The Tax Institute

Local Tax Club-Melbourne & Geelong

Estate planning:

International issues and residency

Succession planning for structures

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1. Overview

Estate planning can certainly bring out the weird and the wonderful and keep you on your toes as a practitioner. Our discussion will talk through a number of practical issues and practice management points that we see on a regular basis, and provide guidance on how to manage some of the more intricate issues - hopefully before they become a problem. This will include:

- background as to why this area is a critical focus in the next 10 - 20 years;
- international issues and residency; and
- succession of business structures.

There are a number of consistent themes that come through in estates that are administered efficiently and effectively:

- having a well prepared estate plan that covers off on all relevant areas such as:
    - Wills with testamentary trusts;
    - powers of attorney to deal with incapacity;
    - trust succession documents;
    - superannuation death benefit nominations;
    - documents to deal with any other structures;
- having a key information file prepared that has asset, liability and key contact details;
- clear communication with people who will be involved including family members, beneficiaries, executors, attorneys and professionals;
- doing a ‘dry run of death’ with the Will maker and key people to test the plan, make sure it works, and identify any issues; and
- keeping the plan up to date with regular reviews, especially in situations where there is family or structural complexity.

Being prepared and having an up to date plan is the best protection from problems, and leave a legacy and not a liability.

2. Background

Succession planning is becoming a key issue for professionals. Think about:

- the demographic of your clients;
- the succession of their business; and
- who your next generation of clients are?

There is a significant level of wealth expected to transfer in the coming 10 - 20 years. The Australian Government Productivity Commission paper on Wealth transfers and their economic effects[1] noted Australians aged 60 and over would transfer approximately $3.5 trillion, or about $175 billion per year, in the next two decades.

Of the funds referred to above, a significant amount of that money is held in three pools:

- superannuation (both public offer and SMSFs);
- trusts (mainly discretionary trusts); and
- directly held assets (such as the family home).

Making sure you are comfortable and equipped to help clients with their succession planning discussions helps to avoid issues, helps to connect you with the next generation of clients, and is also a great value add for your clients.

[1] Commonwealth of Australia, November 2021, 3.1

3. International issues

As at 30 June 2023, 30.7% of the Australian population were born overseas.[2] People are more globally mobile, and it is becoming more common to work with family groups who have family members living overseas on a temporary or permanent basis. Often it may be a child who heads overseas for travel or work temporarily, then meets their partner and decides to remain outside of Australia indefinitely.

This can present some interest considerations in the context of estate planning and estate administration including:

- non resident estates;
- non resident beneficiaries;
- unintended tax outcomes; and
- control considerations.

Thankfully many of these points can be managed ahead of time with the appropriate planning.

3.1 Determining tax residency

The first issue is to work out if the relevant individuals are Australian tax residents or not. This will be determined primarily by Australia's domestic tax laws, as affected by the operation of double tax agreements entered into by Australian and other countries.

The domestic and international rules relating to the tax residency of individuals and structures are complex and entirely fact-dependent, but crucial to understand in advising your clients.

3.1.1 Individuals

Tax residency is assessed for each income year. Under current law, an individual will be a resident of Australia if they meet any one of the following four tests. The primary test of tax residency is called the 'resides test' or 'ordinary concepts' test.

If a taxpayer resides in Australia, they are considered an Australian resident for tax purposes and do not need to apply any of the other residency tests.

'Ordinary concepts test'

The individual will be an Australian tax resident if they 'reside in Australia', which requires consideration of the ordinary meaning of 'resides':

To 'reside' in this context means 'to dwell permanently or for a considerable time, to have one's settled or usual abode, to live in or at a particular place'.[3]

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[2] ABS, Australia's Population by Country of Birth, release date 24.04.24
[3] *Federal Commissioner of Taxation v Miller* (1946) 73 CLR 93 citing *Levene v Inland Revenue Commissioners* (1928) 13 TC 486; [1928] AC 217.

Persons considered residents under this test include both:

- those who ordinarily live in Australia; and
- those who have foreign nationality, citizenship or domicile, but who have their usual place of residence in Australia.

The ordinary concepts test is asking whether an individual's presence in Australia is usual and settled in contrast to temporary and casual.[4] Whether or not an individual is a resident under this test will depend on their individual circumstances and a weighting of relevant factors, including:

- the period of their physical presence in Australia (the ATO considers that six months is a substantial presence suggesting Australian residency) and the duration of, and intention behind, any absences they have from Australia;
- the intention, purpose or reason for their presence in Australia (eg taking up pre-arranged employment opportunities) - this is a critical factor and will be determined with regard to all available evidence;
- their behaviour while in Australia - if the way they live reflects a degree of continuity, routine or habit, coupled with other factors such as intention, it may be consistent with residing in Australia;
- their ties to Australia, including their family, business or employment ties (eg their family is in Australia, they establish a business in Australia);
- the maintenance and location of their assets (eg owning and purchasing a house and car, establishing bank accounts in Australia); and
- their social and living arrangements (eg enrolling children in school, redirecting mail to Australia, committing to a residential lease).

No single factor is necessarily decisive, and the weight given to each factor varies depending on individual circumstances.[5] All factors are considered to determine whether the individual's behaviour over a period of time has the degree of continuity, routine or habit that is consistent with residing in Australia.[6]

Whether a considerable time has elapsed to demonstrate that the individual's behaviour has the required continuity, routine or habit to establish that they are residing in Australia is - as noted above - a question of fact.

The Commissioner's view of the law, as set out in TR 2022/D2 is that:

- When behaviour consistent with residing in Australia is demonstrated over a considerable time, an individual is regarded as a resident from the time the behaviour commences.
- Six months is a considerable time when deciding whether the individual's behaviour is consistent with residing in Australia. However, as residency is a question of fact, individuals who are in Australia for less than six months may establish they reside here. Conversely, individuals may establish that they do not reside here, even if they have been in Australia for a longer time.

[4] Paragraph 20, draft Taxation Ruling TR 2022/D2 - *Income tax: residency tests for individuals* (**TR 2022/D2**).
[5] Paragraph 21, TR 2022/D2.
[6] Paragraph 26, TR 2022/D2.

- If an individual comes to Australia with an intention to reside here permanently, then ordinarily they are taken to be a resident from the date of their arrival in Australia.
- If individuals enter Australia intending to remain for less than six months but later events extend their stay beyond six months, they are regarded as residents from their arrival, as long as their presence has an habitual and routine character during the entire period. This question is particularly relevant where an individual arrives in Australia on a short fixed-term employment contract, but they later decide to extend their stay for a longer or indefinite period. Their behaviour and intention over time will be particularly relevant in determining their tax residence.
- If the individual returns to their country of origin - the frequency, regularity and duration of those trips and their purpose can be decisive factors. If the only reason for the person's absence from Australia is business, this may not be enough in itself to support a claim that the person is not a resident of Australia.

The intention of the taxpayer in *Harding*[7] was critical to the Court's finding that he ceased to reside in Australia when he departed in 2009. At paragraph 43 of his judgment, Derrington J stated:

> 43. The determination of whether or not a person has the intention to treat a particular place as their home will involve a consideration of numerous factors. Certainly, **the evidence of the taxpayer as to their intention at the relevant time will be significant as would be any contemporaneous statement made by a taxpayer as the location of their residency**. **However, the objective manifestation of a person's intention is often a more accurate indicator of their state of mind** at a particular time in the past than is an assertion about that alleged prior intent. A person's present belief about what their intention may have been in the past will necessarily be affected by their sub-conscious and the context in which they called upon to identify that past intention. That is especially so when, at the relevant time, the person did not then consider what their then intention may have been.
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> 44. Even evidence of a person's contemporaneous statement as to their intention at a particular time in the past should be approached with a degree of care. Whilst that is likely to be more accurate than their present assertion of what their previous intention was, the value of the contemporaneous evidence will be affected by the circumstances of the statement and reasons for the making of the statement.
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> 45. That being so, the more cogent evidence of a person's prior intention as to where they resided are the objective facts which reflect the person's then intention. In ascertaining whether a person intended to make a particular place their residence or to terminate their residency in a place, the facts and circumstances surrounding their mode of living will be a strong indicator of their presence in or continued association with a particular place and the intention accompanying that presence.

Derrington J also provided a useful summary of the test in *Commissioner of Taxation v Addy* [2020] FCAFC 135.[8] His Honour stated:

> 76. From these authorities the following factors are relevant to the concept of residency:
>
> A person resides where they live and dwell permanently or for a considerable period of time, being the place where they make their home.

[7] *Harding v Commissioner of Taxation* [2018] FCA 837.
[8] The *Addy* decision was successfully appealed and overturned, but not with regard to the validity of these statements.

A person's intention to make a particular place "home" either permanently or temporarily is an elemental consideration in the identification of where they reside.

Once a person has a home in a particular place they do not necessarily cease to be a resident there merely because they are physically absent. The determinative question is whether they have retained a continuity of association with the place, together with an intention to return to that place which they consider remains their "home".

Determining a person's "continuity of association" in a particular place requires a consideration of all the relevant circumstances, including whether they have retained in that locale a physical home to which they can return, a family unit, possessions and relationships with people and institutions.

The person's own evidence as to their previously held intention is admissible as are any contemporaneous statements of intention, however the objective manifestations of their state of mind at the time are usually more reliable.

The facts and circumstances surrounding a person's mode of living will be an indicator of their presence in or continued association with a particular place and the intention accompanying that presence or continued association.

77. Ultimately, the application of the "ordinary concepts" test in the circumstances of the particular case will involve questions of fact (and perhaps degree): Stockton, [26]; Miller, 103 per Dixon J; and necessitates a consideration of all the person's circumstances. Those circumstances include the person's "habits and conduct within the period" (Gregory) and the character of the place where the person is located (Miller).

Applying the same focus on intention, but in the inverse, the Courts have long recognised that a person may be residing in a place involuntarily - a topical issue at the time of covid for example. At paragraph 24 of Stockton[9] the Court noted:

While undeniably relevant, an examination of an individual's intention with respect to residence can yield mixed or even conflicting signals when considered in conjunction with physical presence. This was appreciated long ago by Lord Buckmater in another leading case, Commissioners of Inland Revenue v Lysaght [1928] AC 234, at 248, in his observation that, "A man might well be compelled to reside here completely against his will". The example chosen by his Lordship was that of a man compelled by the exigencies of business to reside at a particular place but it is readily possible to think of many other exigencies. Without in any way being exhaustive, these might be found in family or cultural duties, military or diplomatic service posting directions or imprisonment or immigration detention. An individual might, for example, intend to comply with such duties or posting directions even though, given a free choice, they would, preferentially, locate themselves elsewhere.

Where this occurs, the taxpayer's intention is relevant. Involuntarily staying in a place may not result in a taxpayer being deemed a resident for tax purposes. Rather, the connecting factors or continuity of association between the taxpayer and the location will be considered to determine whether in fact the taxpayer had the intention of treating the place as their home.

As a result of the COVID-19 pandemic and consequent international travel restrictions, individuals may be present in Australia longer than expected or intended. In such a case it is a question of fact based on their circumstances whether they will be an Australian resident for tax purposes. Where a

[9] *Stockton v Federal Commissioner of Taxation* [2019] FCA 1679.

person's circumstances have been affected by COVID-19 and they have remained in Australia for an extended period for reasons beyond their control, provided they did not intend to take up Australian tax residency, they will ordinarily remain a non-resident despite their extended stay in Australia.

'Domicile and permanent place of abode test'

The individual will be an Australian tax resident if their 'domicile' is in Australia unless the Commissioner is satisfied that the person's 'permanent place of abode' is outside Australia. This draws into question:

- The concept of 'domicile': This is to be determined under the *Domicile Act 1982* (Cth). Ordinarily, a person's domicile of origin is where their father's permanent home was when they were born. Although a person can acquire a new domicile by choice if they have an intention to make his or her home indefinitely in that country.

- The concept of 'permanent place of abode': As held in the *Harding* case:

  - the phrase 'place of abode' includes a reference to a country or state, not to a person's specific house, flat or other dwelling;

  - the test is satisfied where a person has 'definitely abandoned' (stated otherwise, they have abandoned in a permanent way) their Australian residence;

  - what has to be abandoned is not 'Australia' but 'residence' in Australia; and

  - the words 'permanent place' require identifying a country or town outside Australia in which the taxpayer is living permanently. Relevant to that question is whether the taxpayer has abandoned, in a permanent way, their Australian residence.

- Consideration must also be had to the requirement for the Commissioner's 'satisfaction' (which on a strict, but impractical, view rules out a self-assessment).

'183-day test'

The individual will be an Australian tax resident if they have actually been in Australia, continuously or intermittently, during more than one-half of the year of income (183 days), unless the Commissioner is satisfied that the person's 'usual place of abode' is outside Australia and that the person does not intend to take up residence in Australia. This draws into question the meaning of actually being in Australia 'continuously or intermittently' for one-half of a year, the meaning of 'usual place of abode' and the implications of the requirement for the Commissioner's satisfaction as to the individual's intention.

'Commonwealth Superannuation Scheme test'

The individual will be an Australian tax resident if they are a member, or spouse or child of a member, of the Public Sector Superannuation Scheme or the Commonwealth Superannuation Scheme.

Proposed changes

In 2021, the Federal Government announced proposed changes to Australia's individual tax residency rules based on a Board of Taxation report to the Treasurer.

The proposed new rules, which are not yet enacted, would introduce a 'bright line' test, to be determined with reference to some objective factors.

In 2023, the Federal Government released a consultation paper titled ‘Modernising individual tax residency’, which requested public feedback on how the proposed changes. The proposed new model set out in the Board of Taxation report and further developed in the consultation paper would adopt a two-step approach:

1. Primary tests

- *183-day test*: A taxpayer will be a tax resident of Australia if they spend 183 days or more in Australia in an income year. This is similar to the existing 183-day test, without the carve out noted above.
- *Government officials test*: Government officials deployed overseas on foreign service will continue to be tax residents of Australia. Government officials who meet the government officials test will be tax residents irrespective of whether they have met the 183-day test or secondary tests.

2. Secondary tests

Individuals who are not residents under either primary test must consider the following secondary tests. If an individual commences Australian tax residency, they will remain a tax resident of Australia until they satisfy one of the ceasing residency tests.

- *Commencing residency test*: An individual would start Australian tax residency under the proposed new rules if they spend 45 days or more in Australia in an income year and satisfy two of the following four factors in the ‘Factor Test’:
  - a right to reside permanently in Australia;
  - Australian accommodation;
  - Australian family; and
  - Australian economic interests.
- *Ceasing residency test*: An individual that is already a tax resident of Australia would cease being a resident if they meet one of three tests:
  - *Overseas employment rule*: This test will be satisfied if they display all the following factors:
    - they have been residing in Australia for the three prior income years;
    - they are employed overseas with an employment period of over two years from commencement;
    - they have accommodation available in the place of employment for the entire employment period; and
    - they will spend less than 45 days in Australia in each income year of the employment period.
  - *Ceasing short-term residency rule*: A short-term resident will be someone who has been a tax resident of Australia for less than three consecutive income years. To stop being an Australian tax resident, they would need to:

- spend less than 45 days in Australia in the income year; and
- satisfy fewer than two factors (ie satisfy none or only one factor) of the 'Factor Test' noted above.

- *Ceasing long-term residency rule*: A long-term resident will be anyone that is not a short-term resident. To stop being an Australian tax resident, a taxpayer would need to spend less than 45 days in Australia in the relevant income year and each of the two previous income years.

The Federal Government has concluded its consultation process on the proposed changes, although at the time of this paper no further announcements have been made.

3.1.2 Companies

Current rules

Under current law, a company will be a resident of Australia if it meets one of the following three tests:[10]

- The company is incorporated in Australia.
- The company is incorporated offshore and carries on business in Australia, and has its central management and control (**CM&C**) in Australia.
- The company is incorporated offshore and carries on business in Australia, and has its voting power controlled by shareholders who are residents of Australia. It appears that this test has never been applied in practice.[11]

Following recent cases, there not only needs to be a majority of Australian directors for central management and control to be onshore, but there also needs to be substantive management and control in Australia. Taxpayers have lost cases because there was ostensible, but not substantive central management and control in Australia.

Having directors meetings in Australia is required as a minimum step. However, objective evidence should show that the directors in Australia have not merely endorsed or 'rubber stamped' decisions made by a foreign entity which is the trust 'controller' of the company; the evidence should show that a rigorous decision making process has taken place. We need to be careful around vesting certain 'reserve powers' in foreign controlled entities or people, such as powers of an appointor to prevent decisions being made by the trustee.

Board minutes are the starting point for determining who exercises and where a company's CM&C is exercised. When a company has not maintained board minutes, reference may be had to other evidence, including papers circulated to board members, contemporaneous emails and correspondence showing the board's deliberations and the role played by each director in the company's decision making. The Commissioner may also consider oral evidence and statements from those involved in the company's decisions.[12]

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[10] Section 6(1), 1936 Act; section 995-1(1), 1997 Act.
[11] *Review of Corporate Tax Residency* (2020), Board of Taxation, page 7.
[12] Paragraphs 10 and 14, PCG 2018/9.

Where a company's decisions are made in more than one place, care must be taken to identify where its CM&C is located, and it may be divided and located in multiple places. The underlying considerations are the place at which high-level decisions are made as a matter of substance and whether CM&C is exercised in that place to a substantial enough degree to conclude that the company is really carrying on business there. Both are questions of fact.[13]

For the purpose of determining where a decision is made, the Commissioner does not accept that a decision is necessarily made in the place it is formalised or where the last signature is placed on a resolution or vote. For the purpose of determining the location of a company's CM&C, the key question is where decisions are being made as a matter of substance.[14]

TR 2018/5 (together with Practical Compliance Guide PCG 2018/9 - *Central management and control test of residency: identifying where a company's central management and control is located* (**PCG 2018/9**)) was released by the Commissioner regarding central management and control of foreign companies. It highlights the ATO's interest in residency in the global village. It sets out the Commissioner's view on how to apply the central management and control test of company residency following *Bywater Investments Limited & Ors v. Commissioner of Taxation*; *Hua Wang Bank Berhad v. Commissioner of Taxation* [2016] HCA 45 (***Bywater***). The ruling states that the following matters are relevant in considering the central management and control test:

- Whether the company carries on business in Australia. The ruling states that it is not a requirement of carrying on a business in Australia that any of the trading or investment profit-making operations take place in Australia. Rather, carrying on a business in Australia merely requires that the central management and control be in Australia because that is factually part of carrying on the business.

- The meaning of 'central management and control'. The ruling states that the key element in central management and control is 'the making of high-level decisions that set the company's general policies, and determine the direction of its operations and the type of transactions it will enter'. This is distinguished from the day-to-day conduct of the company's operations or the mere ability of a majority shareholder (or person with such power) to appoint those who control the company.

  What constitutes high-level decision making of a company is a question of fact and the nature of the company's business is a relevant consideration. The more extensive a company's activities, the more likely it is that high-level decisions are an exercise of CM&C and control will be distinct from day-to-day operational decisions. The smaller the scale of a company's activities, particularly where there is no division between those who make high-level decisions and those who execute them, the more likely it is that high-level decisions will overlap with, or be the same as, the company's decisions to undertake a particular business operation or transaction.[15]

- Who exercises central management and control? The identity of the person who exercises central management and control is not determined by who has the legal power, but rather who directs a company's operations in reality. Mere legal power or authority to manage a company is neither sufficient, nor necessary, for a finding that a person is exerting central management and control. Regardless of formal appointment, a person who is more than merely influential and in reality dictates or controls the decisions made by the directors will exercise central management and control.

[13] Paragraphs 70 to 71, PCG 2018/9.
[14] Paragraphs 72 to 74, PCG 2018/9.
[15] Paragraphs 15 to 16, PCG 2018/9.

- As highlighted by the Court in *Bywater*, this is dependent on whether the person actually considers a decision or makes a decision because they are instructed it is in the best interests of the company. The willingness of the directors to refuse to follow advice, and their level of knowledge about the business, are relevant to whether they are, in reality, considering a decision. While formal documentation is also relevant, it will be disregarded (as was the case in *Bywater*) where contrary evidence proves how control was actually exercised.

- Where the central management and control is exercised. The ruling states that a company is controlled and directed where the decision making occurs as a matter of fact and substance, rather than where the decisions are recorded or formalised. The Court in *Bywater* considered a range of factors in its determination including:

    - the location of meetings;
    - where dividends are declared and paid;
    - where the company register and books are located;
    - where the registered office is located;
    - the residence of those controlling and directing operations;
    - the residence of the shareholders; and
    - where formal documents are made.

Although it may transpire infrequently, the Commissioner has also recognised that central management and control may occur in two locations where a substantial part of the control and direction occurs in each place.

TR 2018/5 offers the Commissioner's view on the relevant consideration which will determine where the CM&C of a company is exercised and the relative weight to be applied to each factor. The Commissioner states:

- The following matters are most likely to influence a court's consideration as to where those who control and direct the company do so from:

    - where those who exercise CM&C do so rather than where they live;
    - where the governing body of the company meets;
    - where the company declares and pays dividends;
    - the nature of the business and whether it dictates where CM&C decisions are made in practice; and
    - minutes or other documents recording where high-level decisions are made.

- The following matters are less likely to influence a court's consideration of where those who control and direct the operations of a company do so from:

    - where those who control and direct the company's operations live;
    - where the company's books are kept;

- where the company's registered office is located;
- where the company's register of shareholders is kept;
- where shareholder meetings are held; and
- where its shareholders reside.

Proposed changes

In 2020, the Federal Government announced proposed changes to Australia's corporate residency rules. The proposed amendments are to provide that a company incorporated offshore will be treated as an Australian tax resident if it has a 'significant economic connection to Australia'. This would be satisfied where both the company's core commercial activities are undertaken in Australia and its CM&C is in Australia.

This measure, if enacted, is intended to have effect from the first income year after the date of royal assent of the enabling legislation. It was intended that taxpayers will have the option of applying the new law retrospectively from 15 March 2017. It is unclear if this would still occur given the delay in enacting legislation to give effect to these proposed changes.

3.1.3 Trusts

For the purposes of Division 6 of Part III of the 1936 Act, a trust estate is taken to be a '**resident trust estate**' in relation to a year of income if it meets one of the following two tests:

- a trustee of the trust estate was a resident at any time during the year of income; or
- the CM&C of the trust estate was in Australia at any time during the year of income.

It is relevant to note that:

- there is no requirement for a trust estate to carry on business in Australia for it to be a resident trust estate;
- where there are multiple trustees, it is only necessary that one trustee to be an Australian resident at any time during the year of income. By contrast, a company with an Australian director will only be a resident of Australia if that director exercises central management and control of the company (refer to part 3.1.2 of this paper); and
- a trust estate will be a resident trust estate if it has an Australian trustee, even if that entity abrogates its decision-making power in relation to the trust in favour of a non-resident person.

For the purposes of the Capital Gains Tax (**CGT**) rules in Chapter 3 of the 1997 Act, a trust is a '**resident trust for CGT purposes**' in relation to a year of income if, at any time during the income year:[16]

- for a trust that is not a unit trust, a trustee is an Australian resident or the CM&C of the trust is in Australia; or

[16] Section 995-1(1), 1997 Act.

- for a unit trust, one of the requirements in column 2 and one of the requirements in column 3 of the following table are satisfied.

Requirements for unit trust

Item	**One of these requirements is satisfied**	**And also one of these**
1	Any property of the trust is situated in Australia	The central management and control of the trust is in Australia
2	The trust carries on a business in Australia	Australian residents held more than 50% of the beneficial interests in the income or property of the trust

Proposed changes

In 2021, the Federal Government announced it would consult on broadening the proposed amendments to the corporate residency test to include trusts and corporate limited partnerships. This process has not progressed.

3.1.4 Executors and trustees of a Will

The residency status of the executor and trustee of any trust created by the Will needs to be carefully considered.

An executor relationship is not at law the same as a trust relationship. An executor holds both the legal and beneficial ownership of the assets until administration of the estate is complete. In Australia, for tax purposes, estates are taxed as trusts during the period of administration of the estate. The definition of 'trustee' in s 6(1) of the 1936 Act includes an executor and an administrator.

The taxation of trusts provisions under Division 6 of the 1936 Act apply to a deceased estate, but generally, until the administration of the estate is complete no beneficiary will be considered presently entitled to the income unless an amount of income of the estate is actually paid to a beneficiary.[17]

Division 6 applies if the estate is resident in Australia. As outlined at part 3.1.3 of this paper, for the purposes of Division 6, a trust estate is resident if a trustee of the trust estate was a resident at any time in the year, or the central management and control of the trust estate was in Australia during the year (s 95(2) 1936 Act). Accordingly:

- if there is an Australian resident executor, then the estate is resident in Australia. If there are more than one executors named the estate will still be resident even if the other executors live overseas; or

- the estate might still be resident in Australia if it has no resident executor if you can show that the central management and control is effected from Australia.

[17] Taxation Ruling IT 2622.

Care therefore must be taken, not only regarding the residence of an individual executor/trustee, but also regarding central management and control of a corporate trustee where you want to keep either the trust resident, or non-resident, for tax purposes. Refer to part 3.1.2 of this paper for a discussion of corporate residency.

3.2 Application of CGT event K3

Australia does not have inheritance tax. When assets transfer from a person to their beneficiaries on death, the Australian tax system allows for the deferral of any tax that might be applicable on those assets changing hands. The position for CGT is to allow rollover of any gains under Division 128 of the 1997 Act. This means that the beneficiaries and executors of a person's Australian estate, in effect, 'step into the shoes' of the deceased person, so that CGT will be relevant when a beneficiary who inherits property later sells or transfers it, or where the executor sells or transfers the property to someone other than a beneficiary of the estate.

However, the CGT rules operate differently for the estate of a person who is a non-resident of Australia at the time of their death, or where assets of an estate pass to a non-resident. This exception for assets acquired after 19 September 1985 is CGT event K3.[18]

If the Will maker is an Australian resident, gifts to non-Australian resident beneficiaries (other than of assets that are 'Taxable Australian Property') will be subject to CGT event K3, which is taken to have occurred just prior to the testator's death. This operates to tax any unrealised capital gains inherent in an asset passing from an estate to a non-resident beneficiary.

The capital gain when K3 applies is the market value of the asset at the date of death less the deceased's cost base at the date of death. The executor of the estate must include any capital gain in the date of death return for the deceased's last year. The tax will therefore be paid by the estate, reducing the value of the estate, and in turn impacting on some or all of the beneficiaries depending on how the Will has been drafted.

3.3 Estate planning considerations

The operation of CGT event K3 may cause a perceived imbalance is the distribution of an inheritance with the resident beneficiaries footing some of the CGT cost caused by the non resident beneficiaries.

Consideration then needs to be given to whether some form of equalisation mechanism is then appropriate. Other options include:

- make specific gifts of assets not subject to CGT event K3 (such as cash or pre-CGT assets to non-resident beneficiaries) and other assets to resident beneficiaries, with a well drafted equalisation clause if equality is desired, since the value of the assets is likely to change or some may have been sold between the date of the Will (when the testator may have worked out a certain equal distribution) and the date of death;
- include a power of appropriation to allow the beneficiaries to decide which assets they want to receive from the residue (which may be split equally), after taking tax advice to take into account

[18] Section 104-215, 1997 Act.

any tax liabilities inherent in the assets (eg unrealised capital gains) and work out the most tax effective means of effecting the split; and/or

- consider the after-death options at part 3.4 of this paper if the Will does not deal with this.

3.4 Options after death when faced with disposing of assets to non-resident beneficiaries

The following options are potentially available when an executor is faced with the potential distribution of assets to foreign beneficiaries that results in a tax liability and the executors are seeking to minimize or avoid the additional tax burden. Before implementing any of these options, the person making the plan needs to get tax advice to determine the implications of each option and potential liabilities.

3.4.1 Letters of administration with the Will annexed and renunciation

The executor could renounce where the executor is a non-resident, but advice must be obtained urgently to avoid the executor 'intermeddling' with the estate and being seen to have accepted the position. If steps are taken with the estate or its assets, there is a string risk the person will have 'intermeddled' and therefore taken on the executorship.

If there is an Australian resident substitute executor, they can they accept. If not, then letters of administration with the Will annexed can be obtained with an Australian administrator.

The most common application for a grant of letters of administration with the Will annexed are made by the sole or main beneficiary under the Will, however anybody who is a beneficiary under the Will can apply.

3.4.2 Disclaimers

The foreign beneficiary may disclaim their interest in the gift of a specific asset or of residue. However, they may then not benefit at all from the estate. A beneficiary needs to take care, as there might be tax and other consequences for the beneficiary if they disclaim an interest.

Also, it is important to now be aware of the timing and tax implications of disclaimers in light of the High Court's decision in *Commissioner of Taxation v Carter* [2022] HCA 10.

3.4.3 Apply for a variation by the ATO in relation to CGT withholding

There is a 12.5% non-final withholding tax obligation on buyers when they purchase taxable Australian real estate from a non-resident where the purchase consideration is greater than $750,000. This impacts deceased estates where:

- there is disposal of a deceased's property with a value greater than $750,000;
- the deceased, executors or beneficiaries are non-residents for tax purposes and the property is sold under their names; or

- a non-resident executor is acting for a deceased Australian tax resident.

When selling the deceased's real estate, an executor should be aware that the purchaser has an obligation to withhold 12.5% of the purchase price and to remit this to the ATO, unless a Clearance Certificate is provided with the sale, or the sale is an exempt sale (eg less than $750,000), or a variation of the withholding amount has been obtained from the Commissioner.

Circumstances where the application of the 12.5% withholding amount would be considered inappropriate are:

- where the foreign resident will not make a capital gain;
- the foreign resident will not otherwise have a taxable income, for example they have carried forward capital losses;
- there are multiple vendors and only one is a non-resident; and
- properties secured by a registered mortgage and the sale proceeds will be insufficient to discharge both the mortgage and remit funds to the ATO.

3.4.4 Selling the estate early

The asset can be sold during the administration phase of the estate to try and minimise tax if the tax paid by the estate may be less than that caused by CGT event K3. This requires consideration of the marginal tax rates that will apply and whether an exemption or concession is available:

- A capital gain arising from CGT event K3 is taxed to the testator in their date of death tax return at their marginal rates. They should be entitled to the 50% CGT discount in relation to this gain if the asset was held for more than 12 months at the testator's date of death.
- Where income is taxed to the executor:
    - Income derived in the year of death and following two financial years will be taxed at the ordinary Australian marginal tax rates that apply to individuals plus the Medicare Levy (currently 2%).[19]
    - Income derived any time thereafter will be taxed at the ordinary Australian marginal tax rates that apply to individuals plus the Medicare Levy (currently 2%), but with no access to the tax-free threshold.[20]

3.4.5 Division of estate

One option would be to ensure that the non-resident beneficiary receives their interest in the form of assets that are not subject to CGT event K3. Cash is not a CGT asset and therefore K3 will not apply to a gift of cash in a Will. Similarly, CGT event K3 does not apply to taxable Australian property (which is generally speaking any direct or indirect interest in Australian land), as any gain or loss on that property will be captured at the time of any subsequent sale by the beneficiary.

[19] Section 99, *Income Tax Assessment Act 1936* (Cth) (**1936 Act**); Taxation Determination 92/192; clause 1 of Schedule 10 to the *Income Tax Rates Act 1986* (Cth) (**Rates Act**).
[20] Section 99, 1936 Act; clause 1 of Schedule 7 and clause 2 of Schedule 10 to the Rates Act.

This assumes the Will is appropriately drafted to give enough flexibility to the executor to determine which assets pass to which beneficiary.

Peter Greensill Family Co Pty Ltd (Trustee) v Commissioner of Taxation[21]

The Full Federal Court dismissed the taxpayers appeal and confirmed a foreign tax resident may be exempt from Capital Gains Tax (CGT) on capital gains relating to non-taxable Australian property assets (TAP) under section 855-10 of the *Income Tax Assessment Act 1997*, but that is not the case where the gains are realised by a discretionary trust and distributed to them.

3.4.6 Tax equalisation clauses

The Will could include provision for ensuring that the respective shares of the beneficiaries are adjusted to equalise the tax payable by the estate or to be paid from the share to which the non-resident beneficiary is entitled. This might not work in circumstances where there are insufficient assets from which to make the adjustment.

Another option would be for CGT assets to be sold during the administration phase of the estate to try to simplify equalisation between the beneficiaries. This may result in some savings where the marginal tax rates of the deceased and beneficiaries are high, allowing the executor to take advantage of the estate's access (for a time) to the marginal tax rates.

This may also save tax when dealing the deceased's main residence where the capital gain may be disregarded, noting:

- **Foreign resident**: Generally speaking, foreign residents are now unable to access the CGT main residence exemption except in limited circumstances where certain 'life events' occur.
- **Foreign resident deceased estate**: A trustee of a deceased estate is not entitled to the CGT main residence exemption, and a beneficiary of a deceased estate is not entitled to the portion of the CGT main residence exemption, in respect of an ownership interest in a dwelling of a deceased individual if the deceased was an excluded foreign resident at the time of their death.
- **Foreign resident beneficiary of resident deceased estate**: A beneficiary of a deceased estate is entitled to the portion of the CGT main residence exemption in respect of an ownership interest in a dwelling of a deceased individual if the deceased was not an excluded foreign resident at the time of death. This applies even if the beneficiary is a foreign resident at the time a CGT event occurs to the dwelling. However, the beneficiary is denied any additional component of the main residence exemption that they are otherwise entitled to in their own right if they are a foreign resident at the time a CGT event occurs to the dwelling.

The potential implications of this must not be discounted, especially to those Australian tax residents that may become non-residents for tax purposes in the future and could therefore lose the entire benefit of the CGT main residence exemption because of their status as a non-resident at the time of the relevant CGT event.

This treatment is irrespective of the taxpayer's citizenship during their ownership of the dwelling and there is no grandfathering to take into account periods of residence when the exemption applied.

[21] [2021] FCAFC 99

3.5 US and UK estate planning considerations

For clients who have beneficiaries that are domiciled in the UK (which is soon to change to UK tax residents), or are US citizens, there are additional considerations relating to UK inheritance tax and US estate / transfer tax.

While these are not triggered on the death of the Will maker, there are estate planning strategies that can potentially reduce or extinguish these exposures on the subsequent death of the beneficiary.

3.6 UK

3.6.1 Inheritance tax (IHT)

Approximately 1.3 million Britons now live in Australia. Many think that moving to Australia means they no longer need to worry about UK tax, but often they are not fully aware of the tax and in particular the IHT, implications. Similar issues can arise for Australians owning UK assets.

The UK imposes IHT at 40% on the value of their estate above their available nil rate band (currently £325,000). Transfers between spouses or civil partners are exempt provided they have the same domicile status. The nil rate band may be increased in certain circumstances, but transfers to a non UK domiciled spouse (for example, to an Australian spouse) from a UK domiciled spouse are only exempt up to £325,000.

Recent changes introduced by the new UK government focus on the tax residency of an individual (a shift away from the previous domicile focus). These include:

- with effect from 6 April 2025, an individual’s worldwide estate (and any assets they have settled on trust) will be within the scope of UK inheritance tax if they have been UK tax resident for 10 or more of the previous 20 years (‘long term residents’). The length of time long term residents remain exposed to worldwide inheritance tax after ceasing UK tax residence depends upon how long they have been a UK tax resident;

- for trusts where the settlor retains an interest, the trust assets will fall within the settlor’s estate for IHT purposes if they are a long term resident at that date of death (effectively the IHT status of assets held in trust will adjust over time). There are also concessions for existing trusts created before 30 October 2024. Non-UK assets that have already been settled on these trusts will not form part of the settlor’s estate for IHT purposes on their death, but will still fall within the relevant property regime once the settlor is a long term resident.

3.6.2 What to do about IHT?

Some common strategies for individuals with an IHT exposure include:

- IHT effective lifetime giving – each individual is able to make:

  - £3,000 worth of gifts per year plus £250 to any number of individuals;

  - regular gifts out of income (which varies according to circumstances);

- potentially exempt transfers (absolute gifts), which are exempt if the individual survives for seven years (with tapered rates applying if the gift was made more than three years but within seven years preceding death).

- Encumbering property liable to IHT with debt, as IHT is due on the net value of an estate (noting complex rules apply to this now, which complicates this approach).
- Making gifts to UK charities in a Will (which are IHT exempt).
- Considering if any properties qualify for Business Property Relief or Agriculture Property Relief.

3.6.3 What else to do?

It is necessary to consider whether to have Wills and the equivalent of enduring powers of attorney, in the UK and Australia, as the common law conflict of laws rules apply.

Although it is possible to have an Australian State or Territory grant of representation resealed in the UK, this makes the administration of an estate more complicated and lengthy. As Australia does not have IHT, it is usually preferable to have Wills in both countries (which must be carefully drafted to ensure that one does not accidentally revoke the other), since it is possible to be more flexible with Australian estate planning (for example by including asset protective and tax effective testamentary trusts in Australian Wills).

3.7 USA

The USA levies a federal estate tax, known as transfer tax, on an individual's right to transfer property on their death, and a gift tax on gifts made by an individual during their lifetime above certain thresholds. These taxes are citizenship driven and applies to worldwide assets and any trusts US citizens control.

The *Tax Cuts and Jobs Act 2017* was signed into law on 22 December 2017 and doubled the exemption from US$5m to US$10m (adjusted for inflation) on estate and gift taxes for the estate of persons dying in 2019 and before 2026. Recent media coverage suggests that amount will be increased to US$15m with indexation applies from 2026. As at the date of this paper, the IRS the figure for 2023 is US$13.61 million.

3.7.1 US citizens

Estate tax

The estate tax is levied on certain assets of a US citizen testator upon their death at a varying rate of up to 40%, adopting the assets' fair market value at that time. Assets subject to estate tax include cash and securities, real estate, insurance, trusts, annuities, business interests and other assets.

Certain deductions (and in special circumstances, reductions to value) are allowed to reduce the value of the 'gross estate' arriving at the 'taxable estate' value. These deductions may include mortgages and other debts, estate administration expenses, property that passes to surviving spouses and qualified charities. The value of some operating business interests or farms may be reduced for estates that qualify.

After the net amount is calculated, the value of lifetime taxable gifts (beginning with gifts made in 1977) is added to this number and the tax is calculated (reduced by any available credit).

A filing is only required for estates with combined gross assets exceeding US$13.61 million in 2024 (indexed annually). This threshold is reduced by taxable gifts made by the testator during their lifetime (see below).

Estates of testators survived by a spouse may elect to pass any of the testator's unused exemption to the surviving spouse, which can produce a possible combined exemption of US$27.22m.

As noted above, the doubling of the threshold applies to estates of persons dying in 2019 and before the start of 2026, after which it is uncertain what thresholds will apply so it may still be worthwhile taking action now even if you are below this threshold.

Gift tax

The gift tax is a tax on the transfer of property by one individual to another while receiving nothing, or less than full value, in return. The tax applies whether or not the donor intends the transfer to be a gift.

The gift tax applies to the transfer by gift of any type of property, including money. A gift may also include the use of property or income from property, without expecting to receive something of at least equal value in return, selling something at less than its full value, or making an interest-free or reduced-interest loan.

A US citizen can make gifts of up to US$18,000 (per recipient) each year to each of their children and any other person without incurring a transfer tax liability and affecting the current lifetime threshold of US$13.61m. Additionally, gifts can be made for medical expenses and tuition fees up to a maximum amount each year without incurring a transfer tax liability and affecting the current threshold of US$13.61m.

It is also possible to relinquish citizenship, but this may also incur significant tax liabilities.

If the US citizen is married to a non-US citizen, the US citizen is unable to transfer any of their unused portion of the current threshold of US$13.61m to their non-US spouse on death. However, it is possible to 'defer' the payment of tax by transferring the estate to a Qualified Domestic Trust (**QDOT**) that can be established after the US citizen's death but before the due date of the first tax return filed after her death.

The rules around a QDOT must be strictly followed and there must be at least one trustee who is a US citizen or US domestic corporation. Any distribution of capital (except on account of hardship relating to a spouse's health, maintenance, education, or support, or the health, maintenance, education, or support of any person the surviving spouse is legally obligated to support) is a taxable event as is the death of the surviving spouse.

3.7.2 Non US citizen

If a non US citizen owns US assets, US transfer tax still may be payable on their death if the US assets exceed the far lower threshold of US$60,000.

3.7.3 Wills

Australian Wills need to be specially drafted to accommodate the US rules around QDOTs and control of any testamentary trust created for each other.

It may also be beneficial to have Wills in both jurisdictions depending on the assets in which case they must work together from a tax and estate planning perspective.

4. Succession of structures

There are a variety of structures that we see in practice today, including:

- partnerships;
- companies;
- trusts; and
- SMSFs.

A common theme through these structures is what happens in the event of incapacity and death. This can be particularly important when the structure is carrying on an active business and cannot stop operation due to death or incapacity. Key drivers for business succession planning include:

- Ensuring business continuity;
- Minimising or eliminating disruption to the business;
- Enabling a smooth transition of control; and
- A well managed transfer of wealth.

4.1 Partnerships

Partnerships are a legal arrangement between two or more that are generally operated as a business with a view to profit.

Partnerships can be governed by a partnership agreement, or by legislation. Each Australian jurisdiction has partnership legislation. For example in Victoria, the *Partnership Act* 1958 governs partnerships to the extent they are not governed by a partnership agreement.

4.1.1 Victoria: *Partnership Act*

The Act will apply where no agreement otherwise exists between the partners. The Act sets out several key aspects of partnerships, including:

- the relationship of the partners and of people dealing with them, including:
    - partners being bound by the acts of other partners;
    - partners being jointly liable for debts of other partners;
- the relationship between the partners:
    - the mutual rights and duties of the partners under the Act can be varied by consent of all of the partners;
    - retirement of partners;
    - duty to render accounts;

- dissolution of partnership:
  - dissolution by notice, by the Court, death or bankruptcy;
  - rights of partners to application of partnership property;
  - rule for distribution of assets;
  - limited partnerships;
  - incorporated limited partnerships;

4.1.2 Partnership agreements

As noted above, the terms of the Act can be varied by the consent of the parties.

This will most often take the form of a partnership agreement. These agreements are often preferably to the Act, given then can be tailored to the particular circumstances of the partnership and business. A well drafted partnership agreement will deal with key issues including:

- death of a partner;
- incapacity of a partner;
- where partnership property passes on dissolution or death; and
- liability of partners.

4.2 Companies

Many businesses will have agreements in place that can impact on an estate including:

- buy sell agreements;
- key person or other insurance;
- shareholder or unitholder agreements;
- interestholder or family agreements; and
- specific constitutions or other documents that govern the succession of directors and shareholders on death.

Understanding these agreements and their impact on the estate is another critical element. For example, does the payment under key person insurance or a buy sell agreement pass to the estate, or into a discretionary trust, and in turn do the shares held by the deceased pass to surviving business associates (effectively exiting the deceased’s interest in the business for the payment).

4.2.1 Constitutions

The starting point for companies and succession is the company constitution. This will regulate core decisions including:

- appointment and removal of company officers;
- decision making quorum;
- death and incapacity of directors; and
- issuing of shares.

We are preparing more bespoke constitutions for clients operating business, especially where the clients are sole director / shareholders. This has stemmed from the need for business certainty and continuing and making sure there are provisions in place for incapacity and death to ensure the company can continue to operate, and is not caught up in the probate process or in disputes. Mechanisms in this regarding can include:

- more detailed provisions that deal with incapacity and death;
- hardwiring successor directors on incapacity and death; and
- ensuring transfer of shares in the company are properly dealt with under the Will of the shareholder or a shareholders agreement (discussed further below).

4.2.2 Shareholder agreements

Shareholder agreements are imperative for good succession planning. Clients who run businesses with third parties to ensure they have these agreements in place.

In most cases, the agreement can be placed in a bottom draw and only needs to come out in the event of a disagreement. You will often find business owners who have taken the time to properly prepare a shareholders agreement actually have less use for it, given disputes arise less frequently because they have taken the time to discuss key business decisions and goals.

Role of Shareholders' Agreements

Shareholder agreement is the most commonly relied on document for business succession as between shareholders. In summary:

- a shareholders agreement is a contract executed between shareholders of a company;
- a shareholders agreement supplements many provisions of the constitution and regulates the relationship between the shareholders with regard to the management and control of the company;
- a constitution rarely deals comprehensively with exit events; and
- the shareholder agreement permits parties to contemplate a variety of events that may have an impact on the ability of the company to keep operating and how the company would respond to such events.

Some of the key considerations are set out below.

Company Goals:

Enables the company to:

- identify current goals;
- articulate future objectives; and
- express key cultural elements of the business.

Allocation of Board and shareholder decisions

These can include

- allocating responsibility for decision making;
- ensuring ongoing review of business succession plans and strategies;
- ensuring implementation of business succession plans and strategies;

New Share issue protections

Control:

- allows for control over the number and identity of incoming shareholders;
- allows for anti-dilution mechanism; and
- raising capital to ensure ongoing operations of the business.

Insurances

- Directors and officers liability insurance.
- Public liability insurance.
- Professional Indemnity insurance.
- Product liability insurance.
- Business interruption insurance.
- Cyber risk insurance.

Create external funding options

- Bank loans.
- Shareholder loans.

- Director loans.
- Use of company profits.
- Cash reserves.

Dispute resolution process

- Disputes over valuation methodologies.
- Disputes as to key decisions.
- Disputes as to occurrence of exit event and how they should be categorised.
- Expert determination should be an option.

Restraints

- Non compete.
- Non solicit.
- Confidentiality/privacy/data protection.

4.2.3 Exit events

Given succession is the key driver of this paper, we will focus on exit events and how these are commonly dealt with in a shareholders agreements.

There are primarily three key exit mechanisms:

- voluntary exits;
- forced exits due to breach; and
- involuntary exit due to incapacity and death.

Voluntary exit

Voluntary exits are those exits which are on good terms. This might include retirement or resignation of a shareholder, or its key person from business. It may also include circumstances where a shareholder elects to dispose of its shares in a company or receives an offer from a third party.

Again, it is important to include provisions dealing with how the shares of the exiting shareholder are to be dealt with.

It is common for a shareholders' agreement to include pre-emptive rights provisions requiring a shareholder to offer their shares to an existing shareholder before offering those shares to a third party. These provisions ordinarily require shares to be offered at the same price as any third party offer and prevent a sale of shares to a third party below the price offered to existing shareholders.

Where shares are ultimately transferred to a third party, it is common for any third party to require approval by the Board or the existing shareholders before being permitted to acquire shares. This prevents existing shareholders from ending up 'in bed' with someone they do not wish to do business with, but can ultimately inhibit the transfer of shares by a shareholder.

It is also usual to include drag along and tag along provisions:

- drag along right allows a majority shareholder to force the minority shareholders to also sell their shares in the event that a third party wishes to acquire all of the issued shares in a company; and
- tag along right gives minority shareholders the right to require an outgoing majority shareholder to also obtain the sale of their shares, on the same terms and for the same price as the majority shareholder is exiting.

In the voluntary exit context, it is important to ensure that the drag and tag provisions are not unnecessarily prohibitive. Ultimately, the drafting approach to drag and tag provisions will depend on the party that you are representing.

In a voluntary context, the price is usually determined by the outgoing shareholder. However, provisions requiring set valuations can be included in the shareholders agreement.

Forced exits due to breach

It is usual for shareholder agreements to include Events of Default under which shareholders are penalised for certain agreed matters.

Common triggers for an Event of Default include:

- default under or material breach of shareholders' agreement;
- insolvency;
- breach of law;
- termination of employment - whether due to retirement, resignation or for cause; and
- change in control.

Consequences of default can include:

- pre-emptive rights of remaining shareholders;
- selective buy back of shares by the company;
- sale to third parties; and
- application of bad leaver provisions – should a discount to valuation be applied? Where a discount is applied, you need to be careful that the discount is not seen as a penalty in which case it may be unenforceable.

Other involuntary exits

Provisions dealing with circumstances that arise that are outside of the control of any of the parties are often included in shareholders agreements and are important for the continued operation of the business. Common trigger events are death, total and permanent disability and trauma.

- the definition of '*Total and permanent disability*' can vary. In our experience, this should be determined by way of assessment by an independent medical practitioner to ensure that there is an objective basis for determining whether such a trigger event has occurred; and
- trauma is often included as a trigger event. The prevailing opinion in the market is that, as it is possible that an affected party will recover from trauma, it should not be included as a trigger event or, if it is, it should be properly defined by reference to independent medical opinion.

In these types of exit events, other shareholders may not necessarily want to immediately bring a third party into the company as a shareholder. As such, it is important to ensure that there are clear buy/sell arrangements, or a company buy back mechanism, in place. Further, given the nature of the exit, it is also important to consider funding arrangements, which we will talk about in the next section.

4.2.4 Buy sell deeds

It is common to include provisions regarding involuntary exits in standalone deeds, commonly known as '*buy-sell deeds*' or business succession agreements.

What are buy-sell deeds

Buy-sell deeds put in place a formal process between members of a company to deal with circumstances where a member (or its key person) suffers a trigger event.

The purpose of this is to ensure that equity in a company is acquired from an affected member when they are unable to continue in the business. This ensures that the company can continue to operate uninterrupted and that the affected member (or the key person or their estate) is compensated.

Typically, buy sell deeds are structured as put and call options whereby the continuing shareholders can call on the sale of the shares by the affected shareholder and the affected shareholder can compel the acquisition of the shares of the affected shareholder.

We will discuss the various trigger events typically seen in buy-sell agreements as well as valuation and funding methodologies.

What are trigger events

Common trigger events are death, total and permanent disablement and trauma.

Attention needs to be paid to the definitions of 'total and permanent disability' and trauma. Where buy-sell deeds are insurance funded, it is preferable to align the definitions with the definitions used in the insurance policy.

Trauma is typically only included where it is a specific insurable event under an insurance policy.

Valuation

Various approaches to valuation of the shares can be taken, although the most typical are independent valuation based on an agreed valuation methodology or the principals of the business agreeing the value of the business annually or biannually.

Where an Independent valuation is required, the agreement should set out the assumptions to be applied by the independent valuer taking into account the exit by the exiting shareholder. In some businesses this may have minimal impact but in others this can result in a significant discount - for example, the value of professional services businesses is likely to be significantly affected by the unexpected death or incapacity of a principal.

Where the price is to be determined periodically by the Board, you should consider whether a particular valuation methodology should be used and the frequency of valuations. It is important to revisit this each year to ensure that the insurance policies (if any) are appropriate and do not result in a significant gap between the proceeds and the sale price.

As noted in the slide, you should also consider whether any penalties should be applied. However, this is not usually the case for involuntary exit events.

Approaches to funding

Buy sell arrangements are often insurance funded. This means that each of the members, whether in their own capacity or through the company, take out a risk insurance policy in respect of their key person such that, on a Trigger Event occurring, insurance proceeds are received and applied to the purchase price payable for the shares of the affected member.

To the extent that proceeds exceed the price, that amount is retained by the affected member. This approach ensures that any acquisition of shares by continuing members under the buy sell arrangements does not need to be funded by the other shareholders or the company. It is open to the parties to determine whether the individual or the company itself pays the premiums of such policies.

It is possible for buy sell arrangements to be funded by the other members or the company. Often this approach is taken where the cost of the insurance premiums is unduly prohibitive (e.g. where a member or their key person is older or subject to a “higher risk” condition). In such cases, it necessary for the relevant party to have funds available to fund the acquisition of the shares.

Where insurance funding is obtained, you should consider whether the insurance proceeds are intended to fund the entire acquisition of the outgoing shareholders shares (regardless of the value of the business) or whether the continuing shareholders should ‘top up’ any deficit in the fair value.

An option that we frequently use is to ensure that, where there is an excess amount that must be funded by a continuing member or the company, it can be paid by way of instalments to relieve the burden.

Where there are ongoing payments over time, consider whether interest is payable and whether any security should be granted in favour of the outgoing shareholder.

4.3 Trusts

While assets held by trusts are not personal assets, trusts can become an aspect of the estate administration process in a number of ways:

- succession of control of a trust:
    - who becomes director and shareholder of the trustee company, or successor trustee (where the deceased was an individual trustee);
    - who becomes appointor, guardian, protector or any other key roles held by the deceased;
    - are there any trust assets that the trustee resolved to distribute to the deceased prior to their death that have not been transferred (which their estate is entitled to following their death);
    - are there any UPEs owed to the deceased;
    - are there any loans owed to the deceased, or by the deceased to the trust; and
    - do any family trust elections need to be considered following death.

4.3.1 Recap on key control roles - trustee

Role of the trustee

The role of the trustee will likely be well known to all, however, includes making decisions regarding the day to day operation of the trust, how funds are invested, and critically, how distributions are made.

As discussed above, it is usually the appointor that has power to appoint and remove the trustee.

The trustee's job in the context of a discretionary trust can become complicated. In many cases there are competing interests, with tension and sometimes conflict. Here, we briefly review the requirements for trustee decision making.

When a trustee makes a decision regarding a discretionary testamentary trust they must be acting in the best interests of the beneficiaries as a whole. The trustee must demonstrate that they have made the decision with same skill and care as a reasonably prudent person (with a higher expectation in this regard placed on a professional acting in the role of trustee). The trustee must also comply with the terms of the trust and give proper consideration the trust deed and any statutory requirements.

In *Karger v Paul*[22] McGarvie J summarised that trustees must act:

> *'in good faith, upon real and genuine consideration and in accordance with the purposes for which [their] discretion was granted.'*

A trustee cannot act arbitrarily or capriciously in making decisions. This comes back to the requirement to act in good faith.

[22] [1984] VR 161, 164.

In order to discharge this duty the trustee must give proper consideration to relevant matters and exclude irrelevant material.[23] The trustee must therefore consider the particular needs and circumstances of the beneficiaries.

The rules of natural justice do not apply to trustee decisions. A trustee does not have to give a beneficiary the opportunity to make representations to the trustee in relation to any particular proposed exercise (or non-exercise) of a trustee power.[24]

Decision making

Where individual trustees are appointed, the way they make decisions will be regulated by the trust deed. Many trust deeds will specify that trustees have to act either unanimously or by majority where there are multiple trustees.

Where the trust deed is silent, the trustees must act unanimously.

If individual trustees are acting and will continue to act, it becomes more important to ensure that the right decision making provisions are included in the terms of the trust deed, including considering:

how decisions should be made, including what level or majority, or unanimity, is required;

- if any casting votes are to be provided (this is a worthwhile consideration while the matriarch or patriarch is still able to act and wants to retain a level of control); and
- whether an independent person be appointed a trustee and be given a level of decision making in that role (such as a casting vote where there is a deadlock).

In the case of corporate trustees, decision making will be regulated by the terms of the constitution. The rights of members under the constitution can also alter depending on the type of shares they hold, which can sometimes be limited in their nature to only having voting rights in particular scenarios.

Individuals or corporate trustees

From a succession planning perspective, it is often preferable to have a corporate trustee appointed.

This allows current shareholders to plan for the succession of control of the trustee by ensuring their shareholding passes to the appropriate persons under their Wills (which could be children, executors or other independent people).

A corporate trustee can also avoid the confusion that sometimes occurs with an individual trustee in identifying what property is held in their personal capacity, as against property held in their capacity as trustee, and also potentially limit the liability of the directors to the paid up capital of the shares.

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[23] *Meat Industry Employees Superannuation Fund Pty Ltd v Petrucelli* (unreported, 28 February 1991, Supreme Court, Vic, Nathan J).

[24] *Hartigan Nominees Pty Ltd v Rydge* (1992) 29 NSWLR 405 cf *Scott v National Trust for Places of Historic Interest or National Beauty* [1998] 2 All ER 705, 718 and *Maciejewski Telstra Super Pty Ltd* (1998) 44 NSWLR 601, 605.

4.3.2 Recap on key control roles - appointor

The role of the appointor is determined by the terms of the trust deed and its specific requirements. The appointor is sometimes also referred to as a protector or a principal.

Traditionally, the role of the appointor has been to appoint and to remove the trustee of the trust, for example:

> ***Power to remove and appoint***
>
> *Subject to clause #, the Appointor may by deed in writing:*
>
> *(a) remove any trustee;*
>
> *(b) appoint any additional trustee; and*
>
> *(c) appoint a new trustee.*

The role of the guardian has become largely non-existent in modern trust deeds. This has seen some of the consents that were traditionally required from the guardian now passing to the appointor, including requiring the consent of the appointor to:

a. vary the terms of the trust deed;

b. to appoint and remove beneficiaries; and

c. to alter the vesting date of the trust.

Importantly, any appointment under a specific power such as above must be made within the terms of that power to be valid.

4.3.3 Recap on key control roles - guardian

As with the appointor, the role of the guardian is determined by the terms of the trust deed and its specific requirements.

Traditionally, the role of the guardian was to act as a check and balance when the trustee proposed to exercise certain powers (which were specified in the trust deed).

These powers were often referred to as ‘reserved’ or ‘restricted’ powers, including:

a. varying the terms of the trust;

b. making capital distributions;

c. appointing or removing beneficiaries; and

d. appointing capital on vesting.

Many older trust deeds (1970’s and 1980’s) regularly provided for the role of guardian, however, this position has become largely redundant with most modern trust deeds.

Many trust deeds will provide for the guardian to waive the requirement to obtain their consent before the trustee exercises any reserved or restricted powers:

> *'A guardian may at any time by instrument in writing declare that the trustee is not obliged to obtain the consent of the guardian before exercising the specified powers set out in clause #.'*

If the guardian has the power to waive the consent requirement, it can simplify the administration of the trust greatly by having the guardian exercise that power and then resign from the role. This means that the trustee is then free to make any decisions without the need of complying with any notice periods (which can often be up to three months), notice requirements (such as providing written details of the proposed action to the guardian) or obtaining written consent from the guardian.

However, before this step is completed, it is critical to review the powers that require the consent of the guardian against those that can be waived, to make sure all can be waived. Some trust deeds do not allow all of the powers to be waived (such as the power to appoint capital on the vesting day or to remove or appoint beneficiaries), and in those situations it may be best to have the guardian continue in that role.

4.3.4 Succession of trustee, appointor and guardian roles

Trustee

Where the trustee is a company, the shares in the company will pass under the Will of the shareholder, subject to any shareholder or other agreement.

Where the trustee is an individual, the terms of the trust deed should set out who has the power to nominate a successor (which as noted above is usually the appointor).

Appointor and guardian

The trust deed should contain a mechanism to allow the succession of these roles, and will also often contain a default position where this reverts to the 'legal personal representative'. Query whether there is a Will in place that appoints an LPR, and whether that is still the appropriate person.

Best practice is to have a separate deed of nomination (where permitted under the trust deed) as it can avoid issues connected with succession including identifying who the LPR is and whether they need a grant of probate.

4.3.5 What if there is no succession mechanism?

Many trust deeds will contain specific powers that allow for the nomination of successor appointors or guardians. Where these powers exist, they should be used to nominate successors.

In the case of *Mercanti v Mercanti,*[25] Le Miere J confirmed that the terms of the specific power to appoint a successor appointor will govern that appointment. The relevant successor appointment provisions are set out below (with the author's emphasis in bold):

> '*10.1. The Appointor and* ***on the death of the last surviving Appointor such other person as he shall have appointed to act as Appointor*** *and in default of*

[25] [2015] WASC 297, 99.

appointment his legal personal representatives shall be entitled by instrument in writing at any time and from time to time:

10.1.1 to remove any Trustee hereof;

10.1.2 to appoint any additional trustee or trustees; and

10.1.3 to appoint a new trustee or trustees in the place of any Trustee who resigns his trusteeship or ceases to be a Trustee by operation of law.'

Le Miere commented in relation to the specific power above that:

'The FW Trust Deed expressly deals with an Appointor appointing an Appointor and limits it to an appointment upon the death of the last surviving Appointor.'

Any attempt to appoint a successor appointor other than on the death of the existing appointor under the above terms would have been invalid, given it was not provided for under the terms of the power.

There are often cases however where the powers under the trust deed are inadequate, for example they do not allow for appointments on incapacity (only death), or they do not allow for any appointments at all.

In these instances, where there is no specific power, the question comes up - can the variation power be used to deal with the succession of the control roles?

4.3.6 *Mercanti v Mercanti* [2016] WASCA 206

Much of the case turned on the interpretation of the respective variation powers.

The variation power under the FW deed is as follows:

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

…'

The variation power under the MMF deed is as follows:

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

…'

Both variation powers were subject to a number of limitations which had no bearing on the trial. The sections above in bold have been emphasised by the author.

Findings of the Trial Judge - *Mercanti v Mercanti* [2015] WASC 297

A number of grounds were raised to set aside the MMF Variation and FW Variation, including that:

- the variation power did not allow the trustee to vary the provisions of the schedules which sat after the variation powers and were therefore not 'hereinbefore contained' (where the appointor and guardian were nominated);
- the variations were made in breach of trust;
- Tyrone procured Michael to sign the MMF deed of variation in circumstances constituting equitable fraud; and
- the removal of the trustees was made in breach of Tyrone's duties as appointor.

At first instance, the Trial Judge found that the:

a. MMF Variation was valid, as the words *'trusts, terms and conditions'* applied to the trust deed as a whole, and was not limited to provisions before clause 28;[26]

b. FW Variation was invalid, as the words *'trusts hereinbefore provided'* restricted the variation power to only the trusts of the that trust, being clause 2, and clauses 4 to 8, and did not extend to the power to alter an appointor.[27]

Court of Appeal - *Mercanti v Mercanti* [2016] WASCA 206

Seven grounds of appeal were lodged, which all focussed on the MMF Trust (which held the property assets and operated the main business). No appeal was lodged regarding the finding for the FW Trust.

A joint judgement was given by Newnes JA and Murphy JA and a separate judgement by Buss P. All Judges dismissed the appeal. Buss P noted that:

> *'Each of the definition of 'the Appointor' in cl 1(15), the relevant provision of the Schedule dealing with the Appointor and the operative provision with respect to the Appointor in cl 21 is not to be read or construed in isolation. All of those provisions must be read and construed together and in the context of the MMF Trust Deed as a whole.'*[28]

The key points of the judgement in relation to the interpretation of the variation power are summarised below:

a. the schedule should be read and construed as if part of the definition of appointor;

[26] *Mercanti v Mercanti* [2015] WASC 297, 87.
[27] Ibid, 100.
[28] *Mercanti v Mercanti* [2016] WASCA 206, 138.

b. the schedule and the definition should be read and construed with the operative provisions relating the to the appointor in clause 21;

c. terms and conditions hereinbefore means the provisions (other than trusts) appearing before clause 28;

d. terms and conditions hereinbefore however include the relevant provisions of the schedule as if it were in the appointor definition;

e. the language in clause 28 extends to the variation of terms and conditions by deletion of the original appointor provisions and replacement with new provisions;

f. nothing in the deed requires or justifies restricting the normal meaning of the words in clause 28; and

g. the use of clause 28 to change the appointor did not derogate from the fundamental purpose of the variation power, and can be distinguished from *Jenkins v Ellet*[29].

The other key grounds that were rejected included:

a. that the deed of variation was consented to by the trustee despite there not being a formal process. Evidence was accepted that the directors knew what the document was and resolved in a meeting to execute the document;[30]

b. that the characterisation of the transfer of effective control to Tyrone as 'an advance on his inheritance' did not make the exercise of the variation power improper, and was therefore not a 'fraud on the power';[31]

c. the execution of the deed was not brought about by equitable fraud (undue influence) as evidence was accepted that Michael knew what the role of the appointor was and the effect of the documents, and had received legal advice to that effect;[32] and

d. the exercise of the appointor power to change trustees to a trustee controlled by Tyrone was not a fraud on the appointor power. The exercise of this power was held to be consistent with the control of the trust to preserve the status quo. It was also held Tyrone did not act dishonestly or in bad faith.[33]

4.3.7 *Re Owies Family Trust* - [2020] VSC 716

This case is a lengthy judgement, however touches on many practical points relevant for practitioners who practice in trusts on a regular basis.

Background

This proceeding related to a discretionary family trust established by the parents John and Eva Owies, who had three children, Michael, Paul and Deborah. Eva died on 27 November 2018 and John died

[29] Ibid, 146 - 153.
[30] Ibid, 216.
[31] Ibid, 264.
[32] Ibid, 294 - 300.
[33] Ibid, 316 - 320.

23 January 2020. Michael maintained a close relationship with his parents throughout, whereas Paul and Deborah had a strained relationship with their parents and irregular contact.

Paul and Deborah commenced proceedings which centred on three main areas with nine issues. One of the issues related to the validity of variations to change successor guardians / appointors in 2002, 2010 and 2017 via deeds of variation. If these variations were valid, Michael would be the appointor and guardian, whereas if they were invalid John would have continued until his death (issues 1 - 4);

Variation powers

The terms of the variation power at clause 20 stated:

> *'20 The Trustees for the time being may at any time and from time to time by deeds with the consent of the Guardian if alive revoke add to or vary all or any of the trusts hereinbefore limited or the trusts limited by any variation or alteration or addition made thereto from time to time and may by the same or any other deed or deeds declare any new or other trusts or powers concerning the Trust Fund or any part or parts thereof the trusts whereof shall have been so revoked added to or varied but so that the law against perpetuities is not thereby infringed and so that such new or other trust powers discretions alterations or variations –*
>
> *(i) may relate to the management or control of the Trust Fund or the investment thereof or to the Trustees' powers or discretions in these presents contained;*
>
> *(ii) shall not be in favour of or for the benefit of the Settlor or result in any benefit to the Settlor but shall otherwise be for the benefit of all or any one or more of the General Beneficiaries or the next of kin of any of them or the next of kin of the Primary Beneficiary or Primary Beneficiaries or any of them;*
>
> *shall not affect the beneficial entitlement to any amount set aside for any Beneficiary prior to the date of the variation, alteration or addition.'*

Findings of the Trial Judge

A summary of the key aspects in relation to issues 1 - 4 of Justice Moore's judgement are:

- the schedule named John '*during his lifetime and after his death*' Eva as the appointor and guardian of the trust;
- '*trust*' in the context of the variation power was taken to refer to the primary trust established under clause 2 of the deed:

> *'2 IN consideration of the premises the Settlor as Settlor HEREBY DECLARES that the Trustees shall and the Trustees HEREBY DECLARE that they will henceforth stand possessed of the Trust Fund and of the income thereof upon the trusts and with and subject to the powers and provisions hereinafter expressed concerning the same.'*

- the declaration of trust in cl 2 to which the 'trusts hereinbefore' in cl 20 must be taken to refer, expressly distinguishes between '*the trusts*' upon which the trustee is to hold the trust fund, on the one hand, and the '*powers and provisions hereinafter expressed concerning the same*', on the other[34]. Although dealing with a differently expressed power of variation, the same distinction in relevantly similar provisions of a trust deed was important in the task of construction undertaken by Buss P in *Mercanti v Mercanti* and by Douglas J in *Jenkins v Ellet*;

- definitions of appointor and guardian are '*provisions*' and not '*trusts*';

- '*trusts hereinbefore*' does not extend to authorise a variation of all of the rights and obligations the trustee is subject to under the trust deed[35], and does not give the trustee power to amend the description of the persons named as guardian and appointor;[36] and

- the reference to the '*last surviving Guardian*' in sub-cl 1(5) implies that the class of persons who may hold the office of guardian is finite and ascertainable. That intention is reflected in the specification only of John and then Eva as guardians in the schedule to the trust deed. It is also consistent with the absence of any express provision in the trust deed for the appointment of new or additional successor guardians[37].

The exercise of the variation powers in each instance was held to be invalid.

4.3.8 Exercise caution when exercising the variation power

Given the increase in litigation regarding family trusts, practitioners should exercise caution where there is uncertainty over the scope of the variation power. If there is uncertainty, an application could be made to the Court to make a declaration regarding the interpretation of the variation power, and in the alternative to approve a variation to appoint successors.

While this may seem expensive when compared to a deed of variation, if clients want to ensure certainty and avoid potential future disputes, it is a sensible consideration (especially in light of the potential costs if the validity of an appointment was litigated between arguing siblings after the death of the appointor).

4.3.9 Takeaways from *Mercanti* and Re *Owies*

Looking at the above cases, some key takeaways include:

- using a specific power to deal with the succession of the positions of appointor and guardian;

- provided there is a specific power, ensuring the appointment is within that power (for example, does it only allow for an appointment on death, or on death or incapacity);

- where there is no specific power, reviewing the variation power to determine if it allows for variations to deal with the succession of these positions;

- is the variation power:

[34] *Re Owies Family Trust* - [2020] VSC 716, **[40]**
[35] Ibid, **[73] - [78]**
[36] Ibid, **[74]**
[37] Ibid, [81, 86]

  - restricted to the '*trusts hereinbefore provided*', which will usually rule out the use of the variation power as the definition of appointor or guardian is not a '*trust*'; or
  - broader, and refers to '*trusts terms and conditions*', which will generally allow the variation power to be used to deal with the succession of these positions;
- does the use of the variation power affect the substratum of the trust (from *Jenkins*, this would appear to be the case where the trustee unilaterally uses the variation power to change the guardian or appointor in a circumstance where the guardian or appointor regulates the exercise of the trustee's powers); and
- where there is uncertainty, obtain Court approval regarding any proposed variation.

4.4 Other types of documents for succession

There are a number of documents and arrangements that are discussed in the context of dealing with the control of trusts, including:

a. family or interestholder agreements (which are a hybrid agreement that regulate decision making of the trustee and also distributions from a trust);

b. family constitutions; and

c. letters or memoranda of wishes.

4.4.1 Family agreements

A formal '*family agreement*' can be used to document matters relating to a trust structure or a number of connected structures. The parties could be individual family members being the current generation of controllers and also those who will succeed into controlling roles (shareholders and directors of corporate trustees, appointors).

The agreement documents how the family structure will run during the lifetime of both parents, when one survives and after both are deceased. An agreement can be used in circumstances where:

a. there are a number of individuals all likely to wish to have a say in the management and control of the trust structure;

b. there might be a number of separate businesses held in one structure or multiple structures forming part of a group;

c. a number of family members wish to '*own*' or have certainty around future ownership of part of the business or family wealth;

d. there is a need to ensure those working in a family business are compensated/rewarded appropriately and balance this with needs and expectations of non-active family members;

e. there is a need to deal with retirement of current generation and ensure appropriate levels of income are maintained while transitioning control to the next generation; and

f. 'exit' or cash out provisions are needed so that the whole family does not have to remain bound together by their inheritance in the structure.

All these issues might need addressing, but the actual structure does not allow for simple division of the assets by separation, or there would be a significant cost to separation. For example, assets held in discretionary family trusts or shares held by an incumbent generation of owners.

4.4.2 Councils and Constitutions

> *'We found that too much emphasis on business can cause conflict and resentment within the family. Conversely, an over-emphasis on family objectives can undermine business performance.*
>
> *Over 80 percent of the family businesses surveyed indicated they had experienced some conflict or tension between family members over the last 12 months. The most common reasons for conflict were issues around the following:*
>
> *vision, goals and strategy*
>
> *balancing the needs of the business vs. the family*
>
> *a lack of family communication.*

Analysis of the 2015 survey data reveals that family businesses with a Family Council (i.e. formal family gatherings) are significantly less likely to have encountered conflict within the family within the last 12 months.'[38]

All families are different and each is going to go about the process of communicating in different ways. Also it is not necessarily a matter which can be achieved quickly. The process itself is very important. This may involve a review of the expectations and outlook of all family members as well as the values and focus of the parents.

The end result being family members understanding that the wealth of the family or operating business is not a birth right or a '*marriage right*', but intended to be managed for the benefit of the generations to come. Formal mission statements, councils and constitutions will not suit every family however any open communication is to be encouraged.

Mission statement

Stephen Covey, who in 1989 published the highly successful book 7 Habits of Highly Effective People, [39] demonstrates that his approach can be applied to families. Stephen refers to families needing to begin with a clear vision of what they want their family to be like. He also describes a mission statement as being a habit and not an event, so it should not be 'announced' by senior family members but a process.

The process is as important as the end result, but families must also keep the agreed mission statement under review and live by it.

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[38] KPMG*, Family Business Survey 2015: An overview* (27 October 2015) <https://home.kpmg.com/au/en/home/insights/2015/12/family-business-survey-2015-overview.html>..

[39] Stephen R. Covey, *The 7 Habits of Highly Effective Families* (Allen & Unwin, 1998).

Constitution or family agreement

A constitution or agreement is a formal agreement documenting the values, goals and '*rules*' for the family. The constitution defines the relationships between the family members with the business management body. It is a mutual agreement between the family, and does not necessarily have a binding legal effect.

The agreement might be one page or might be a 20 page volume. Some families start simple and the document expands with time and change in the family and business.

In most cases, the business has good structures and individual roles are well understood and defined by the family and those working in the business. The family may just want to take the opportunity to:

- collaboratively develop systems and formal structures to organise and confirm matters which currently exist on the basis of a common understanding between family members;
- confirm values and objectives to maintain business for future generations; and
- avoid conflict in future generations.

Developing the document, as with the mission statement, is a process which may evolve over time. It may involve family meetings or retreats, adviser input and facilitated meetings.

This can be a long process and when finalised, some families choose to have a celebration to formally adopt the constitution. This is important to demonstrate the commitment of the family to the constitution.

A common process might involve:

- clarifying and confirming the facts (family members, structures and, where relevant, business facts);
- identifying objectives and the overall goal of the process;
- confirming the plan and strategies;
- implementation of the plan; and
- agreement to regular review and update of the documents

The agreement, when finalised, must be a living document. It must be something that the family live by and can live with. The only way to achieve this is to ensure it is developed collaboratively, so that it represents the values of the whole family.

A constitution or family agreement may not have any binding legal effect. However, if the process for its development is inclusive of all family members (including partners) then it is likely family will 'buy in' and be committed to its content[40].

Effective family governance can ensure harmony and success so that the wealth made by the family is kept in the family.

[40] See Simmons and Simmons [2008] FamCa 1088- Family Council and constitution referred to in proceedings.

Family Council

A Family Council can take many forms. It is often a group of nominated representatives from the family (particularly where there are different branches from multiple marriages). In the context of a family business this would include representatives who work in the business and those who do not actively participate in the business. The group is the voice of the family and presents comments, questions and requests to those controlling the family structures and businesses. The group will not have any formal role in directing the management of the family's wealth.

It is also a forum where the controllers can report back and provide information about the family's structures for the dissipation to the family.

To be effective the group should meet regularly and have an agenda together with clear procedures for operation. The criteria for membership should be determined and maintained.

4.4.3 How effective are they?

There may be issues with binding legal effect in that the agreement may seek to create interests that do not exist at law (such as a notional share in a discretionary trust).

It can be argued that equity would support a party to enforce the agreement if another party failed to adhere to its requirements (promissory estoppel).

Fettering the discretion of the trustee

> One point that is often raised in the context of agreements that attempt to regulate the discretion of a trustee is that they fetter the discretion of the trustee.

Dagenmont Pty Ltd v Lugton & Anor* [*2007] QSC 272

Facts

The Lugton Family Trust operated a business, with Dagenmont Pty Ltd acting as trustee of the trust. When the trust was established, James Lugton and his brother in law, Mr Pal, were the only directors and shareholders.

A deed was entered into between the parties where James agreed to take a number of steps, including resigning as director, transferring his shares in the trustee and disclaiming his interest to capital in the Trust. In return, the trust was to pay James $150,000 per year.

The trustee brought an application to have the agreement set aside on the basis it was an unlawful fetter on the trustee to distribute income.

Findings

The Judge dismissed the application on the following grounds:

a. the Judge commented that the deed did operate to restrict the trustees discretion, however for a number of reasons it was not a fetter;

b. the variation power allowed the trustee to vary the trust with respect to part of the income. The deed could be construed as a valid variation under that power to make a separate trust for James for the set amount of income;

c. the trust deed also allowed the trustee to release any power conferred on it by the trust deed in whole or in part despite the exercise of that power being a fiduciary obligation. The effect of the deed meant the power to distribute income was no longer unfettered, but reduced by the obligation under the deed. The trustees discretion remained unfettered as to the balance of the income not dealt with by the deed; and

d. the Judge also noted it was the role of the Court to uphold a bargain where it could, and not destroy them.

The last point is an interesting one, as it suggests the Courts may be prepared to uphold an agreement that is entered into in good faith, and with the interests of the beneficiaries at its core, as is the intention of many trust related agreements.

4.4.4 Wishes: can a trustee follow them?

Monaghan v Monaghan [2016] NSWSC 1316

Background

The Will of the deceased left a number of wishes regarding the disposal of assets held by a discretionary trust as follows:

> *IT IS MY WISH that my executors in their role as directors of PETER MONAGHAN PTY LIMITED exercise their discretion to divide the Assets held on Trust in the Monaghan Discretionary Trust equally among my sons PETER ALEXANDER MONAGHAN and JUSTIN RYAN MONAGHAN.*

The deceased also left a memorandum of wishes that stated:

> *'This Memorandum of Wishes has been prepared by me in connection with Monaghan Discretionary TRUST, being a Trust established by Deed of Settlement dated 27.02.03 between ACIS Settlements Pty Ltd as Settlor and Peter M. Monaghan Pty Ltd as Trustee as amended from time to time ('the Trust') to convey to the Trustee of the Trust my wishes in respect of the distribution of the capital and income of the Trust following my death.*
>
> *It is my wish that following my death the capital and income of the Trust should be applied by the Trustee as if that capital and income formed part of my estate and accordingly was subject to distribution in accordance with my Will, to the intent that, the Trustee of the Trust should notionally add the capital and income of the Trust to the assets of my estate and deal with the capital and income of the Trust as if the capital and income of the Trust formed part of my estate for distribution along with the assets of my estate in accordance with my Will.*
>
> *I declare that the contents of this direction are provided to the Trustee on a confidential basis and the terms are not to be communicated to any potential beneficiary.'*

Proceedings were brought under the *Succession Act* 2006 (NSW) which altered the distribution of the deceased's estate, and provided for it to be distributed to the deceased's wife Gerlie, former wife Madeline (who had not completed a property settlement), and his son Peter.

At the time of his death, the deceased was the sole director and shareholder of the trustee company, and was also the sole principal (with the power to appoint and remove trustees).

The trustee sought judicial advice as to whether it was able to distribute the trust property in accordance with a deed of settlement entered into to distribute the estate of the deceased (as that question was reformulated by the Court).

Findings

The Court found that the trustee was entitled to take into account a memorandum of wishes in exercising its discretion, and is also entitled to take into account the views of the beneficiaries.[41] Some key points of the judgement include that:

a. the rules of natural justice are a matter of construction of the trust documents, however, do not normally apply to private trusts;

b. the trustee must give 'genuine consideration' to the exercise of discretion which may require the trustee to gather information, however, in the case of family discretionary trusts the trustee will normally have enough information to make an appointment without gathering extra information; and

c. the terms of the trust deed as originally constituted contemplated the deceased could as controlling shareholder of the trustee and principal control the exercise of the trustee's discretionary power to benefit himself as primary beneficiary. The terms of the trust deed displaced the usual equitable prohibitions against the trustee benefitting itself or its directors or shareholders in exercising its fiduciary discretions.[42]

Cardaci v Cardaci [2023] WASCA 158

Background

- Marc executed a Memorandum of Wishes expressing his desire that income and capital received by the family trust be paid to Mae after his death:

  > *'The Trustee of the Trust pay all income and capital received by the Trust from time to time to my wife Mae Cardaci (Mae), after making suitable provision for tax and other expenses, provided that if Mae shall predecease me, then the Trustee of the Trust shall pay all income and capital received by the Trust from time to time to such of my children as shall survive me and if more than one, then in equal shares.'*

- Marc's brother Philip took control of the family trust after his death act and initially acted per wishes;

[41] *Monaghan v Monaghan* [2016] NSWSC 1316, 49.
[42] Ibid, 62 - 66.

- May 2016: Mae had commenced a relationship with another person;
- 18 May 2016: Philip told Mae that he would 'never' distribute anything to her from the family trust;
- 13 July 2016 Philip:
  - said he would '*only*' distribute from the trust to a foundation to be established; and
  - made a '*settlement offer*' to '*buy out*' Mae's interest in Marc's estate, the family trust (which he valued at nil as it was discretionary) and the testamentary trust.

Mae commenced proceedings in the WA Supreme Court, succeeding on most points. Philip appealed the original decision in the Court of Appeal, and failed on most points. Philip was removed as trustee for a number of reasons including:

- statement to never distribute from the trust showed a ‘closed mind’ re exercise of discretionary powers and a disregard for trustee responsibilities;
- did not consider ensuring Mae was adequately provided for by discharging trustee duties; and
- there was a real risk, even with correct legal advice, that the interests of Mae may not be given real and genuine consideration.

4.5 SMSFs

In an SMSF with individual trustees you need to look at the SMSF trust deed for the rules about trustee control. If a corporate trustee is involved, you need to review the constitution of the trustee company. Trustee control is important because, if a member lacks capacity or dies and is no longer a trustee, the continuing trustees will retain the pre-existing powers and discretions.

For example, if a member dies having not implemented one of the member control measures discussed below, remembering death is a compulsory cashing event, the surviving trustee will have the power and discretion to decide which of the deceased member’s dependants or their estate will receive the death benefit or a proportion of the death benefit.

If you have SMSF members who are a blended family or business partners, you can see how the interests of the surviving trustee or director may not align with the interests of the deceased member’s dependants.

The decision of *Katz v Grossman* [2005] NSWSC 934 highlights how critical it is to address the issue of succession of trustee control on the death of a member.

4.5.1 Passing control of the trustee

Section 17A of the SISA requires a member to be a trustee or a director of a trustee company, and that each trustee or director of a trustee must be a member, in order for the fund to be an SMSF. Further, section 17A(3) of the SISA provides an exception to the trustee/member rule, where a member has died or is under a legal disability. In those circumstances, the LPR of a deceased or incapacitated member is able to be appointed as a trustee in place of the affected member, and the fund will satisfy the requirements of an SMSF.

It is, however, important to note that the appointment of the LPR upon death or incapacity does not occur automatically, but must occur within six months of the death or incapacity, or the fund will no longer satisfy the requirements of an SMSF.[43] There are significant tax consequences of becoming a non-compliant fund.

While the SISA allows the deceased member's LPR to be a trustee in place of the member, during any period of incapacity and during the period beginning with the death of the member, and ending when the death benefits commence to be payable, the appointment is not automatic. Accordingly, the SMSF trust deed must be reviewed to determine who has the power to appoint trustees.

Where there is a corporate trustee, the company's constitution must be reviewed to determine who has the power to appoint directors, which will typically be the shareholders. Consideration must also be given to the fact that there will be a time delay between the date of incapacity or death of the member, and the appointment of the member's LPR. During this time any surviving trustees, or surviving directors of the trustee company, are able to act alone. This is another reason to ensure SMSF members' have a comprehensive estate plan. As seen in *Katz v Grossman* having individual trustees is a particular problem and a real risk if you include one, but not all, the member's children.

4.5.2 Individual trustees

Typically, an SMSF trust deed will give the members the power to remove and appoint trustees. It is also important to note when the membership ceases, as some SMSF deeds may specifically provide that membership ceases on death. This is problematic as it may prevent the LPR of the deceased member becoming a trustee and exercising the power of appointment of trustees. In this scenario the LPR may have no control over the appointment of trustees, and consequently no control over payment of death benefits. This is not the typical scenario, but is worth checking in every case.

More often membership will continue after death, until the deceased's benefits are paid out. This allows the LPR to have a vote in appointing themselves as a trustee. In a single member fund this may be enough to allow the LPR to appoint themselves as a trustee and represent the interests of the deceased member until their death benefits are paid.

In multi member SMSFs, ensuring that the deceased member's LPR can exercise the power of appointment does not of itself allow the deceased member's LPR to be appointed as a trustee. It will be necessary to consider the voting rights conferred on members to determine how the power of the appointment is exercised. Typically, each member would have one vote, therefore in multi member SMSFs it is easy for surviving members to outvote the deceased member's LPR.

Consider the scenario where the trust deed provides that appointing a trustee requires a majority of members. The fund has two members. The trust deed further provides that if there is a deadlock the member with the largest account balance has a casting vote. One alternative is to allow each member the power to appoint one trustee, rather than having a power of appointment by a majority of members.

[43] Section 17A(4) of the SIS Act.

4.5.3 Corporate trustees

A corporate trustee will continue to exist, despite the death of its directors and shareholders. So rather than looking to the SMSF deed for powers of appointment, where we have a corporate trustee, we need to look at the constitution of the corporate trustee to determine how directors are appointed.

Typically, the deceased will be a shareholder of the corporate trustee, however the SISA and SISR do not require the member of an SMSF be a shareholder of the trustee company. They only require that the member be a director. If the deceased was a shareholder of the corporate trustee, then the shares and the rights attaching to them will transfer to the deceased member's LPR, and be distributed in accordance with the deceased's Will.

In the case of an incapacitated member however, the LPR under an ordinary prescribed form EPOA may not have the right to exercise the powers of a shareholder. It is prudent to have a specific power in the EPOA which expressly provides that the attorney's power extends to exercising shareholder rights.

The constitution of the corporate trustee will determine who has the power to appoint a director. Commonly constitutions provide that the directors, or a majority of shareholders, have this power. To avoid the same difficulties as just discussed with the succession of an individual trustee, you could amend the constitution so that each shareholder has the ability to appoint a director. Provided the member also has a properly considered EPOA, their LPR on incapacity or their LPR on death will have sufficient power to appoint themselves as a director of the trustee company without the necessity for the other members or directors of the fund to consent.

Securing the LPR as either an individual trustee or director of the trustee company in place of the member on incapacity or death is only half the battle. Agreement between the LPR and the other trustees with respect to the ongoing administration of the fund or the payment of the death benefits must still be reached. If there are two or more other trustees or directors, then the LPR may be outvoted. Alternatively, if there is only one other trustee or director, there may be a deadlock.

To ensure the LPR has the ability to direct the payment of death benefits without agreement from other surviving trustees or directors it is necessary to consider the voting requirements for the trustee.

Unless a trust deed provides differently, trustees are required to act unanimously. Special provisions will need to be included if there is an intention to permit one of a number of trustees to make specific decisions regarding a member's benefits. Alternatively, a guardian could be used, whose consent is required to validate a resolution of the trustees with respect to payment of a member's benefit during their lifetime and on their death the payment of death benefit. These provisions are found in some SMSF deeds.

Another approach is to use a corporate trustee and ensure the constitution provides that the LPR, acting as director in place of the deceased member, has the only vote on a resolution regarding payment of the incapacitated or deceased member's benefit. Alternatively, the constitution may provide that voting rights are based on the account balance of the member they represent.

4.5.4 Member control

Subject to the provisions of the relevant trust deed, a member can take steps to control the payment of their death benefits by any one or more of the options outlined below. Careful consideration should be given to any decision by the member to take control of the payment of death benefits, as removing the discretion of the trustee creates certainty and inflexibility upon the death of the member.

When clients choose to implement one of these control measures it is important that the estate plan is reviewed regularly to ensure the measure remains appropriate. Where the member intends to pass their benefits to the estate, this becomes even more critical given those benefits will be distributed under the terms of their Will. There are significant consequences of using these control measures inappropriately.

Control by the member should also be considered in the context of substitute decision makers (the enduring attorney of a member). In drafting an EPOA for a member of an SMSF, it is vital for members to consider the extent of the powers they wish to provide to their attorney in order for the attorney to deal with the member's superannuation interests.

The Superannuation Complaints Tribunal (as it was then known, now AFCA) in a determination (P07-08/030)[44] confirmed and acknowledged an attorney's power to complete and sign a binding death benefit nomination (**BDBN**) on behalf of a member. Further, in *Re Narumon*, the Queensland Supreme Court confirmed the validity of an extension of a BDBN signed by the attorneys of the member.

It may be necessary to limit, extend or direct the use of the attorney's power in an EPOA document. One obvious measure which can be included in an EPOA, particularly if the client has a lapsing BDBN, is to include power for the attorney to confirm the existing BDBN but not to revoke or amend. Alternatively, a member could choose to extend their attorney's powers to exercising all rights in relation to the member's superannuation interests including specifically the power to revoke, confirm, amend or make a new BDBN. If the member wishes to extend their attorneys powers in this way, they must also consider the issue of conflict transactions.

There is a lot to consider when implementing member control. It will be particularly important to consider member control and the removal of the trustee's discretion where:

1. the member is part of a blended family and wants their superannuation to be paid to a particular family member (for example, the member's children from their first marriage, rather than to their second spouse who is possibly the other member and trustee of the fund);

2. there is likely to be arguments between the member's possible beneficiaries as to who should receive the death benefits;

3. there is a risk of dispute between the controllers of the superannuation fund following the member's incapacity or death; or

4. there is a risk that the controllers will not distribute the death benefits in accordance with the member's wishes.

There are a number of ways that a trustee's discretion in relation to the distribution of death benefits can be removed.

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[44] D07-08\030 [2007] SCTA 93 (3 September 2007).

5. Solutions?

Having appropriate documents to deal with the succession of control of trusts is a key element, but not the only one, in controlling the family unit on death. The other key element is communication. Discussing issues, explaining intentions and documents help manage expectations and help bring out issues while they can still be discussed.

> *'There is an increasing trend for family businesses to adopt formal governance mechanisms. These are critical for aligning the needs of both the family and the business, developing goals and increasing business performance.*
>
> *Significant increases in the 2015 survey included:*
>
> - *52 percent of businesses have a formal board of directors (39 percent in 2011)*
> - *43 percent have a shareholders' agreement in place (36 percent in 2013)*
> - *31 percent have a family constitution or code of conduct (20 percent in 2011).'"*[45]

The issues of transitioning wealth are further complicated when families come together through marriage and become 'blended'. It is important that the whole family works together to work out where they are and where they want to be (together and individually).

> *'If you wish to transfer your valuables you have to first transfer your values.'*[46]

Roy Williams makes this statement when identifying the real need for families to be more effective communicators.

A family which communicates effectively during the lifetime of the generation currently controlling the family trust(s) has a much better chance of a smooth and effective transition of wealth. The process itself of determining the plan for succession of control is very important. The family might consider putting in place family governance types of informal agreements or arrangements. They may also include more formal or legal documents to give some legal structure to manage succession of control of trusts. The plan may have two parts:

- a communication and consultation process resulting in an informal family constitution or council; and
- document agreement in legal form where possible (for example family agreements, shareholder agreements, changes to trustee control and appointors).

Ultimately, communication is key. It engages people, it can tease out concerns when they can be dealt with better, and it helps to reduce risks on death.

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[45] KPMG Family Business Survey 2015 : An Overview (accessed 27 October 2016)https://home.kpmg.com/au/en/home/insights/2015/12/family-business-survey-2015-overview.html

[46] Roy Williams, The Williams Group of California cited in Dr Robb Musgrove TEP, Estate Planning: useful, but is it successful? Are we missing the point?

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