Bust-proofing trusts

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Abstract: Longstanding views about the form and level of asset protection afforded by trusts have been challenged and made less certain by a number of recent court decisions and legislative changes. This article explores the key issues to consider when seeking to "bust-proof" a trust, that is, to render a trust structure less vulnerable to challenge on taxation grounds. The article examines the consequences of recent family court decisions involving trusts, some practical recommendations when dealing with trusts in the context of structuring a client's affairs, the impact of the decision in the *Richstar* case in 2006, some bankruptcy issues, and critical issues to consider whenever establishing or amending a trust deed. In the author's view, for the time being, the benefits of discretionary trusts are generally still sufficient to make them the preferred structure for asset protection purposes, but great care should be taken when restructuring and establishing discretionary trusts.

As previous articles have highlighted, the need for effective structuring of business and personal assets has been brought into sharp focus for high net wealth individuals and business owners in recent years.

In particular, the potential ineffectiveness of trust structures has been highlighted by a myriad of court decisions and legislative changes since 2010.

This article explores the key issues to consider when seeking to "bust-proof" a trust in broadly the following order:

(1) the consequences of recent family court decisions involving trusts;

(2) some practical recommendations when dealing with trusts in the context of structuring a client's affairs;

(3) the impact of the decision in *Australian Securities and Investments Commission in the Matter of Richstar Enterprises Pty Ltd (ACN 099 071 968) v Carey (No. 6)*[1] (*Richstar*);

(4) the *Bankruptcy Act 1966* (Cth) (Bankruptcy Act); and

(5) some critical issues to consider whenever establishing or amending a trust deed.

While the impact of the family court decisions on trusts is obviously significant, this article only focuses on decisions since the publication in this journal of the author's detailed article "Trust assets and estate planning: how has the dust settled after Kennon v Spry".[2]

Overview

The asset protection typically understood to be afforded by trusts is derived from the longstanding view that a mere discretionary beneficiary of a trust does not have a proprietary interest in a trust's assets, and the main right of a discretionary beneficiary is limited to enforcing due administration by the trustee. Consequently, it is difficult to value this right when the beneficiary has no present entitlement to the trust's assets and may never have any entitlement to any part of the income or capital of the discretionary trust.

While this has been the accepted view for hundreds of years, recent decisions in Australia potentially undermine the level of asset protection afforded by trusts.

The high profile decision of *Richstar* considered whether a beneficiary can have a proprietary interest in the assets of a trust where that beneficiary has "effective control" over the trust.

In *Richstar*, the court held that some of the defendants had "at least a contingent interest" in the trust property, which was sufficient for the property to be potentially available to the receivers. A contingent interest was found to arise where "the trustee is effectively the alter ego of the relevant beneficiary or otherwise subject to his or its effective control".

Although the court did not allow the full order sought by ASIC, the decision challenged the traditional view that for a beneficiary of a discretionary trust, mere "expectancy" is not sufficient to constitute "property" which is available to creditors.

For completeness, it should be noted that *Richstar* was a decision about proprietary interests in a bankruptcy context.

Family law considerations

Overview

As explained in detail in the author's earlier article,[2] initially the *Spry*[3] decision raised concerns that it effectively created a significant widening of the courts' power to effectively disregard the existence of a trust when considering the division of assets on a property settlement.

Over time, the practical impact of the decision has arguably softened, not least of which due to the fact that the outcome of the decision appears to be strongly linked to the somewhat unique circumstances of the case.

In particular, the arguably questionable conduct by the husband (such as mismanagement of trust assets, threatened destruction of trust assets, misleading representations to the courts and attempted direct communication with the judges) may have contributed significantly to the outcome.

A number of cases since 2008 reinforce the conclusion that the impact of *Spry* has not been as severe as initially feared. Aside from the numerous cases analysed in the author's earlier article, there have also been a number of recent family court cases

that are directly relevant to the ability to structure trusts robustly.

A number of the key cases in this regard are summarised below.

Family Courts' power to adjust inheritance rights

Arguably, the most widely published case since *Spry* was the High Court judgment of *Stanford v Stanford*[4] (*Stanford*) where the Family Courts' powers to potentially displace the distribution of assets under an estate plan that involved a form of trust (namely a life estate) were analysed.

The brief facts were that Mr and Mrs Stanford had no children together, although both had children from previous relationships. The Stanford's had both crafted their estate plans to provide for their respective children, without making provision for each other, other than a life tenancy in the family home. The house was owned solely in the name of Mr Stanford (he had bought it before the marriage), although it had been lived in by the couple for over 40 years.

Critically, Mrs Stanford appointed her children, not Mr Stanford, under her guardian and attorney documents.

Due to ill health and mental incapacity, Mrs Stanford was moved into residential care. Despite no suggestion that the couple were anything other than happily married, on her mother's incapacity, Mrs Stanford's daughter initiated proceedings in the Family Court (as Mrs Stanford's legal guardian) seeking orders for equal division of the marital property (the main asset was the family home) between Mr and Mrs Stanford.

The initial judge ordered that Mr Stanford pay a fixed sum of approximately half the value of the marital property to Mrs Stanford, which payment would have effectively passed directly to her guardians. To fund the payment, the family home would have needed to be sold, forcing Mr Stanford to leave the house.

Mr Stanford appealed the decision. However, Mrs Stanford passed away before judgment was delivered by the Court of Appeal. The Court of Appeal ultimately decided that Mrs Stanford's legal personal representatives should receive the fixed sum upon the death of Mr Stanford. This decision effectively altered the distribution of Mr Stanford's estate (which Mrs Stanford had agreed with while she had capacity) under his will as the house (following his wife's death) would have otherwise passed to his children.

The decision of the Court of Appeal was ultimately set aside on appeal to the High Court, on the basis that the order was not just and equitable. However, importantly, the High Court confirmed that the death of a party to a marriage "does not transform the nature of the claim (for example, into a claim by the beneficiaries of the wife's estate)".

In other words, the right of a guardian or attorney to commence property settlement proceedings was effectively confirmed, even where (as here) they would have no entitlement to challenge the estate of their stepfather.

Asking the right questions

Beeson v Spence[5] (*Beeson*) highlights the importance of the factual matrix on how exposed the assets of a trust are in a family law context.

The wife and the husband met in 1996 in this case, and married in 1997. They had two children and subsequently divorced in 2004. In 2001, the wife had established a trust known as the S Trust.

On establishment of the trust, the wife's father and her solicitor were appointed as trustees and the wife was the appointor. The specified beneficiaries were the two children of the marriage and the wife and husband were within the class of potential beneficiaries.

In 2003, at a time when the husband was going through financial difficulties, and when the wife and husband had separated, the deed was varied to exclude the wife and the husband as potential beneficiaries of the trust, as well as to resign the wife as appointor. A new appointor, being the wife's sister, was nominated in her place.

After the variation, the deed practically still entitled the wife and husband to receive distributions, not as potential beneficiaries, but as "parents" of the children who remained specified beneficiaries.

In the property settlement proceedings, the husband argued that the trust was established for the benefit of the family as a whole and not just the children. In contrast, the wife suggested that the trust was ultimately established for the purpose of benefitting the children of the relationship and therefore the assets should not be treated as property of the marriage.

Having reviewed all of the available facts, the court ignored the release of direct control by the wife (through her resignation as the appointor and the removal of beneficiaries) and held that the wife still retained sufficient control of the trust to support a conclusion that the assets should be treated as property of the marriage.

Some of the key questions the court in *Beeson* took into account when deciding the assets of the trust were property of the marriage are set out below.

Who is the trustee of the trust?

The trustees of the trust were the wife's father and her solicitor. They had the discretion to administer the trust.

Does the trust deed restrict the range of beneficiaries who can receive income or capital distributions?

The specified beneficiaries were the children of the husband and wife, and the husband and wife were initially potential beneficiaries as parents of the specified beneficiaries. By the deed of variation (instigated by the wife) in 2003, the husband and wife were removed as potential beneficiaries. After the deed of variation, the wife and husband were entitled to receive distributions, not as potential beneficiaries, but as "parents" of the specified beneficiaries.

Does the trustee need consent/approval of any other person for distribution?

No. However, the trust deed gave the wife ultimate control of the distribution of income and capital by giving her power of appointment and removal of trustee, who in turn had the discretion to distribute to the wife and the husband to the exclusion of the children. This level of control pointed towards the trust being an alter ego of the wife, and the conclusion that the assets were property of the marriage, not the children.

Does the trustee effectively/practically control the trust in an unfettered way?

No. Up until her resignation under the deed of variation in 2003, the wife as appointor had complete control over the appointment and removal of the trustee. The consent of the appointor was required for the trustee to vary the terms of the trust deed. Nothing, including a request by the trustee, obliged the wife as appointor to relinquish control of the trust.

Does the trustee exercise its powers independently or are they controlled or subject to approval by any other person or entity?

While the trustee had the discretion to make distributions, the power to vary the deed was subject to approval by the appointor and the appointor could remove the trustee at any time.

Can beneficiaries be removed or added, and if so, by whom?

The beneficiaries could be removed or added by the trustees, only with the consent of the appointor.

Is there any risk that the trustee may be seen as simply the "alter ego" of some other person?

The court found that the trust was created with the wife in control of the appointment of those with the duty of administering it and it was never created to benefit the children alone. The assets of what was essentially a "standard" discretionary trust were controlled by a party to property proceedings who ultimately had the power to legitimately determine at any point to whom income and/or capital was to be distributed, including herself.

Does someone (eg an appointor, guardian, principal) have the power to unilaterally change the trustee?

Yes. The appointor was the wife initially. While she subsequently relinquished control and appointed her sister as replacement appointor in 2003, the steps taken via the deed of variation were seen as having been taken at the wife's direction. This conclusion pointed towards the trust being the alter ego of the wife, and thus the property of the marriage and not the property of the children.

If the appointor ceases to act, do their powers pass to anyone else, and if so, who?

The deed provided for the appointor powers to pass to Mr Beeson, the wife's father and trustee of the trust, upon her death. The deed also allowed for the wife as the original appointor to name a successor appointor (which she did, namely her sister).

For an existing trust, has there been a pattern of income or capital distributions?

Distributions were made from income in both 2002 and 2003 to the specified beneficiaries being the children. Distributions were also made to the wife in this period, which she applied, among other things, to payment of her legal costs. While the wife argued the legal costs incurred showed the fund was used for the children's benefit, it was held that the legal costs should be seen as being incurred on her own account. This supported the conclusion that the trust was not the sole benefit of the children.

Further, there was nothing improper about the trustees distributing funds in the wife's favour, as she was a potential beneficiary up until the variation in 2003, and continued to be entitled to receive distributions as a "parent" of the specified beneficiaries after the variation.

Access to trust documents in Family Court cases

The case of *Schweitzer & Schweitzer*[6] considered the disclosure of documents claimed by one spouse to be in the possession, or under control, of the other.

The specific facts of this case were that the husband was a director of two corporate trustees, but not the sole director. In one corporate trustee, the husband's father was the other director. In the other corporate trustee, the husband's father and mother were the other directors.

While the husband was not a shareholder of either of the trustee companies, he was however a discretionary beneficiary of both trusts.

The appointor of both trusts was the husband's father.

The wife applied to the court asking that the husband disclose the financial statements, tax returns, bank statements and the minutes of meeting relating to trust distributions by the corporate trustees.

The wife's request was rejected on the grounds that the husband had a fiduciary obligation in relation to the holding and use of trust and corporate trustee documents.

The court also held that the documents were not under the husband's "control" for the purpose of the Family Court rules. The decision confirms that directors of corporate trustees have no right to "possession" or "control", but only to "access" trust documents and that such access must be used strictly for the trust or company purposes.

The documents might have been accessible if the wife was able to join the corporate trustees as parties to the proceedings, although this was not necessarily something the court would approve; and even if they were joined, disclosure of the documents would still be subject to the court's discretion.

In the case of *MacDowell & Williams*,[7] the court denied the request for disclosure of the wills and documents relating to the corporate and trust structures of the wife's parents.

The wife and the husband married in April 2004 and separated on a final basis on 12 July 2010. The husband had submitted that the documents requested were relevant to the marital property pool and in determining the financial resources available to the wife.

The wife's parents filed an objection to the husband's request on the basis that:

- the documents sought from them in their personal capacity were not relevant as they maintained testamentary capacity; and
- the documents sought from them in their capacity as directors were not relevant as neither the wife nor the husband had any proprietary interest.

In relation to the parents' wills, the court said the request was a "fishing expedition" by the husband. Although there may be compelling circumstances which warrant the disclosure of will documents (for example, when a parent has lost capacity), here, both parents were alive, in good health and possessed full testamentary capacity.

In relation to the financial and corporate documents, it was held that there was no evidence to suggest that the wife had control over any of the entities, or that control was likely to arise in the future.

The court then considered the previous distributions of one trust where the wife was both the primary and default beneficiary. Given, however, that the wife had only received $28,000 over the ten years of the existence of the trust, and during that time, distributions had also been made to other beneficiaries of the trust, the court held that it was clearly "discretionary" in nature.

The husband also sought to rely on purported interpretation of *Spry* and argue that the wife's interest in the trust were property, that being her "right to consideration" and "due administration". The court held in favour of the wife's parents that this was a misstatement of the law on this point and that while such rights could be taken into account, they would generally be very difficult to value.

The court also bluntly distinguished *Spry* by noting that Dr Spry had total ultimate control of the trust in question, which was not the case here.

Similarly, the case of *FCT & Darling*[8] confirms that generally the ATO can only obtain information via Family Court proceedings if it demonstrates, on a case-by-case basis, that it is a person with "a proper interest" along with all of the reasons that support allowing such access.

In this case, it was acknowledged that while the ATO does have special powers to obtain information to carry out its duties, this did not mean those powers could be used to undermine the preference of the Family Court to create an environment that encourages full and frank disclosure between former spouses.

Trusts and asset protection – protection from bankruptcy

Risk of claims by a trustee in bankruptcy

Where an individual or entity is involved in a profession or conducting a business, claims against them by creditors or potential litigants can expose all of the assets held.

The possibilities for litigation and claims by creditors against individuals to arise (and, therefore, also the potential for bankruptcy to occur) are numerous and include:

- claims against a business by their suppliers;
- product liability of manufacturing businesses;
- professional negligence claims against professionals (eg accountants, doctors, lawyers and financial advisers); and
- general negligence claims (eg operation of a motor vehicle causing personal or property damage).

There are also a number of potential risks of claims being made against directors of companies, including personal liability, for:

- the company's debts incurred in insolvent trading;
- some tax obligations of the company;
- unpaid employee's superannuation deductions;
- an ever-widening statutory liability where directors are personally liable for the company's actions. Many state and federal Acts impose this personal liability — one example is workplace health and safety legislation;
- negligence; and
- guarantees.

Even relatively passive assets can result in litigation against the owner which brings with it the potential for bankruptcy. For example, a person who owns an investment property in their own name can be personally sued if a tenant trips and injures themselves on the property, subject to any insurance cover.

It is, therefore, vital to ensure that as many assets as possible are quarantined from an "at risk" individual or entity to avoid them from being exposed to potential claims. It is also vital to ensure that assets with high-risk exposure are quarantined from all other assets to limit the potential exposure to the value of those assets.

> *"... there was no evidence to suggest that the wife had control over any of the entities."*

Movement into bankruptcy

Even if an individual or entity has caused litigation to arise, a lot must happen before a trustee in bankruptcy becomes involved. In summary, the steps are as follows:

- there must be a debt;
- if that debt is a judgment debt, there will have been a claim that has been successfully prosecuted in the courts;
- there must have been a failure to meet that debt; and
- the creditor must then have sought to appoint a trustee in bankruptcy to the debtor's estate. Depending on the circumstances, other arrangements might be considered to avoid the appointment of a trustee in bankruptcy. For example, the debtor might enter into an informal agreement with creditors, or enter into arrangements under Pts IX or X of the Bankruptcy Act.

A discussion of these various arrangements and options is outside the scope of this article, rather the focus here is the worst-case scenario, where a trustee in bankruptcy is appointed. However, the principles of protecting assets from exposure to claims against individuals are also relevant in the case of a scheme of arrangement.

Sections 120, 121 and 122 "claw-back" rules

In considering claims that might be brought by a trustee in bankruptcy, it is relevant to bear in mind the voidable transaction provisions in the Bankruptcy Act. These provisions, often referred to as "claw-back" provisions, enable the trustee in bankruptcy to trace and reclaim assets that were transferred prior to a person becoming bankrupt.

In particular, a transfer can be overturned, subject to certain exclusions:

- if the transfer took place within two years before the commencement of the bankruptcy where no consideration was paid or where consideration was less than market value (s 120(3) of the Bankruptcy Act) — or four years for related entities;
- if the transfer took place within five years before the commencement of the bankruptcy and at the time of the transfer the person was insolvent, where no consideration was paid or where consideration was less than market value (s 120(1) of the Bankruptcy Act);
- if the transfer took place within six months before the commencement of the bankruptcy, the transfer is to a creditor, the creditor obtains a preference, priority or advantage over other creditors and at the time of the transfer the transferor was insolvent (s 122 of the Bankruptcy Act); or
- at any time where the main purpose in making the transfer is to prevent the transferred property from becoming divisible, or to hinder or to delay the process of making property available for division among creditors (s 121(1) of the Bankruptcy Act).

As the commencement of the bankruptcy may be dated from the first act of bankruptcy within the six months before a relevant petition was presented, up to a further six months could be added to these periods of "claw-back".

It is significant to note that, if ss 120 and 121 void (claw-back) the transfer of property, there is a requirement to pay to the transferee the consideration (if any) that they had paid.

These provisions pose a potential threat to the whole strategy of accumulating assets in the hands of "low-risk" entities, where value must be "moved" (a financial contribution) to that "low-risk" entity.

Ultimately, in any asset protection exercise, the impact of the "clawback" rules under the bankruptcy legislation needs to be carefully considered.

Probably the fundamental aspect in this regard is whether a decision by a person to divest themselves of assets was done for the main purpose of defeating creditors.

The leading case in this area arguably remains *Williams v Lloyd*.[9]

In this case, a bankrupt transferred assets to family members while he was solvent, but knowing that he was likely to start engaging in a "risky" business activity in the future.

The court held that the transfers could not be clawed back and the key aspect of the decision was as follows:

> "Once it is acknowledged, as upon the evidence I think it must be, that in 1926 the bankrupt was in a perfectly sound financial position and had nothing to fear, subsequent conduct and events form an insufficient basis for a finding that the documents were shams, or that he had an intent to defraud his creditors, or that they were made subject to a suspensory condition allowing them to take effect only in case of attack by creditors."

Bankruptcy issues with trusts

Vesting of property upon bankruptcy

Generally, the property of the bankrupt vests in the trustee in bankruptcy as and from the commencement of the bankruptcy.

However, subject to the comments below, the property of the bankrupt does not include the assets of a trust of which they are a discretionary object. The primary reason for this is that no beneficiaries of a trust have any defined interest in the trust assets, but rather merely have a right to have the trust administered in accordance with the terms of the trust established under the deed (*Gartside v Inland Revenue Commissioners*[10]).

Therefore, if a beneficiary becomes bankrupt, the assets of the trust will not be available to their creditors unless the trustee makes a distribution to that beneficiary.

This general position is subject to a number of possible exceptions, including:

- flow-through of income;
- exposing the assets of the trust;
- "beneficiary loan accounts" or other debts owed by the trustee to a bankrupt beneficiary;
- where the bankrupt is a default beneficiary;
- where the "at risk" beneficiary is the appointor/principal; and
- where the "at risk" beneficiary is the trustee.

Each of these issues will be dealt with in turn below, before the implications of the Richstar decision are considered in detail.

Flow-through of income

Income derived by a trust will usually flow through to the beneficiaries by force of tax pressure. This is to ensure that the trustee is not assessed at the top marginal tax rate under s 99A of the *Income Tax Assessment Act 1936* (Cth) on any undistributed income.

Beneficiaries will be presently entitled to income, which is appointed or applied to them by the trustee. Clearly, where a beneficiary who has a vested interest because the trustee exercises its discretion to vest income (or indeed capital) in the beneficiary, that interest will be exposed to a claim against the beneficiary.

A simple solution would be for the trustee to exercise its discretionary power to distribute the share of the income for any year where a beneficiary is bankrupt to beneficiaries who are themselves not at risk.

Other solutions may include:

- establishing separate or sub trusts in relation to income to which beneficiaries other than the bankrupt are presently entitled. In either case, the amounts distributed to those trusts will be liabilities in which the trustee in bankruptcy will have no priority; or
- ensuring that the terms of the trust prohibit the trustees from distributing income and capital to the "at risk" beneficiary.

Invalid distributions

In the context of trust distributions, the "read the deed" mantra is well known.

The family law case of *Harris v Harris*[11] is one example of a situation that turned in part on the range of potential beneficiaries.

In that case, the trial judge in a family court matter noted that the recipient of trust distributions (being a company), who was being challenged, was not in fact an eligible beneficiary of the relevant trust. If the company had been simply nominated as a potential beneficiary, then the distributions would have most likely been valid.

A more common example of where difficulties with invalid distributions arise, however, relates to where particular potential beneficiaries are in fact expressly excluded by the trust deed. The most common example in this regard is the exclusion of the trustee, be that the current, former or even a future trustee, from being a beneficiary of a trust.

> *"… it is generally sensible to appoint multiple trustees to act jointly with the beneficiary …"*

These types of clauses are often found in deeds prepared by New South Wales advisers. This is primarily because s 54(3) of the *Duties Act 1997* (NSW) limits the nominal duty exemption for a change of trustee to trust deeds that contain provisions ensuring that:

(1) none of the continuing trustees remaining after the appointment of a new trustee are or can become a beneficiary under the trust;

(2) none of the trustees of the trust after the appointment of a new trustee are or can become a beneficiary under the trust; and

(3) the transfer is not part of a scheme for conferring an interest, in relation to the trust property, on a new trustee or any other person, whether as a beneficiary or otherwise, to the detriment of the

beneficial interest or potential beneficial interest of any person.

An example of a clause adopting an approach that ensures access to the stamp duty relief is as follows:

"The Trustee for the time being of the Trust cannot be a beneficiary of the Trust. None of the continuing Trustees remaining after the retirement of a Trustee is or can become a beneficiary under the Trust, and none of the Trustees of the Trust after the appointment of a new Trustee is or can become a beneficiary under the Trust."

New South Wales is the only Australian jurisdiction that has this type of restriction on accessing the duty concessions for a change of trustee and, understandably, clauses drafted in this manner are extremely prevalent with deed providers or lawyers based in New South Wales.

In many instances, however, there may in fact be no other connection with New South Wales for anyone associated with the trust.

The risks created by this drafting approach will, therefore, often be less than obvious. Anecdotally, there would seem to be an increasing number of situations where invalid distributions are being discovered that stretch back over many years and involve significant levels of invalid distributions. The exact ramifications of this type of situation will depend on a range of issues, including how any default provision under the relevant trust deed is crafted.

ATO tracing of trust distributions

One stark example of the ATO's attitude towards trust distributions is its review around identification of beneficiaries of certain distributions, particularly where trust-to-trust distributions are involved.

In particular, trustees are required to complete an ultimate beneficiary statement where a distribution is made to another trust, failing which ultimate beneficiary non-disclosure tax is imposed on the trustee of the original trust equal to the highest marginal tax rate plus the Medicare levy.

Following the 2013 federal Budget, the ATO also announced details of the "Trusts Taskforce" which, in addition to the stated goal of identifying "egregious tax avoidance and evasion using trust structures" is stated to be focused on:

- unregistered trusts and their beneficiaries;
- trusts that are irregular in lodging tax returns;
- offshore trust dealings involving secrecy jurisdictions;
- sham transactions; and
- artificial re-characterisation of amounts.

The ATO has, however, stated that the intended targets of the taskforce are high-risk taxpayers and not ordinary arrangements and tax planning associated with genuine business or family dealings.

Exposing the assets of the trust

It is important to remember that using a trust does not magically confer protection to the assets of the trust. The assets of the trust can easily be exposed within the trust environment. In particular, where the trustees carry on a business or apply the assets to other high-risk activities.

Ideally, therefore, trusts should be utilised solely for passive investments or alternatively sub trusts or separate structures should be used to quarantine more risky activities.

Beneficiary loan accounts

The balance of "beneficiary loan accounts" which have built up as a result of tax distributions not being matched by cash payments out of the trust should be reviewed regularly.

Any credit beneficiary loan accounts are an asset of the beneficiary, and thus are exposed to any claim brought against the beneficiary. It is important to ensure that trustees do not create beneficiary loan accounts in beneficiaries with a high level of exposure.

It is also unwise to have "at risk" beneficiaries lending back distributions received to the trust, which also leads to the creation (and accumulation) of a loan account in favour of the beneficiary with the trust.

It is important to ensure that beneficiaries with a level of exposure properly deal with loan accounts on an ongoing basis, particularly having regard to claw-back provisions of the Bankruptcy Act set out above, which could mean that the assets of the trust still remain exposed four years or more after a beneficiary gifts a previously created loan account back to the trust.

Default beneficiaries

Most trusts include default provisions in relation to both income and capital. That is, if the trustee fails to effectively exercise its discretion to distribute income in any year or capital on the trust vesting date, the trustee will be deemed to hold the undistributed income or capital for nominated default beneficiaries.

Some commentators have argued that the interest of these default beneficiaries constitutes property which may vest in the trustee in bankruptcy if a default beneficiary is declared bankrupt.

It has generally been argued that the interest of default beneficiaries is of a different character to that of a discretionary object and may well be property of a bankrupt (*Dwyer v Ross*[12]).

However, it has also been argued that the interests of takers in default do not have a vested interest in the assets of the trust until the trust vests and until that event occurs, the assets of the trust have not been the subject of an effective appointment. That is, such interests can be deferred or taken away at any time prior to vesting or termination of the trust and accordingly such interests are "mere expectancies" in respect of property which is not capable of vesting in a trustee in bankruptcy.

The preferred position adopted by the cases (despite the *Richstar* decision) remains that a default beneficiary does not have an interest in trust assets that amounts to property that is attackable by a trustee in bankruptcy.

This said, it is always appropriate when establishing a trust to consider carefully who should be nominated as the default beneficiaries to ensure that the assets of the trust do not become unnecessarily exposed to claims against those beneficiaries if the law in this area changes.

Powers of appointor/principal

Many trusts create a position for an appointor or principal who generally has the power of removal and appointment of the trustee.

A question that often arises is, whether, if a principal/appointor is subsequently declared bankrupt, is their power of appointment a "property" which vests in and can be exercised by the trustee in bankruptcy?

The property of a bankrupt which is available for distribution to creditors includes "the capacity to exercise, and to take proceedings for exercising, all such powers in, over or in respect of property as might have been exercised by the bankrupt

for his own benefit …" (see s 116(1)(b) of the Bankruptcy Act).

However, it has been held that the right of a bankrupt to exercise a power of appointment under a discretionary trust is not property of the bankrupt (*Re Burton; Wily v Burton*[13]).

Further, the decision in *Dwyer v Ross* suggests that a trustee in bankruptcy cannot compel the trustee of a trust to exercise the trustee's discretion in favour of a bankrupt beneficiary. To do so could be construed as a breach of the trustee's duty to the solvent beneficiaries of the trust. It would be against the interests of the beneficiaries as a whole to exercise the power in that way. As a practical matter, however, if a trustee in bankruptcy purports to act in that way, the beneficiary and trustee is left to take action against the trustee which on a number of levels (not least of which being financial capacity) may not be possible.

Again, however, with reference to the principles following the *Richstar* case outlined below, it may still be prudent to ensure that:

- there are at least two persons filling the appointor/principal role, who must act jointly;
- any appointor/principal can resign; and
- any appointor/principal is automatically removed if declared bankrupt.

Appointor succession

There does not necessarily need to be an appointor provision under a trust deed, however where there is, a trust deed will normally set out in some detail the way in which the role of appointor is dealt with on the death or incapacity of the person (or people) originally appointed.

Failing to understand succession arrangements of an appointor can create a range of difficulties as highlighted in the case of *Montevento Holdings Pty Ltd v Scaffidi.*[14]

The case concerned a challenge by a beneficiary of a discretionary trust to a change of trustee by the appointor. The challenging beneficiary was Guiseppe Scaffidi who, along with Maria (his mother) and Eugenio (his brother), was within the range of potential beneficiaries of the Scaffidi Family Trust.

The original appointor of the trust was Antonio Scaffidi (the father). On Antonio's death, Maria became the appointor and by deed Maria subsequently appointed Eugenio Scaffidi as the appointor.

After his appointment, Eugenio appointed Montevento Holdings Pty Ltd (a company of which he was the sole director and shareholder) as the sole trustee, effectively giving him complete control over the trust and its assets.

Guiseppe's challenge to the appointment of the trustee company ultimately failed before the High Court essentially because the appointment complied with the provisions of the trust deed. The decision highlights that the role of appointor can often give ultimate control of a trust.

The relevant clause in this case precluded individual appointors from personally being appointed as trustee. However, the individual appointor appointed a company as trustee of which he was personally the sole director and shareholder.

The High Court held that the ordinary and natural meaning of the clause was that an individual person holding the office of appointor could not personally appoint themselves as trustee. As the trust deed consistently distinguished between individuals and companies, it did not prohibit the appointment of a corporate trustee, even if that trustee was controlled by the individual appointor.

Powers of trustees

Similar to an appointor or principal, the trustee's powers may be available for distribution for creditors and therefore a similar approach to the appointor/principal should be adopted to minimise the risk for a trustee of the trust

Especially in circumstances where a beneficiary under a trust is also appointed as a trustee, it is generally sensible to appoint multiple trustees to act jointly with the beneficiary and may include a:

- family member;
- family friend;
- trustee company; or
- a combination of the above.

Alternatively, as mentioned above (in relation to an appointor/principal), the trust may contain a clause that automatically removes the trustee if they are declared bankrupt.

Share self-ownership

Whenever reviewing existing structures or establishing new entities, reference to the *Corporations Act 2001* (Cth) (Corporations Act) is important. In particular, the Act expressly prohibits companies from owning shares in themselves.

This can arise in instances where a trustee company is incorrectly established with the trust (for which it is trustee) owning some or all of the shares. As the legal owner of those shares is the trustee, this results in the trustee owning shares in itself.

The relevant section is s 259A of the Corporations Act, which provides as follows:

> "Directly acquiring own shares
>
> A company must not acquire shares (or units of shares) in itself except:
>
> (a) in buying back shares under section 257A; or
>
> (b) in acquiring an interest (other than a legal interest) in fully-paid shares in the company if no consideration is given for the acquisition by the company or an entity it controls; or
>
> (c) under a court order; or
>
> (d) in circumstances covered by subsection 259B(2) or (3)."

Under s 259F of the Corporations Act, if a contravention has occurred, a person who was involved (which is widely defined and includes any person who was, directly or indirectly, knowingly concerned in or party to the contravention) in the contravention may be subject to a civil penalty of up to $200,000. There are also potential criminal consequences that can flow from the breach.

Due to the potentially significant penalties that can arise under the Corporations Act, together with the likely adverse commercial ramifications, any identified breach of s 259A should be remedied as soon as practical following identification of the issue.

One option is for the persons involved in the contravention to apply to ASIC for a no-action letter, whereby ASIC confirms it does not intend to take any steps as a result of a particular contravention of the Corporations Act.

As flagged above, a breach of the Corporations Act most typically arises where a trustee company of a family discretionary trust is listed under ASIC records as having its shares owned by the trust. That is, the trustee of the trust owns shares in itself. While "circular" ownership arrangements can be beneficial from an asset protection perspective, they must still comply with the Corporations Act.

The preferred approach, therefore, where the shares in a corporate beneficiary are to be owned by a trust, is for a structure along the following lines:

- the shares in the corporate trustee should be owned by individuals with a low-risk profile;
- the corporate trustee should undertake no activities other than its trusteeship and the value of the shares in the trustee company should therefore be limited to their issue price; and
- the trustee company in its capacity as trustee should own all of the shares in the corporate beneficiary.

The Richstar case and beyond

The *Richstar* case in 2006 set alarm bells ringing because of its redefinition of established discretionary trust principles.

Background

The *Richstar* case stemmed from the litigation surrounding the failed WestPoint group. The Federal Court had already appointed receivers to the property of several directors and companies of the failed group. ASIC sought to have the meaning of "property" (for the purposes of it being available for distribution amongst creditors) extended to include property held by a third party on trust for a defendant, including where the defendant was a general beneficiary of a discretionary trust.

> *"The court made a clear distinction between actual ownership and effective ownership ..."*

The key issue considered by the decision was the definition of "property" in s 9 of the Corporations Act. Section 9 provides that property "means any legal or 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 court held that some of the defendants had "at least a contingent interest" in the trust property, which was sufficient for the property to be available to the receivers. A contingent interest was found to arise where "the trustee is effectively the alter ego of the relevant beneficiary or otherwise subject to his or its effective control".

Although this was not the full order sought by ASIC, the decision challenged the traditional view that a beneficiary of a discretionary trust has a mere "expectancy", which is not sufficient to constitute "property" which is available to creditors.

The court held that the difference between "exhaustive" and "non-exhaustive" discretionary trusts was important.

Exhaustive trusts

Under an "exhaustive" trust, the trust deed requires the trustee to distribute all of the income after each defined period.

Where an exhaustive trust has a closed class of beneficiaries, the beneficiaries as a group can direct the trustee how to deal with the property, and can require that the legal interest in the property be transferred to them.

Non-exhaustive trusts

Under a "non-exhaustive" trust deed, the trustee can distribute the trust income however they see fit whether that is a distribution of some, none or all of the trust income.

Under a non-exhaustive trust deed, even a closed class of beneficiaries acting together cannot direct the trustee how to deal with the trust property.

Richstar held that "in the ordinary case the beneficiary of a discretionary trust, other than perhaps the sole beneficiary of an exhaustive trust, does not have an equitable interest in the trust income or property which would fall within even the most generous definition of 'property' in section 9 of the Corporations Act".

However, the court went on to "distinguish the 'ordinary case' from the case in which the beneficiary effectively controls the trustee's power of selection", in case, "there is something which is akin to a proprietary interest in the beneficiary".

Issues not considered

Somewhat surprisingly, the judgment did not address whether any of the trusts in question had default beneficiaries, even though default beneficiaries have long been regarded as perhaps having a legal interest in the trust property. Further, although some significance was given to the identity of the appointor, no mention was made of previous cases which have held that an appointor's power of appointment is not "property" for the purposes of the Bankruptcy Act.

Effect of Richstar

On the face of it, the *Richstar* decision appears to support the position that discretionary trust assets cannot be regarded as the "property" of a person merely because that person is a beneficiary, trustee, director or shareholder of a trustee company, or an appointor.

However, certain combinations of these roles may be sufficient to trigger a finding of effective control and hence an interest in "property". The distinction between the effect of each role individually and the effect of a combination of roles was not discussed in any detail in the case.

For many years, the Family Court has been able to "look through" formal trust structures to decide who has de facto ownership of trust property.

The decision in *Richstar* was significant because it was the first time that a beneficiary's interest in a discretionary trust had been held to potentially amount to a form of property in a commercial situation.

The decision in *Richstar* considered a number of Family Court cases in concluding that it was appropriate to look beyond the structure of the different legal entities involved (including lifting the corporate veil) to determine whether the relevant person could have been said to have effective control of the assets in question, and thus some form of contingent interest.

The court considered the likelihood that a beneficiary who controlled the trustee's power of selection would have exercised that power in their own favour. In this regard, it was held that:

> "… where a discretionary trust is controlled by a trustee who is in truth the alter ego of a beneficiary, then at the very least, a contingent interest may be identified because it is as good as certain that the beneficiary will receive the benefits of distributions either of income or capital or both."

What does this mean for discretionary trusts?

The decision in *Richstar* represents a significant departure from the traditional view of discretionary trusts, but it was far from conclusive. As the case involved an interlocutory application in relation to a

specific provision of the Corporations Act, its application was, and arguably still is, limited to similar fact scenarios. It is also worth remembering that this was an interim decision to preserve the trust assets held. Whether the assets could in fact be distributed to creditors was not considered.

The main concern is that, if this approach is accepted and adopted generally within the context of appointing receivers, it could pave the way for trust assets to be available to, for example, trustees in bankruptcy or company liquidators. If this were to happen, maintaining "control" over a trustee would come at the significant price of reduced asset protection.

Cases since Richstar

It is also important to remember that the *Richstar* decision was only a single judge interim decision. While the judge is now the Chief Justice of the High Court, the decision itself has not yet been followed or applied by any other judges and could still be challenged in the future.

Furthermore, in *Public Trustee v Smith*[15] (*Smith*), there is some indication of the likely scope of the *Richstar* decision. The key issue in *Smith* was whether property that was owned by a discretionary trust could be considered as being owned by a person, who was the sole shareholder and director of the corporate trustee, to enable the assets to be gifted via that person's will.

The court made a clear distinction between actual ownership and effective ownership and concluded that the will maker was not the actual (beneficial) owner of the trust assets. In relation to *Richstar*, it was noted by the court in that case:

> "Did not say that it followed from the defendant's position as beneficiaries of discretionary trusts and their control of the trustees that this amounted to actual ownership as distinct from effective control."

In *Smith*, the judge also confirmed:

> "I do not understand … Richstar … 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 power 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."

The above reasoning in *Smith* was applied by the same judge in a subsequent 2008 case.

Conclusion

For the time being, the benefits of discretionary trusts are generally still sufficient to make them the preferred structure for asset protection purposes.

That said, the issues and questions raised in *Richstar* remain significant and care should be taken when restructuring and establishing discretionary trusts.

In this regard, arguably the optimal approach for the establishment or review of any trust deed is to methodically follow a tailored checklist.

An example in this regard of some of the matters that should normally be considered is set out below. The various questions summarised above in the *Beeson* case are also obviously relevant.

20-point checklist – trust review

(1) What is the vesting date for the trust, and has it passed already?

(2) Should the trust deed be amended due to changes in the law since it was established?

(3) Does the trust deed restrict the range of beneficiaries who can receive income or capital distributions? Is the trustee excluded from receiving distributions?

(4) Can beneficiaries be removed or added?

(5) What is the date by which income distributions should be made in each financial year?

(6) How is trust income defined and does the trustee have power to alter the meaning of trust income?

(7) Does the trustee have absolute discretion in relation to income and capital distributions?

(8) Is there a default distribution of the income and capital of the trust to particular beneficiaries?

(9) Does the deed deem unpaid distributions to be treated as loans by the beneficiary?

(10) Who is the trustee of the trust? If the trustee ceases to act, do their powers pass to anyone else, and if so, who?

(11) Does the trustee need consent/approval of any other person to exercise any of its powers?

(12) Does someone (eg a principal, guardian, appointor) have the power to unilaterally change the trustee?

(13) Is the role of trustee and principal (if any) automatically terminated on certain events (eg death or bankruptcy)?

(14) If the principal ceases to act, do their powers automatically pass to anyone else, and if so, who?

(15) Is the trustee in reality the "alter ego" of an "at risk" person?

(16) Will the trust own more than one asset class?

(17) Has there been a pattern of income or capital distributions to "at risk" beneficiaries?

(18) Is there a power to vary, and are there any restrictions on that power?

(19) Have variations to the deed been validly made? For example, is there an appropriate exercise of the variation power and have all necessary consents been obtained?

(20) What is the governing jurisdiction?

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Disclaimer

This article covers legal and technical issues in a general way. It is not designed to express opinions on specific cases. This article is intended for information purposes only and should not be regarded as legal advice. Further advice should be obtained before taking action on any issue dealt with in this publication.

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