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The use of special purpose trusts in estate planning - Part I

IN LIGHT OF FUNDAMENTAL CHANGES TO THE TAXATION REGIME AND THE EXPANDING WEALTH OF AUSTRALIA'S AGING POPULATION, THERE IS A GROWING NEED FOR ESTATE PLANNING TO UTILISE APPROPRIATE STRUCTURING. THIS ARTICLE FOCUSES ON THE USE OF SPECIAL PURPOSE TRUSTS IN THE ESTATE PLANNING PROCESS.

INTRODUCTION

In recent years, the need for effective structuring of business and personal assets has been brought into sharp focus for high net worth individuals and business owners.

Fundamental changes to the taxation regime, the vast amounts of wealth accumulated within superannuation funds and the increasing tendency for both business and personal relationships to be relatively short term, as opposed to life long, have meant that traditional estate planning has been revolutionised.

A significant factor to note in the changing face of estate planning is the transfer of wealth from Australia's "baby boomer" generation. Statistically, this segment of the population is by far the wealthiest and best educated in Australia's history, and consequently far more sophisticated estate planning strategies are being developed in order to minimise the ability for wealth to be attacked by creditors, former spouses, business associates and (in some instances) disgruntled beneficiaries.

While tax effective strategies incorporating complex will arrangements and testamentary trusts continue to be of relevance, recent developments in estate planning have been more focused on the protection of underlying wealth.

In particular, additional structures are now being utilised in conjunction with wills to ensure wealth passes efficiently to the intended recipients and that the transfer takes place at the intended time. Often the desire to ensure a suitable tax outcome needs to be balanced against a desire to ensure assets are protected from family disputes, spendthrift beneficiaries and creditors in deciding on an estate plan.

Asset protection strategies and the use of special purpose trusts are important issues to consider in estate planning, particularly where potential beneficiaries are in occupations, professional practice or in business, or where there is a risk that a personal relationship of a beneficiary may degenerate in the future. Potential beneficiaries that fall into any of these "at risk" categories will be exposed to losing assets, unless appropriate structures are put in place.

The difficulty in many estate planning exercises is that serious attempts to devise and implement a plan are often not made until some "triggering event" stimulates action. Often the triggering event is itself an issue that may jeopardise the ability to implement appropriate strategies, for example financial or matrimonial misfortune or life threatening illness.

Given that the first wave of the baby boomer generation is now nearing 60, it is likely that the increased importance placed in recent years on appropriately structuring intergenerational wealth transfers will continue to intensify.

There are an enormous number of aspects to a comprehensive estate plan. This paper will focus on the use of special purpose trusts in the context of estate planning.

The paper will consider the use of trusts in the following situations:

(a) passing your estate to wastrel children;

(b) the use of trusts and family law;

(c) bankrupt or at risk beneficiaries;

(d) Division 6AA issues and tax; and

(e) superannuation and death benefits.

Each of the above issues are dealt with in turn below.

WASTREL CHILDREN

In the event that it is necessary to protect an estate from wastrel children or likewise spendthrift children testamentary trusts and estate proceeds trusts can be useful. The structure of each of these two trusts and the advantages and disadvantages are outlined below.

Testamentary trusts

Testamentary trusts are simply trusts established pursuant to a will. In recent years numerous different types of testamentary trusts have included fixed, unit, discretionary (family), hybrid, resulting (constructive), bare, lineal descendent and superannuation proceeds trusts. The various types of trusts have a number of different features and specific uses, but fundamentally the legal structure of all testamentary trusts are very similar.

Structure of testamentary trusts

Essentially, the share of the estate intended for each beneficiary can be managed via a testamentary trust by the trustee appointed by the testator in their will (often the trustee and a beneficiary of the trust may be the same person although the advantages and disadvantages of this approach are dealt with in more detail below).

During each year the trustees of the trust may have complete discretionary power to choose which beneficiary takes what share of income for that year. They may also have the absolute discretion as to the distribution of capital, but often the distribution of capital can be limited to set amounts and for a limited range of direct descendants, or otherwise as instructed by a testator.

A will maker (or testator) sets out the terms of the trust in their will and can give the trustee complete discretion as to who should receive capital and income from the trust or alternatively the testator can restrict the trustee's discretion as much as they like.

A "lineal descendant" trust is simply a specific type of testamentary trust whereby the testator may restrict the ability of the trustee so they may only distribute income or capital (or both) to the testator's children and grandchildren and so on, excluding any spouse of the children and/or grandchildren.

The main attraction to excluding spouses as potential beneficiaries is that in the event of a matrimonial (or de facto) relationship breakdown it is unlikely that a lineal descendant trust would be taken into account by the Family Court as anything other than a resource of the relevant marriage. Thus the assets of the testamentary trust are likely to be protected in this scenario.

Conversely, many people argue that the flexibilities normally associated with a trust structure are significantly diminished if a whole class of potential beneficiaries are excluded.

In recent times many people have adopted a "hybrid" approach to testamentary trusts so that spouses can be potential income beneficiaries from year to year but that in relation to any capital distributions from the trust, these distributions may only be made to lineal descendants of the original will maker.

Advantages of testamentary trusts

The main advantages of an appropriately drafted testamentary discretionary trust ("TDT") established by a will are as follows:

(a) the flexibility given to the trustees to allocate income and capital with reference to the facts at the time, rather than a testator's prediction (no matter how careful) of the future. It allows the trustee to make a greater distribution for a testator's child with a special need, such as (in particular) wastrel children, as well as those with a disability;

(b) if an estate was left to a child absolutely then it is their property and could be jeopardised by their financial position at the time of death or after. In addition, should that child suffer matrimonial or financial misfortune at some time in the future, the trust at least provides a facility whereby the inheritance can be kept separate. As indicated above, it is unlikely (particularly where spouses are not potential beneficiaries) that the assets of the TDT would be seen as anything more than a resource for the relevant beneficiary and not part of the assets of the matrimonial pool which are physically distributed between the parties to the marriage breakdown;

(c) the TDT can be drafted such that it complies with the requirements set out in s 102AG(2)(a)(i) *Income Tax Assessment Act 1936* ("ITAA 1936"), so that income each year allocated to minor children is not subject to the same tax rates as if it were a normal family discretionary trust established during a person's lifetime (where the first $772 distributed to a child is tax-free but then any further income is taxed at the highest rate which could be up to 66 per cent);

(d) where income is derived under the section quoted above infant children are assessed at the normal, individual rates (the first $6,000 tax-free and the balance at normal adult rates) which may be a significant saving in tax when you look at the gross income for a family unit. The Commissioner does have some discretion in these cases, but generally the discretion is exercised in favour of the TDTs as they are a "traditional" form of trust; and

(e) even if, for any reason the trust does not come into effect through the operation of law, or it fails, then the will can include a fall-back provision whereby the capital vests in the intended beneficiary anyway, with provision for their children if necessary, or even revert to trusts established for other beneficiaries.

Ultimately TDTs are particularly useful structures in the following circumstances:

(a) to ensure concessional tax treatment is available to distributions of capital and income to minor beneficiaries;

(b) to protect accumulated wealth from wastrel or spendthrift beneficiaries;

(c) to provide for infant children and disabled beneficiaries; and

(d) to protect inheritances from attack by the family law courts and trustee in bankruptcy.

Disadvantages of testamentary trusts

There are a number of potential disadvantages to TDTs, including:

(a) once income is determined to be distributed to an infant and is then not applied in payment of the infant's needs there will be an accumulating debt owing to that infant by the TDT. Thus when it comes time to wind up the trust and for the beneficiaries to take the capital, they may find the capital substantially eroded by the necessity to pay these debts to the children or other beneficiaries, unless of course they are in some way forgiven. Alternatively, when the relevant child reaches the age of majority it may be that they seek repayment of the loan owing to them;

(b) the TDT structure requires a reasonable degree of control, similar to a normal family discretionary trust, including recourse to competent accountants and lawyers for trust administration advice. This all involves a cost;

(c) the taxation aspects of a TDT have not been ably and forcefully contested in a Court in the last decade. Notwithstanding this, the language of s 102AG(2)(a)(i) of the ITAA 1936 is clear and there are income tax rulings (both private and public rulings) given in favour of the establishment of TDTs; and

(d) where the beneficiary of a trust is also a trustee, they should for safety's sake always have at least one trustee with them when undertaking trust-related issues, so the beneficiary will need to be able to work with their co-trustee/s. Protection against creditors or former spouses is diminished when a beneficiary is the sole trustee of the trust, as that beneficiary has power as trustee to distribute the whole of the income and/or capital to themselves. Finding suitable co-trustees can be a difficult exercise, and can also cause increased expenses where a professional is appointed.

Estate proceeds trusts

A proceeds trust can be either an "estate proceeds" trust (where the proceeds were originally part of the deceased estate), or a non-estate proceeds trust (where the proceeds originate from an asset which does not form part of the deceased estate). Some common examples of non-estate proceeds are superannuation entitlements or life insurance.

An estate proceeds trust is a trust established by a deed after the death of the deceased. It is most commonly used to obtain advantageous income tax treatment for income allocated to minor beneficiaries.

Generally, an estate proceeds trust is more restrictive than an ordinary TDT established pursuant to the terms of a will. An estate proceeds trust differs from an ordinary testamentary trust on account of the following features (s 102AG of ITAA 1936):

(a) minor beneficiaries (persons under 18 years of age on establishment of the trust) must be the ultimate capital beneficiaries of the trust, meaning the assets of the trust must ultimately vest in them;

(b) the transfer of estate assets to the trust must occur within 3 calendar years of the date of death of the deceased; and

(c) the assets transferred must not exceed the entitlements that the minor beneficiaries would have received if the deceased had not left a valid will (ie if the deceased had died intestate).

The main advantage of an estate proceeds trust other than providing a level of asset protection (particularly for wastrel beneficiaries) is the concessional tax treatment of income distributed from the trust and the ability to split income according to the financial circumstances and needs of the deceased's children.

The income distributed from the trust may be used to pay for the children's education, living and other expenses and any income received by a minor will be taxed at the normal adult rate, rather than the penal rate that normally applies to income distributions to infant children. As noted above, this means that assuming the children are not earning other income they will be eligible for the $6,000 tax-free threshold for income received by each child per financial year. Any additional income will be taxed at the ordinary adult marginal rates.

There are a number of technical issues that must always be reviewed before establishing an estate proceeds trust including:

(a) the concessional rates of tax will generally not be available to the grandchildren of a testator;

(b) while assets in excess of what the testator's children may have received on an intestacy can be contributed to the estate proceeds trust, only the income generated by that portion of the capital which the testator's children would have received on an intestacy will be entitled to the concessional rates of taxation; and

(c) any assets that do not form part of the testator's estate such as assets owned as joint tenants with a spouse or insurance policies that are owned by the surviving spouse will not be able to be contributed to the estate proceeds trust.

THE USE OF TRUSTS AND FAMILY LAW

Trusts and the Family Law Act

Generally speaking the Family Court only has power to deal with the rights or impose duties on parties who are the subject of the application (in other words the husband and wife personally). This means that the Family Court cannot deal with assets held via a trust structure as they do not form part of the asset pool available for distribution.

There are a number of exceptions to this general rule, including:

(a) where assets have been transferred to a trust as part of a "sham" directly designed to defeat an application of a spouse. Generally the Court will only interfere where a transfer of assets to a trust has taken place during or in anticipation of property settlement proceedings and there are no other commercial reasons justifying the transfer;

(b) if the parties to the relationship have made some sort of nuptial (or financial) agreement in relation to the assets of the trust then the trust can be bound to comply with this agreement; and

(c) where the family trust is seen as simply the "alter-ego" or as a "puppet" of a party to the marriage. This issue revolves mainly around the Court's determination of who controls the trust, and this issue is dealt with in more detail below.

If none of the abovementioned factors apply then the most the Family Court is likely to do in relation to the assets of a trust is to take those assets into account as a "resource" of the marriage, as opposed to an "asset".

Resource / asset distinction

Generally speaking the distinction between a resource and an asset for family law purposes is as follows:

(a) a resource is property that, while a party to the marriage may have access to, they do not directly own or control it. Therefore while the resource may be taken into account when determining the division of matrimonial assets the property cannot be directly dealt with by the Court;

(b) an asset is an item of property the interest in which can be allocated by the Court in such ways it determines reasonable.

In order to determine the way in which the assets of a relationship are divided and the extent to which resources are taken into account, the Family Court determines the parties' financial and non-financial contributions to the asset pool and then considers a number of factors which are set out under the *Family Law Act* 1975 including:

(c) the age and state of health of each of the parties;

(d) the income, property and financial resources of each of the parties and the physical and mental capacity of each of them to obtain appropriate gainful employment;

(e) whether either party has the care or control of a child of the marriage who has not attained the age of 18 years;

(f) commitments of each of the parties that are necessary to enable the party to support:

  (i) himself or herself; and

  (ii) a child or another person that the party has a duty to maintain;

  (g) the responsibilities of either party to support any other person;

  (h) the eligibility of either party for a pension, allowance or benefit under:

  (i) any law of the Commonwealth, of a State or Territory or of another country; or

(ii) any superannuation fund or scheme, whether the fund or scheme was established, or operates, within or outside Australia; and

(iii) the rate of any such pension, allowance or benefit being paid to either party;

(i) where the parties have separated or the marriage has been dissolved, the standard of living that in all the circumstances is reasonable;

(j) the extent to which the payment of maintenance to the party whose maintenance is under consideration would increase the earning capacity of that party by enabling that party to undertake a course of education or training or to establish himself or herself in a business or otherwise to obtain an adequate income;

(k) the extent to which the party whose maintenance is under consideration has contributed to the income, earning capacity, property and financial resources of the other party;

(l) the duration of the marriage and the extent to which it has affected the earning capacity of the party whose maintenance is under consideration;

(m)the need to protect a party who wishes to continue that party's role as a parent;

(n) if either party is cohabiting with another person, the financial circumstances relating to the cohabitation;

(o) any child support under the *Child Support (Assessment) Act 1989* that a party to the marriage has provided, is to provide, or might be liable to provide in the future, for a child of the marriage;

(p) any fact or circumstance which, in the opinion of the court, the justice of the case requires to be taken into account; and

(q) the terms of any financial agreement that is binding on the parties.

Obviously the weighting given to each of the above factors will vary from case to case.

Control of family trust

As indicated, the control of a family trust by one of the parties to the marriage will be a key factor in determining:

(a) firstly, whether it will be treated as an asset of a party to the marriage, due to one or more of the factors set out above; and

(b) secondly if it is not an asset of the marriage, the extent it will be taken into account as a resource of a party to the marriage.

(j) whether a party has responsibility for the day-to-day administration of the trust.

The effect of trusts and binding financial agreements on family provision applications

Increasingly there is a focus in any estate planning exercise on preventing a Family

> Under a 'lineal descendant' trust ... the trustee... may only distribute income or capital (or both) to the testator's children and grandchildren and so on, excluding any spouse of the children

Provision Application ("FPA") being brought against an estate by an estranged child or the children of the client's second spouse. It is usually the case that a potential applicant has to establish financial need or show their efforts significantly contributed to the assets of the deceased. Where this is potentially the case, and the will maker is still wanting to minimise that person's entitlement, the will maker will often transfer assets into a family discretionary trust (or other similar entity) such that there are no assets in their estate on their death which can be subject to the FPA.

The effectiveness of such asset protection strategies have come under increasing scrutiny in recent years.

The recent High Court decision of *Barns v Barns* (2003) HCA 9 (where the High Court decided not follow the majority decision of the Privy Council in *Schaefer v Schuhmann (1972) AC 572* but to follow the Privy Council's judgment in *Dillon v Public Trustee of New Zealand (1941) AC 294* and the dissenting judgment of Lord Simon in Schaefer) is an example of the Court upholding an applicant's statutory rights in the face of a traditional asset protection strategy (mutual wills) being used in an attempt to frustrate a FPA. The lesson from *Barns* is to never take anything for granted when dealing with potential FPA applicants and to ensure that all contingencies are properly considered before the effort and expense of transferring assets into a discretionary trust or similar entity.

In the case of *Barns*, Mr Barns entered into a Deed with his wife and son whereby he and his wife agreed not to revoke the wills which were annexed to the Deed, without the written consent of the other parties to that Deed. The mutual wills would firstly leave the estate to the surviving spouse. On the death of the surviving spouse, the estate would then be left to the son. The intention behind the drafting of the Deed and the mutual wills was to prevent the parents' daughter from benefiting or participating in the estate of the surviving parent.

On the death of Mr Barns (the first spouse), his daughter made a successful application for provision under the *Inheritance (Family Provision) Act 1972 (SA)* ("the Act").

Barns case

The key questions in *Barns* were:

(a) did the Deed operate to effectively reduce the testator's estate to nil, in that the testator had entered into a contractual arrangement with his wife and son to dispose of his entire estate at death, so there is no estate which can be subject to the FPA?; or

(b) was the Deed and the contractual rights it conferred on the wife and son subject to the Act, and the statutory rights it provided for the daughter of the deceased?

As noted above, the High Court decided that Deed and contractual rights were subject to the FPA provisions under the Act.

The central issue of the case was to determine what effect the operation of the Act had on the Deed and the annexed mutual wills which were executed pursuant to that Deed.

In particular, it was argued by the wife and the son as the First and Second Respondents that the decision in *Schaefer* and that of Nicholls CJ in *Re Richardson's Estate (1935) 29 Tas LR 149* should be followed. It was argued that the rights of a party to a deed do not arise under the will but arise contractually in accordance with the terms of the deed entered into between the parties. Accordingly, it would be inappropriate for such contractual rights to be reduced to what effectively becomes a gift under the will.

The determination of the way in which trust property will be dealt with in any particular case is a question of fact. The determination will depend upon the way in which the Court interprets all the relevant circumstances of the particular case. In making this assessment the Court normally has regard to the following aspects of control (in no particular order):

(a) the benefits derived from the trust by the parties to the marriage such as loans, salaries and payment of expenses etc;

(b) the degree to which a party is able to distribute to themselves all of the income and capital of the trust;

(c) the history of the party's treatment of the trust property;

(d) the history of distributions made by the trust to the party;

(e) the party's past exercise of powers and involvement in variations or amendments to the trust deed;

(f) the degree of the party's influence over the trust including the trustee (or directors of the corporate trustee) and the appointor;

(g) the ability to direct or otherwise control the trustee;

(h) the capacity of a party to borrow on trust funds;

(i) the potential for the party to receive the ultimate benefit of the trust property; and

Lord Cross in *Schaefer* followed the reasoning of Nicholls CJ in *Richardson* and rejected the notion that the performance of the contract by a party to leave their estate to another then turns the other party to the agreement from a creditor into a mere beneficiary.

However, in both *Richardson* and *Schaefer*, there was dissenting opinion against the argument that statutory rights could not make inroads to the contractual obligations created or entered into prior to death. Firstly, Clarke J in *Richardson* argued that the contract in that case was that the testator would make a will and leave his estate to the Respondent in consideration of them agreeing to remain his housekeeper for little or no remuneration until his death. The testator did this and therefore completed his contractual obligations.

Accordingly, the estate was under no liability to the housekeeper, as the deceased had performed his promise and left the estate to the housekeeper in his will. However, this does not mean that the estate cannot then be affected by statute, as the housekeeper's rights must be considered alongside the rights of those who may apply for provision under the Act.

Lord Simon in *Schaefer* dissented, preferring to follow the decision in *Dillon*. In Lord Simon's opinion, a promisee's contractual or equitable rights will fail to be considered along with a dependant's statutory rights for provision.

Ultimately then, despite the decision in Barns, the effect of the FPA legislation can always be avoided by disposition of the estate before death so that the deceased dies with no estate. However, the rights a promisee obtains under a deed are always liable to be affected by the potential operation of the Act where the estate has not been so disposed of prior to death.

Binding financial agreements

Following on from *Barns*, a relevant question is whether binding financial agreements entered into between parties where one party subsequently dies still bind the deceased person's personal representative and their estate such that any FPA which is subsequently filed, can only access those assets to which the deceased is entitled under the agreement?

Section 90H *Family Law Act* states that:

> 'a financial agreement that is binding on the parties to the agreement continues to operate despite the death of a party to the agreement and operates in favour of, and is binding on, the legal personal representative of that party.'

The succession legislation in all jurisdictions has modified the common law rule that personal actions did not survive the death of a party such that now all causes of action subsisting against or vesting in the person shall survive against, or, as the case may be, for the benefit of, the person's estate.

Accordingly, it would ordinarily be the case that a binding financial agreement could frustrate any FPA claim which might be brought, particularly where the agreement transfers a substantial portion of the assets to the surviving spouse.

One of the conflicting things to come out of *Barns* was an affirmation that an order of the Court pursuant to a FPA has the effect of being a codicil to the will of the deceased executed immediately before death. As such, the agreement entered into prior to death would be binding on the estate, preserving certain assets from the FPA applicant, as the FPA order can only draw from the assets of the estate.

In effect, any successful FPA applicant can only be treated as a beneficiary who does not take priority over an estate's creditors or parties with a contractual interest. So is there a difference between the deed of mutual wills which was set aside in *Barns* and a binding financial agreement? Most commentary suggests there is.

Policy reasons aside, the difference in *Barns* was that the FPA was brought on the death of the first party to a deed of mutual wills such that the Court was able to determine that the second party to the deed had not yet relied on the deed and had received no valuable consideration. It is likely that the Court would have reached an entirely different view if the FPA had been brought against the estate of the surviving party to the deed in *Barns* when they had died, because they would have relied on the deed and not changed their will or transferred assets or done something else to try and give effect to their wishes.

Accordingly, *Barns* can be said to be limited to the specific circumstances where the first spouse has died after executing mutual wills and does not alter the law in so far as it relates to the effect of mutual wills following the death of the second spouse.

The case also does not change the position that existing contractual obligations bind the estate. Thus, provided there has been consideration given and the parties have relied on the binding financial agreement in some way, then the FPA will not have access to the assets which are subject to the binding financial agreement.

This said however, a binding financial agreement entered into for the sole purpose of defeating a FPA, as opposed to the objects for binding financial agreements as expressed in the *Family Law Act*, may fail for policy reasons to prevent the FPA having access to the assets which are the subject of the binding financial agreement (as occurred in Barns).

The Courts have looked at the relationship between a binding financial agreement (of sorts) and a FPA in the past and most notably in *Smith v Smith* (1986) FLC 91 – 604 and *Singer v Berghouse* (1994) 181 CLR at 201 where the High Court confirmed that while a clause in a binding financial agreement which bars any claim against the estate of a party (ie effectively a double dip) is not binding of itself such a clause (and indeed the binding financial agreement itself), will be given serious consideration by a Court in any proceedings brought for a FPA by a party who has received benefit under the binding financial agreement. What these cases do not say though is whether or not another applicant (that is, someone not a party to the binding financial agreement) could access assets subject to the binding financial agreement for inclusion in their FPA.

Trusts and other asset protection strategies

A Court has the power to make a determination of whether adequate provision has been made for an applicant out of the estate of the deceased person. The rules are similar in each jurisdiction, although there is some difference in wording of the legislation.

In all jurisdictions, the legislation is such that the executor must sell the assets of an estate for realising sufficient funds to meet the debts and legacies of the deceased estate, and in Queensland, an executor is only able to sell the assets of the estate for the purposes of realising sufficient funds to meet the debts of the estate.

Accordingly, any FPA can only be brought against an estate of a person, and as with a beneficiary's rights, will be subject to the debts and encumbrances of the deceased's estate before any payment can be made. This means that transferring assets to a trust or mortgaging assets can be effective strategies for guarding against a FPA. Gleeson CJ in *Barns* noted that:

> 'First, provision may be made, and can only be made, out of a deceased's estate; that is to say, out of property which is beneficially owned by the deceased at the time of death and which passes to the deceased's legal personal representative.
>
> Secondly, contractual obligations undertaken by a deceased during his lifetime, which bind an estate, may affect the property available to meet an order under the Act. For example, if, during his lifetime, a testator contracted to sell Blackacre, and the contract remained on foot at the time of death, although full beneficial ownership of Blackacre had not passed to the purchaser at the time of death, Blackacre would not be an available asset for the purposes of an order for provision, although the purchase price payable under the contract would be. And, of course, if the contract were subsequently rescinded, the position would change.
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> Thirdly, the estate out of which an order for provision may be made is the available estate after meeting the liabilities of the deceased. Obligations incurred by a deceased, and binding upon a legal personal representative, must be taken into account in determining the extent of the estate out of which provision may be made.'

Gleeson CJ went on to say that:

> 'Reference has already been made to an inherent weakness in the scheme of the Act, and its earlier legislative counterparts, as an instrument to deal with the mischief at which it is aimed. Provision under the Act can only be made out of the assets of which a person dies possessed. If property is not beneficially owned by a deceased, then (subject to later legislative amendments in some jurisdictions) it does not form part of the deceased's estate, and cannot be made a source of provision for a claimant under the Act. Furthermore, contractual obligations undertaken by a person prior to death, which bind the legal personal representative in the administration of the estate, may diminish the available estate out of which provision may be made.'

Gleeson CJ also pointed out that contractual obligations and transactions entered into during a person's life (including, presumably binding death benefit nominations for superannuation savings – see s 6 below) would still effectively avoid the FPA provisions, unless the legislation expressly extends to such transactions, as is the case under the *Family Provision Act*, 1982 (NSW) and its use of notional estate.

There are of course costs associated with such strategies, including stamp duty and the realisation of potential capital gains. However, where a will maker is adamant they want protection from a potential FPA, a trust provides an alternative, providing of course that the terms of the deed are appropriately drafted, as the assets which are transferred into the trust will no longer form part of the deceased's estate.

Notional estate

While the use of trusts, mortgages and other strategies may for the time being provide effective protection from a FPA, New South Wales has introduced legislation dealing with "notional estates" and the ability of a FPA applicant to clawback assets into an estate (ie assets transferred during a will maker's life, to a trust for example, to avoid a FPA).

With the national uniform succession laws becoming increasingly likely the use of trusts and similar strategies to prevent a successful FPA being brought will be undermined.

Notional estates allow the Court to look beyond the assets held by the deceased at the date of death and to examine the assets held by the deceased in the years prior to death, when considering a FPA. Effectively it means that contracts entered into whereby the deceased promises their estate to a party, could be subject to an application for provision by a person entitled, such that the promisee effectively becomes a beneficiary and not a debtor of the estate.

The decision in *Barns* endorses this concept in that it ensures the rights of the promisee do not take priority and are indeed considered alongside the statutory rights granted to an applicant for provision. As noted above however, *Barns* is limited to the particular circumstances where a testator has promised their estate to a person for valuable consideration or pursuant to a deed.

Child maintenance trusts

Child maintenance trusts are specifically provided for in s 102AGA of the ITAA 1936. As with the estate proceeds trust, super proceeds trust and testamentary trusts, the main advantage of a child maintenance trust is the ability for income of the trust to be treated as excepted trust income.

As discussed above, excepted trust income means that any infant children who are beneficiaries of the trust and are entitled to income of the trust will have access to the normal adult rates of tax (for example the first $6,000 worth of income tax-free, with the balance at normal adult rates).

A child maintenance trust, like most trusts, must be established by deed. There are also a number of other requirements that must be met before the income of the trust is treated as excepted, including:

(a) the children named as the "primary beneficiaries" of the trust must be younger than 18 at the time the trust is established;

(b) income must be derived by the investment of property transferred to the trustee of the trust for the benefit of the beneficiary/beneficiaries as a result of a "family breakdown". The definition of a "family breakdown" is relatively wide however reference should always be had on a case by case basis to the definition set out in s 102AGA(1) of the ITAA 1936;

(c) there is no set time frame in which a child maintenance trust must be established following the family breakdown;

(d) the children for whom the trust is established to benefit must ultimately receive all of the capital from the trust in equal shares; and

(e) the potential income beneficiaries of the trust may include persons other than children of the relationship subject to the family breakdown.

The income of a child maintenance trust which results from non arm's length transactions must be of equal value to that which would have been derived on an arm's length basis in order to be considered excepted trust income for the purposes of Div 6AA, for the same reasons discussed above.

One tax effective alternative often used in establishing a child maintenance trust is to contribute depreciating assets such as plant and equipment and motor vehicles to the trust. These assets can be leased either to a related individual or business entity for value.

Provided the lease repayments are on an arm's length basis then the income will be able to be distributed to infant children as excepted trust income.

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Part 2 of this article will appear in the next edition of *Taxation in Australia.*