respect of one person, and that person must meet the definition of having a 'severe disability'. When determining whether the beneficiary has a severe disability, the relevant definition depends on whether the beneficiary is 16 years or over, or if they are under the age of 16.

A Special Disability Trust can only be established in respect of one person, and that person must meet the definition of having a 'severe disability'.

If the beneficiary is 16 years or over, the definition is set out in s 1209M(2) of the *Social Security Act 1991* (Cth) and s 52ZZZWA(2) of the *Veterans' Entitlements Act 1986* (Cth). These provisions state:

> If a principal beneficiary has reached 16 years of age:
>
> (a) The beneficiary must:
>
> (i) Have an impairment that would qualify the person for disability support pension; or
>
> (ii) Be receiving invalidity service pension under Part III of the *Veterans' Entitlements Act*; or
>
> (iii) Be receiving income support supplement granted on the ground set out in subparagraph 45A(1)(b)(iii) of the *Veterans' Entitlements Act*; and
>
> (b) The beneficiary must:
>
> (i) Have a disability that would, if the person had a sole carer, qualify the carer for carer payment of carer allowance; or
>
> (ii) Be living in an institution, hostel or group home in which care is provided for people with disabilities, and for which funding is provided (wholly or

partly) under an agreement, between the Commonwealth, the States and the Territories, nominated by the Secretary under subsection (3); and

(c) The beneficiary must have a disability as a result of which he or she is not working, and has no likelihood of working, for a wage that is at or above the relevant minimum wage.

Persons with mental illnesses may find it difficult to meet the limb in paragraph (c) by virtue of the episodic nature of some of these illnesses.

Practically, before establishing a Special Disability Trust, the first step would be to verify with Centrelink as to whether they would regard the beneficiary in question as having a severe disability.

If the principal beneficiary is under the age of 16, the beneficiary must be 'profoundly disabled', as defined in s 197 of the *Social Security Act 1991* (Cth), to qualify as having a 'severe disability'.

Expenditure

Importantly, the income and capital in the trust can only be expended for the *reasonable care and accommodation* of the principal beneficiary, for expenditure directly attributed to the disability. There is an indication in the *Social Security (Special Disability Trust) (FaCSIA) Guidelines 2006* of the types of expenditure that this may encompass, for example, modifications to homes for wheelchair access and the payment of fees to a third-party carer.

Any income not spent in a financial year must be accumulated in the trust (which will thus incur tax at the highest marginal tax rate). Therefore before establishing a Special Disability Trust, it will be important to project the likely expenditure of the trust and estimate the level of income likely to be generated.

Arms-length and regulatory requirements

By virtue of the protective nature of this trust, there are a number of requirements which need to be met.

- Any payments by the trustee for the care of the principal beneficiary, for repairs and maintenance of accommodation and to purchase or lease property can only be made to third parties. Therefore such payments cannot be made to a parent/guardian, grandparent, sibling or child of the person with the disability.
- There cannot be one individual trustee unless they are a professional. Therefore there must either be two or more individuals, a corporation with two or more directors, or a professional trustee (including a trustee company), acting as trustees of the trust. There are further requirements for trustees, for example they must be Australian residents, and not have been convicted of an offence of dishonest conduct.
- The trust cannot receive any assets from the principal beneficiary or their partner, unless it is a bequest or superannuation death benefit and is transferred to the Special Disability Trust within three years of receipt.
- The trustee is required to prepare annual financial statements and submit them to Centrelink each year.
- There are certain persons who can request that the trustee have the financial statements audited, such as the principal beneficiary, certain immediate family members, a guardian or Centrelink.

Conclusion

The introduction of Special Disability Trusts provides a useful vehicle for some families who wish to make provision for beneficiaries with significant disabilities. The particular circumstances of each family and each principal beneficiary need to be examined to determine the utility of the trust. The exemptions provided will be of substantial benefit to some families, and these benefits will need to be balanced against the requirements outlined above. ●

Suhanya Ponniah, Lawyer, MooresLegal, <SPonniah@MooresLegal.com.au>

legislation update

Capital gains tax concessions for small business

The Tax Laws Amendment (2006 Measures No 7) Bill 2006 passed through Parliament on 29 March 2007. It now awaits Royal Assent.

The Bill aims to improve the access of small business to a number of capital gains tax (CGT) concessions. These enhancements are the government's response to recommendations by the Board of Taxation.

Improvements to the concessions include the following.

Significant individual test

The controlling individual 50 per cent test is replaced by the significant individual 20 per cent test.

- The new test allows up to eight people operating a small business jointly through an entity to access the concessions, compared with the previous rules which allowed a maximum of only two controlling individuals.
- Unlike the previous test, the new test can be satisfied on the basis of direct and indirect holdings through interposed entities.

Gifts are eligible for retirement exemption

The new rules allow a person to gift a business asset rather than requiring the asset be sold.

- This recognises that some people would prefer to gift an asset, such as the family farm, to their children rather than selling

it to access the retirement exemption.

The improvements also include the following.

Small business rollover

This change allows a taxpayer to defer a capital gain in the year the gain is made, pending the reinvestment of the sale proceeds into a replacement asset.

- If the proceeds have not been reinvested within two years, a capital gain arises at that time.
- Previously, a taxpayer would have to account for a capital gain upfront in the year it is made if they had not yet reinvested the proceeds, potentially incurring additional compliance costs once the proceeds were reinvested.
- In addition, rollover will now be available to the extent the sale proceeds are reinvested in a replacement asset or in improving an asset already owned, rather than the proceeds having to be wholly reinvested in a newly acquired asset.

Deceased estates

The new rules allow legal personal representatives or beneficiaries of a deceased estate to access the concessions to the same extent that the deceased could have used them just prior to their death.

Small business 15-year exemption

The exemption will be available provided there has been a significant individual in relation to the company or trust for at least 15 years and not necessarily for the entire period of ownership of the asset.

Extending types of liabilities taken into in calculating the maximum net asset value test

The test will allow provisions for annual leave, long service leave, unearned income and tax to be taken into account.

Calculating the maximum net asset value test in relation to partnership assets

The test will be applied to the value of assets of individual partners rather than to the partnership as a whole.

Interests in companies and trusts as active assets

In determining whether 80 per cent of a company's or trust's assets are active assets, cash and financial instruments inherently connected with the business can now be counted.

The amendments apply to CGT events that happen in the 2006/07 and later income years.

New simplified minimum pension standards and portability arrangements

On 3 April 2007 the Minister for Revenue and Assistant Treasurer, the Hon Peter Dutton MP, announced that Regulations have been made to provide new simplified minimum standards for pensions.

'The new rules will also accommodate both account-based and more traditional guaranteed income stream products. Retirees will therefore retain the ability to choose between these two broad product categories,' Mr Dutton said.

The Regulations also give effect to changes to the portability of benefits, including introducing a standard portability form — from 1 July 2007, the maximum number of days in which a fund has to action a member's request to transfer benefits will be reduced from 90 to 30 days.

They also confirm the removal of the requirement for compulsory cashing of superannuation benefits for people over the age of 65 years, which have been in place since Budget night 2006. Other amendments include revised rules for the payment of superannuation death benefits, new rules for the acceptance of member contributions made without a tax file number and improvements to the regulation of self managed superannuation funds. ●

<*http://assistant.treasurer.gov.au*>

Frequently asked questions in estate planning

Louise Biti
ASTERON

Q: My client has a $2 million life insurance policy inside his superannuation fund. For tax planning, he currently has a binding nomination to pay up to the pension reasonable benefit limit (RBL) ($1.3 million) to his wife as a lump sum with the balance paid as allocated pensions to his three children who are all under age 18.

Will the 1 July 2007 changes to superannuation have any impact on this strategy?

A: There are a number of impacts from 1 July 2007 that will mean this strategy should be reviewed.

Taxation aspects on payment

Under the current rules, the spouse can receive up to the pension RBL tax-free, but the excess is taxed at 46.5 per cent. From 1 July 2007, any amount paid to the spouse is tax-free. This allows her to receive the full $2 million tax-free.

Binding nomination update

Also important to consider is the validity of the binding nomination. From 1 July 2007, pension RBLs do not exist. Therefore, this binding nomination is potentially invalid from that date if it links the payment split to the pension RBL as a concept rather than a specific dollar amount.

If he dies with an invalid binding nomination, trustee discretion will apply to decide to whom to pay the superannuation death benefit.

Using pensions

The wife's needs should be examined before she accepts payment of the death benefit. Some funds may offer her the options to take an income stream or a combination of a lump sum and income stream.

If she takes a lump sum and invests the money at 8 per cent per annum, her tax on the income could be up to $54,750. If she wants to get the money back into super to take advantage of future tax savings, it will take her up to 13 years to get it back in.

Alternatively, she can convert the whole amount into an allocated pension. There is no tax on the earnings in the fund, and she is taxed on only the income she withdraws, with a 15 per cent tax offset.

If she withdrew the earnings in the fund (that is, $160,000), her tax liability is only $30,750 after allowing for the offset.

If she wants access to lump sums, she should withdraw these before starting the allocated pension so they are tax-free. If she withdraws lump sums from the allocated pension, depending on her age, she could pay tax up to 21.5 per cent.

It can also be beneficial to pay some of the death benefits as allocated pensions to the children to further reduce the tax liability on income. Each child can receive income up to $29,300 tax-free. However, any remaining balance in the allocated pension must be commuted to a lump sum when the child reaches age 25 and the money vests in the child. ●

Louise Biti,
Head of Technical Services,
Asteron,
<*Louise_Biti@asteron.com.au*>.

Disclaimer: The information contained in this article has been provided to address particular situations and may not cover all issues that could be considered in relation to each scenario.

calendar

LexisNexis Professional Development Conference

Estate Planning Masterclass Queensland 2007

Date: Day 1 'Succession law principles and practice'
12 July 2007

Workshop: Day 2 'Practical approaches to will drafting, trusts and estate administration
Date: 13 July 2007
Venue: Conrad Treasury Brisbane
Contact: 1800 772 772 or <www.lexisnexis.com.au/aus/conferences>.

Chairpersons:

- Paul Gleeson, Principal, Gleeson Lawyers; and
- Judy Smith, Partner, Smith & Stanton

Presenters:

- Mark Ostwald, Partner, Cartwrights Tebbett & Ostwald: 'Home made wills and suicide notes — considering case law developments post *Succession Act* amendments'
- Michael Klatt, Partner, Mullins Lawyers: 'Evaluating the introduction of statutory wills';
- Craig Spink, Solicitor, Hillhouse Burrough McKeown Lawyers: 'Including superannuation as part of your will and estate planning advice';
- Jeff Otto, Barrister, Queensland Bar: 'Are trusts still effective? — *Australian and Securities Investments Commission, Re Richstar Enterprises Pty Ltd v Carey (Richstar)* case study';
- Sharon Winn, Consultant, Flower and Hart Lawyers: 'Planning and providing for people with disabilities';
- Michael Liddy, Barrister, Queensland Bar: 'Claiming remuneration or commission by personal representatives and trustees';
- Jane McMahon, Associate, McMahon Clarke Legal: 'Exploring the interaction between family law, bankruptcy and estate planning';
- Scott Whitla, Senior Associate, McCullough Robertson: 'Risk management strategies for succession law practitioners';
- Darren Hayes, Principal Legal Officer, Public Trustee of Queensland: 'Will drafting and other matters' tutorial;
- John Cowen, Director, Lifewealth Financial Strategies: 'Wills and trusts refresher' tutorial; and
- Betty Leung, Solicitor, McCullough Robertson: 'Solving estate administration dilemmas' tutorial.

COMMISSIONING EDITOR: Virginia Ginnane BA/LLB MANAGING EDITOR: Bruce Mills PRODUCTION: Christian Harimanow
SUBSCRIPTION INCLUDES: 10 issues per year plus binder SYDNEY OFFICE: Locked Bag 2222, Chatswood Delivery Centre NSW 2067 Australia
CUSTOMER RELATIONS: 1800 772 772 GENERAL ENQUIRIES: (02) 9422 2222 FACSIMILE: (02) 9422 2404 DX 29590 Chatswood
www.lexisnexis.com.au virginia.ginnane@lexisnexis.com.au

ISSN 1329-4326 Print Post Approved PP 244371/00048 This newsletter may be cited as (2007) 9(9) *REP*