Estate planning strategies and traps for clients with discretionary trusts

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1. **INTRODUCTION**

Many wealthy clients hold substantial assets in trusts rather than in their own name, which can give rise to difficult estate planning issues.

The use of discretionary trusts became popular in the late 1960s and early 1970s following several court decisions in the United Kingdom that validated the discretionary trust concept.\(^1\)

Clients who established family trusts 30 or more years ago are now realising that the flexibility that is an inherent feature of discretionary trusts makes it difficult to provide a certain outcome in the way in which assets in the trust are dealt with after their death.

This issue will become increasingly relevant as more clients who have accumulated assets in trusts move into old age.

Also clients with substantial assets in a trust may want the trust to continue after their death for the benefit of the next generation rather than the assets being sold off or distributed on death, particularly where they have built up significant family businesses in a trust structure.

Quite apart from wanting to preserve trust assets for the benefit of the family group, there are other reasons why it may make good sense to preserve assets in an existing trust. For example, distributing trust assets to beneficiaries following the death of the principals may trigger substantial stamp duty and accelerate capital gains tax assessments.

In this context there are often two significant issues. Firstly clients may be concerned to ensure that only blood relatives can benefit from the trust (or at least that only blood relatives can participate in distributions of capital).

Another issue is that, while clients may want to leave open the option of the trust continuing after their death, they may also have a concern that, if the control of a discretionary trust passes to several children, this may create tensions because none of the beneficiaries has a defined interest in the trust assets.

In this paper I will consider some practical strategies to deal with these and other issues - with a focus on issues arising with traditional family discretionary trusts as, in my experience, these are the most common trust structures used by clients to hold investments and carry on businesses.

2. **ASSETS IN TRUST CANNOT BE DEALT WITH BY WILL**

Many clients are not aware that the assets in their trusts cannot be transferred under their Will.

However, you will all have seen Wills prepared for clients who have trusts and companies (‘controlled entities’) that make absolutely no reference to those controlled entities. The classic case is the ‘simple Will’ where clients leave everything to their surviving spouse and if they die to the children.

Where clients hold assets in a discretionary trust or a company, they cannot transfer ownership of those assets via their Will, irrespective of the degree of control they may have over the assets while alive.

*Public Trustee v Smith*\(^2\) provides a good illustration of the problems that arise when clients attempt to deal with trust assets in their Will.

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\(^1\) E.g. *Gartside v Inland Revenue Commissioners* [1968] AC 553
\(^2\) [2008] NSWSC 397
In that case Dr Ward had established a trust with a corporate trustee in September 1979 and, in 1981, the trustee acquired a residential property in which Dr Ward resided until around the time of her death in 2002.

In her Will, she gave a friend (Robyn Smith) the right to live in the residence, which she described in the Will as ‘my property’.

The Public Trustee was the executor and filed a summons to seek directions from the court as to whether the provision purporting to allow Robyn Smith to reside in the house was effective.

Essentially, Robyn Smith’s argument was that, because Dr Ward controlled the trustee company and the assets of the trust at her death, she effectively held the beneficial interest in the property and was able to dispose of it under her Will.

There were a number of problems in this case (including the fact that Dr Ward was not actually nominated as an eligible beneficiary under the terms of the trust). The court was prepared to accept for the purpose of the application that Dr Ward controlled the trust but rejected Robyn Smith’s argument and said:

neither the fact that Dr Ward was in a position to control the exercise of the trustee’s powers, and was in any event entitled to remove the trustee and appoint a new trustee, nor the fact that she could cause the trustee to appoint the income or capital of the trust to herself, would mean that she was the beneficial owner of the trust property.

A similar argument was raised by the surviving spouse in the context of a family provision application in Farr v Hardy. White J. (who also was the judge in Public Trustee v Smith) again rejected the proposition that where a beneficiary controls a trust then the assets in that trust should be treated as that person’s assets.

3. STRATEGIES TO ENSURE TRANSFER OF CONTROL OF TRUST

Therefore, the challenge for advisers where assets are held in trusts is to ensure that the estate plan will result in the control of the trust assets being transferred in accordance with the clients’ wishes.

Dealing with shares in corporate trustee

If the client has a corporate trustee, they need to carefully consider how their shares in the company and the voting rights attaching to the shares are dealt with.

Shares in a company that acts only as trustee have no inherent value but, whoever owns the shares will generally have a degree of control of the trust as they will generally have the power to appoint the directors and it is the directors who effectively exercise the trustee discretions.

That is, the person who owns the shares is in substantially the same position in relation to the trust assets as are the executors in relation to the estate assets, except that they will have a discretion as to how the assets and income are distributed.

For that reason it is quite important to identify any trust entities and to ensure that the estate plan addresses who is to control those entities after death. This control can be passed to the executors (or alternate nominees if required) in a number of ways.

If the client’s intention is that the executors should take control of a trustee entity, they should leave the shares in the corporate trustee (if there is one) to those persons as an absolute gift – not in their capacity as executors.

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3 At paragraph 108
4 [2008] NSWC 996
This will mean that they do not have to deal with the shares as assets of the estate but can retain them personally. By retaining the shares, those persons can appoint themselves as directors of the corporate trustee and exercise the trustee discretions in relation to income and capital of the trust.

However, gifting shares in a trustee company to the executors in their personal capacity may not provide a certain outcome if the Will is challenged in a family provision action because, while they may only have a nominal value, the shares will still be assets in the estate and a court may order that those shares (and therefore control of the trust) should be transferred to alternate beneficiaries.

In *Farr v Hardy* the applicants raised this precise argument and sought an order that shares in the trustee company should be transferred to the applicant personally pursuant to a family provision application.

In that case the court rejected the application because that would have resulted in the applicant gaining sole control of the assets in the trust to the potential detriment of other eligible beneficiaries; but the case illustrates the problem that can arise where otherwise valueless shares in a trustee company are dealt with under the Will.

There are a number of alternative strategies that allow the voting rights attaching to shares in the trustee company to be transferred to the intended controllers of the trust.

One option is for the client to transfer an interest in the shares to the proposed controllers while they are alive and then hold the shares as joint tenants.

This means the shares pass automatically to the designated controllers on the client’s death (by survivorship) and this transfer of control cannot be defeated as a consequence of a challenge to the Will. In New South Wales, this strategy may still be at risk as a result of the claw back provisions in Part 3.3 of the *Succession Act 2006* (NSW).

To ensure the client still has control of the voting rights attaching to the shares while they are alive, it will be important to ensure that their name appears first on the share certificate as this generally entitles them to exercise the votes under most private company constitutions.

It is also possible to amend the company constitution to ensure that they are the only person who can exercise a vote in respect of the jointly held shares while they are alive.

The potential disadvantage of this strategy is that it is inflexible. If, having transferred an interest in the shares in the trustee company to the third party, the client changes their mind, it may be difficult to remove that third party as a joint shareholder. In many cases this problem (if it arises) could be dealt with if the client also has a power to change the trustee – in which case they could appoint a new corporate trustee with a different shareholding structure.

Another alternative that provides more flexibility is to restructure the share capital and amend the constitution so that the control of the corporate trustee will automatically pass to designated persons irrespective of any disputes in relation to the Will. This is achieved by having different classes of shares in the corporate trustee with cascading share rights.

**Example:**

Clients are a husband and wife who want two of their children (B and C) to take control of their family trust with remaining children receiving other benefits under their Will. The clients currently hold ordinary shares in the trustee company.

The clients can reclassify their existing shares to ‘A’ ordinary and issue ‘B’ and ‘C’ class shares to the designated children.

The constitution can then be amended to provide that the ‘B’ and ‘C’ shares have no voting rights while either of the parents is alive and hold ‘A’ shares but, on the death of both parents, the voting rights

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5 E.g. Part 4 *Succession Act 1981* (Qld)
attaching to the ‘A’ class shares are automatically extinguished, and the ‘B’ and ‘C’ class shares become the only voting shares.

The shares issued to the future controllers should be redeemable shares so that they can be redeemed if the client changes their mind.

Before implementing any change in the share structure of the corporate trustee it is important to consider the stamp duty implications as dealings with shares in a company that acts as trustee of a discretionary trust may be subject to corporate trustee duty in Queensland.

However, if the Commissioner of State Revenue accepts that the trust was established and is being maintained primarily for the benefit of a particular family group and the share interests are transferred to family members, corporate trustee duty will not apply.

**Role of appointor/principal**

In many cases, ensuring that the shares in the corporate trustee are transferred to the designated controllers may not of itself be sufficient to ensure that those persons will be able to take control of the trust.

Most (but not all) trust deeds stipulate that a designated person has the power to remove a trustee and appoint a replacement. This person is commonly referred to as an appointor or principal.

Generally it will be desirable that whoever is left the shares in the trustee company also has the power to remove and appoint trustees. Therefore, it will be most important to check the provisions of the trust deed to ascertain whether the initial appointor can nominate a replacement and the procedures that must be followed.

Many deeds allow the appointor to nominate a replacement in their Will and stipulate that, if no replacement is appointed, the executors of a deceased appointor will take over that role.

If there is a material risk of a challenge to the Will, it may be prudent to ensure that the role of appointor can pass to the designated controllers independently of the Will.

This may require an amendment to the trust deed. For example, the deed could be amended to allow the current appointor to nominate a successor but on the basis that the successor did not become an appointor until the existing appointor dies.

Alternatively the client may prefer that this power of appointment of new trustees ‘dies’ with the client so that the strategy of gifting the shares in the trustee company to the designated controllers cannot be defeated by a change of trustee.

Amendments to the appointor provisions in trust deeds should not constitute a resettlement of the trust as it is more of an administrative issue that does not impact on the beneficial interests in the trust fund.

Also, following the issue of draft Taxation Determination TD 2012/D4, it seems clear that the ATO will now accept that an amendment to a trust deed that is made in accordance with a valid power to vary the deed will not trigger a resettlement.
4. CARE REQUIRED IF TRUST DEED HAS TO BE AMENDED

If it is necessary to amend an existing trust deed to facilitate a proposed estate planning strategy or, more particularly, to prevent parties who have existing powers in relation to the trust from being able to exercise those powers on the death of the client, care is required to make sure that those changes are within the scope of the power of variation in the trust deed.

This can be particularly important where the variation purports to remove a person who has powers to change the principal or appointor.

These issues were highlighted in Jenkins v Ellett\(^9\), which involved an estate dispute in relation to a Mr George Jenkins who was the primary beneficiary and ‘principal’ of a discretionary trust. The deed stipulated that, on the death of the principal that person’s executor assumed the role of principal.

Mr Jenkins controlled the trust and purported to have the trustee exercise its power of amendment under the deed to vary the schedule so that he was removed as principal and Joyce Ellett (his daughter) was nominated as the principal.

The executor argued that the variation of the trust purporting to change the principal was ineffective and that, as a consequence, the executor became the principal under the terms of the original trust deed.

The power of variation in that deed was one that appears in quite a lot of trust deeds. It read as follows:

> The Trustee may by Deed revoke add to release or vary all or any of the Trusts declared or any Trust declared by any variation, alteration or addition made from time to time and made by the same or any other Deed declare any new or other trusts or powers concerning the Trust Fund …

The executor (applicant) argued that this power of variation only authorised the trustee to make variations in relation to the trusts declared in the deed and did not extend to a power to vary the schedule to the trust deed and, in particular, did not allow the trustee to remove the principal.

Douglas J. held that the principal’s ability to remove and replace a trustee was a fundamental feature of the structure of the trust and that purporting to use the amendment power in the deed to remove the principal was ‘akin to destroying the substratum of the deed’\(^10\).

The lesson from this decision is that it is very important to carefully consider whether a power of variation in a trust deed is sufficiently wide to allow ‘estate planning changes’.

It is also important to appreciate when drafting a new trust deed that the amendment clause should be drafted to provide maximum flexibility to facilitate future changes. The problems that arose in Jenkins v Ellett is should be avoided if the power of variation allows the trustee to vary any trusts or powers in the deed and any provisions in schedules to the deed.

5. CONTROL OF DISCRETIONS AFTER DEATH

A dilemma facing clients whose preference is for their family trust to continue after their death is how to ensure that their children (or other beneficiaries) receive ‘their share’ of the trust income and assets given that no beneficiary has a defined interest in the trust.

Statement of wishes

A strategy commonly adopted is to leave the shares in the corporate trustee to the persons named as executors and leave a statement of wishes as to how the client wants those persons to exercise the trustee discretions.

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\(^9\) [2007] QSC 154

\(^10\) Paragraph 19
There are several problems with this approach.

The statement of wishes is not binding and beneficiaries who are not happy with how the directors of the trustee are exercising their powers have limited rights to object.

There may be some basis for beneficiaries to challenge decisions of trustees that clearly deviate from the statement of wishes as individuals who have an interest in a trust estate have the standing to apply to the Court to review decisions of the trustee. However, this is not ideal.

If the clients rely solely on a statement of wishes, a further problem is that none of the beneficiaries can require the trustee to distribute ‘their share’ of the trust assets if they wish to terminate their involvement in the trust.

Creating fixed entitlements in discretionary trust

Any amendment of the trust deed to give designated beneficiaries a vested interests in either income or capital is likely to be considered a resettlement of the trust by the ATO notwithstanding the more benevolent approach indicated by TD 2012/D4.

However, it is possible in many cases to achieve a reasonable degree of certainty without triggering duty or tax consequences by making complementary amendments to the trust deed and the constitution of the corporate trustee.

While the appropriate strategy will depend on individual circumstances and the terms of each trust deed, an approach along the following lines will be available in most cases.

Firstly amend the trust deed to:

- identify the children (or other persons) the clients want to ultimately benefit from the trust (designated beneficiaries);
- provide that the designated beneficiaries may request the trustee to distribute ‘their share’ of the trust capital at any time after a specified date or event (eg. the death of the clients) and require the trustee to consider this request; and
- vary the amendment provisions so that these ‘estate planning amendments’ cannot be deleted or varied after the death of the clients.

These changes should not have any duty or tax consequences as they do nothing more than identify particular beneficiaries who may make a request to the trustee. However, the amendments do not require the trustee to make a distribution of capital if a request is made, merely to consider it.

In addition to amending the trust deed, the constitution of the corporate trustee should be amended to:

- ensure the designated beneficiaries will be entitled to nominate a director to the board of the trustee after the death of the clients;
- provide that the director representing the interest of each designated beneficiary has the power to determine how that beneficiary’s ‘share’ of trust income will be distributed;
- provide that, if a designated beneficiary makes a request to the trustee to distribute ‘their share’ of trust capital, the designated beneficiary (or their nominee director) will effectively have 51% of the votes at the meeting of directors that considers this request.

As part of this overall strategy, the clients should ensure their shares in the trustee company are left to the designated beneficiaries in equal shares. It may be necessary to implement a share split now to ensure that there are sufficient shares on issue to allow for this.

11 Section 8 Trusts Act 1973 (Qld)
This strategy will allow the designated beneficiaries to control the distribution of ‘their share’ of trust income and terminate their involvement without having to rely on the agreement of their co-beneficiaries.

The changes to the constitution of the corporate trustee will not have any stamp duty consequences.

Stamp duty is payable in Queensland if there is a ‘relevant acquisition’ of a ‘share interest’ in a corporate trustee. A share interest is a person’s interest as a shareholder in a corporate trustee. There will be a relevant acquisition if a person acquires a share interest as part of an arrangement under which any person obtains a benefit in relation to trust property.

However, the suggested strategy does not involve any transfer or other dealing with shares in nor any change in rights attaching to shares in the corporate trustee. The primary changes are directed at the voting rights of directors in certain circumstances and the issue of voting rights of directors of trustee companies is not dealt with under chapter 3 of the Duties Act.

6. PROTECTING AGAINST CLAIMS BY SPOUSES/PARTNERS OF CHILDREN

Some clients who anticipate that their trust will continue after their death may be concerned to protect against the possibility that their children will be divorced or have a relationship breakdown and that the child’s spouse or partner may make a claim against the trust assets.

There is an increasingly long line of cases where the Family Court has been prepared to make orders in respect of assets held in discretionary trusts where the court considered that a spouse had a sufficient level of control over the trust assets.

These concerns reached a peak following the High Court decision in *Kennon v Spry* where the Court held that the rights of the husband as controller of the trust coupled with the wife’s right as a beneficiary to require proper administration of the trust constituted ‘property of the parties to the marriage’.

However, in assessing the likely impact of *Kennon v Spry* it has to be appreciated that the case involved a quite unique factual scenario and that there was little doubt in the minds of the majority judges that the husband had complete control of the trust.

There have been a number of cases since *Kennon v Spry* that have held that, assets in a discretionary trust should not be included in the pool of matrimonial assets unless a spouse has effective control of the trust.

In *Leader & Martin* the court considered that the principles in *Kennon v Spry* would not be applicable where a wife was merely an eligible beneficiary of a trust established by her parents and the trust was controlled by other family members.

In *Harris & Harris* the court similarly found that a husband did not control a trust of which he was a beneficiary and therefore, the assets of the trust were not included in the matrimonial pool. The following extract from the judgement is relevant.

64. In seeking to uphold his Honour’s decision to include the assets of the Trust in the assets of the husband, Counsel for the wife has sought to rely on the observations of French CJ in *Kennon v*
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Spry [2008] HCA 56; (2008) 238 CLR 366 at 387-389 [52]-[57] that the term ‘property’ when used in s 79 of the Act should be given a wide meaning. However in that decision French CJ also said:

77. The beneficiary of a non-exhaustive discretionary trust who does not control the trustee directly or indirectly has a right to due consideration and to due administration of the trust but it is difficult to value those rights when the beneficiary has no present entitlement and may never have any entitlement to any part of the income or capital of the trust.

65. In the present case and on the basis of the material before us the husband appears to be no more than such a beneficiary of such a trust. He is not the appointor of the Trust nor does he hold any position in the current trustee company. On the assumption that by the use of the word “directly”, the Chief Justice was referring to the strict legal position, it therefore cannot be said that the husband “directly” controls the current trustee. Nor could it be said that he “directly” controlled the previous trustee.

66. On the assumption that the reference by the Chief Justice to “indirect” control of a discretionary trust by a beneficiary was a reference to a “puppet” situation, in the sense that the person with legal control of the trust is a puppet of the beneficiary, that could be the situation in the present case. In the sense, that is, of the mother (who is the appointor of the Trust, and one of the three directors of the trustee company holding two shares in that company with each of the other two directors holding one share each) being the puppet of the husband. This, as was made clear by Counsel’s oral submissions to us, has always been the wife’s case.

67. The difficulty, however, for the wife on this appeal is to be able to point to any evidence which would support a finding that the husband’s mother is his puppet, and that it is through her, or perhaps otherwise, that he exercises de facto control of the trustee company and of the Trust.

In Morton & Morton, the husband and his brother jointly controlled a discretionary trust but the wife argued that the husband had de facto control of the trust and that the trust assets should be regarded as assets of the husband.

Bell J determined that:

….. there is not sufficient evidence before me to convince me that the Husband has that sufficient control over the entities to which I have referred, to make me believe that they are in fact his property. 18

However, in such circumstances, the assets in the trust might still be taken into account as a financial resource of the wife.

There are a number of strategies that can reduce the risk of claims against the family trust assets by partners of the clients’ children.

One option may be to encourage the children to enter into financial agreements with their partners in which the children’s partners acknowledge they have no interest in and will not make a claim in respect of the assets in the trust.

Indeed, it appears to be an increasingly popular trend to insert provisions in family trust deeds that preclude any distribution to the descendants of the primary beneficiaries if they are married or in a de-facto relationship and do not have a financial agreement.

While the enforceability of financial agreements may be problematic, the security of assets held in the trust is likely to be enhanced if there is an agreement in place.

It is also common for clients to amend their trust deed to provide that ‘non-family’ members cannot receive capital distributions but it is questionable whether this provides any additional protection where the trust is totally discretionary.

Provided these restrictions do not involve any restriction on the class or entitlements of default beneficiaries this should not trigger any stamp duty in Queensland.19

18 Paragraph 38
This amendment should also not result in a resettlement for tax purposes as the strategy involves a change in the membership of a continuing class of beneficiaries of the trust rather than a redefinition of an existing class of beneficiaries.\(^20\)

If clients want to ensure non-family members cannot acquire any interest in or control over assets in the trust fund it is important to consider limitations in relation to the trustee as well as amending the trust deed.

In many cases the trustee will be a private company and clients who want to impose these ‘family restriction’ will generally be interested in ensuring that non-family members cannot acquire shares or become directors of the trustee.

The constitution of the corporate trustee may simply provide that shares in the company cannot be transferred without the approval of directors. Unless the constitution provides otherwise, the directors are not obliged to give reasons or grounds for any refusal of approval for a transfer of shares.

While the discretion is broad it is not absolute. The power to refuse to register a share transfer is a fiduciary one and the directors must act in good faith in the interests of the company when exercising that discretion.\(^21\)

It is not legitimate for directors to refuse to register a transfer in a family company on the ground that the transferee is not a family member unless the constitution expressly authorise exclusion on those grounds.\(^22\)

Therefore, if the clients wish to impose these family restrictions it will be necessary to insert specific provisions in the constitution of a corporate trustee that empower the directors to refuse approval for the transfer of shares to non-family members.

However, the effectiveness of these family restrictions in a family law context has been significantly reduced as a consequence of the introduction of Part VIIIAA into the Family Law Act.

Given the extensive powers of the Family Court, the more effective strategy to avoid in-laws getting any degree of control of the trustee is to try to ensure that none of the who have shares in the trustee (or who are likely to receive shares under a Will) will have sufficient shares to exercise any unilateral control because, with a company that only acts as trustee, the only real power of the shareholders is to appoint and remove directors.

### 7. ENTRENCHING ESTATE PLANNING RESTRICTIONS

While clients and advisers are becoming more aware of the need to insert restrictions and controls on the way in which trustee discretions can be exercised after the death of the principals, one aspect that seems to be commonly overlooked is that most discretionary trust deeds allow a wide flexibility to amend the deed.

Unless these powers of amendment are restricted, then the control mechanisms a client puts in place before their death may be unwound after they pass away.

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\(^{19}\) section 57(2), Duties Act 2001 (Qld)
\(^{20}\) ATO Creation of a New Trust - Statement of Principles (August 2001) – para 5.1
\(^{21}\) Bell Bros. Limited [1891] 65 LT 245; Waters v Winmardun [1991] 9 ACLC 238
\(^{22}\) Bell Bros at 246 and Waters at 244
For example, if the trust deed is amended to stipulate that non-family members can never take a capital distribution or to restrict the trustee from making distributions to family members who are in a relationship but do not have a financial agreement, it is imperative that these restrictions cannot be removed or modified by subsequent amendments.

If the control mechanisms have been built into the trustee constitution, then it will also be necessary to ensure that that company cannot be removed as trustee (or at least not without the unanimous consent of all shareholders and directors in the trustee company).

8. SEPARATING ASSETS IN TRUSTS

A common dilemma for clients arises where they operate a business in a trust structure and want to leave some of their children in control of the business (because they have been working in it) but want to leave some of the value in the business to other children.

Similar issues arise where clients hold substantial assets in a trust and want particular children to take control of specific assets that is generally in direct conflict with the provisions of the trust deed.

The issues that have to be considered in these situations are complex and many clients will decide that it is ‘too hard’ and accept that the assets in the trust will have to be sold or distributed to family members that may trigger capital gains tax liabilities and possibly stamp duty.

However, there are strategies that allow the clients to leave some children in control of a business (or other assets) held in a trust but also give their other children a benefit that relates to the value of the trust assets or to segregate trust assets into separate asset portfolios that are controlled by different children.

For example, consider a situation where the clients started up a business in a trust and the business now has substantial value. Two of their children work in the business and three have chosen other careers.

The clients want the two children who have worked in the business to take it over on their death but do not believe that leaving their non-business assets to the other three children will result in an equitable division of their assets.

One option is for the trustee to revalue trust assets (particularly goodwill) and then make a capital distribution to the parents that they lend back to the trustee.

The end result is that the clients can leave the two children who work in the business in control of the trust but they will have created an additional asset that will be included in their estate and distributed to the other three children – namely the debt that is now owed to them by the trustee.

To minimise the potential cash flow impact on the business they can structure the loan so that it is payable over a reasonable period after their death.

There are a number of important issues that must be considered before a strategy along these lines is implemented.

Firstly, the trustee must have power to revalue assets of the trust and make interim capital distributions of capital from the revaluation reserve.

A trustee in Queensland has a general power to carry out a valuation of trust assets. That section provides that the trustee may for the purpose of giving effect to any of the provisions of the trust deed ascertain and fix the value of any trust property. However, where the trustee is not personally qualified to value the property, they must consult a ‘duly qualified person’.

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23 s 51 Trusts Act 1973 (Qld)
In my view it is preferable if there is a specific power in the trust deed that allows the trustee to revalue trust assets.

The tax implications of making distributions from a revaluation reserve need to be carefully considered.

A distribution of capital to a beneficiary of a discretionary trust will not generally be subject to tax.

Section 99B(2) of the 1936 Tax Act specifically provides that any distribution to a beneficiary out of trust ‘corpus’ will be not included in their assessable income subject to certain exceptions.

The main exception is if the capital distribution is ‘attributable to amounts derived by the trust estate that, if they had been derived by (the beneficiary) … would have been assessable’.

Where the capital distribution is made from a revaluation reserve, no amount will have been derived by the trustee and therefore the exclusion in section 99B(2) should apply.

The ATO have determined that there are no capital gains tax consequences arising from an interim capital distribution to beneficiaries of a discretionary trust.

While they did not analyse the issue in any detail, the ATO also appeared to accept in an earlier ruling that an interim capital distribution out of a reserve created by the re-valuation of a capital asset, was not assessable in the hands of the beneficiary.

However, the tax outcome may not be as clear where the asset re-valued is a revenue asset such as trading stock because when an increase in value of the trading stock is realised, it will be ‘ordinary’ trading income of the trust not a realisation of capital.

There is no definition of ‘corpus’ in the tax legislation and the ATO might argue that a distribution out of a reserve created as a result of a re-valuation of a revenue asset is not a distribution of corpus.

A company dividend paid out of a re-valuation reserve is paid out of ‘profits’, but the concept of profit has a different context in relation to company law and payment of dividends.

In Class Ruling 2003/112, the ATO contended that capital distributions from a trust could still be assessable in the hands of beneficiaries in some circumstances. The ATO argued that Division 6 of the 1936 Tax Act 'is not an exclusive code for taxing a beneficiary's share of the income of a trust estate... The taxation of distribution of corpus similarly has to be considered in the light of other provisions of the ITAA 1936 and ITAA 1997'.

While the ATO has recently indicated that it will not pursue the question of whether Division 6 is an exclusive code for taxing trust distributions pending the current review of the taxation of trusts, care is still required before implementing a strategy involving interim capital distributions attributable to unrealised gains, particularly unrealised gains on revenue assets such as trading stock.

While the beneficiary who receives the capital distribution may not be subject to tax, the remaining beneficiaries will be liable for tax when the gain on the asset is realised on sale. Therefore, if this approach is adopted it is common to pay a discounted amount to the departing beneficiary to reflect their share of the likely tax payable on any future capital gain.

It will also be necessary to consider the impact of the trust streaming measures in Tax Laws Amendment (2011 Measures No. 5) Act 2011.

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24 Taxation Determination TD 2003/28
25 Taxation Ruling TR 2005/12 - example 1 - paragraph 31
26 Class Ruling 2003/112 - paragraph 49
The effect of these measures is that a beneficiary who is ‘specifically entitled’ to a gain will be liable for the tax on the gain. The concept of specific entitlement is dealt with in sections 115-227 and 115-228 of the 1997 Tax Act. The Explanatory Memorandum to the amending legislation makes it clear that a beneficiary who receives an interim capital distribution attributable to a revaluation reserve will be ‘specifically entitled’ to the capital gain arising when the asset is later sold.\(^{27}\)

If the person who receives the interim capital distribution is no longer a beneficiary of the trust when the gain is realised then the trustee or other beneficiaries may be liable for the tax on the gain.

Also, if the trust has previously distributed (or intends to distribute) income to a corporate beneficiary and, as a result, there are or will be unpaid present entitlements owing to that corporate beneficiary, an interim capital distribution to beneficiaries that is attributable to unrealised gains may trigger a deemed dividend under Division 7A.\(^{28}\)

**Trust cloning/splitting**

Clients may also be able to effect a transfer of control of assets held in a single trust by implementing a trust cloning or trust splitting restructure.

Under this option, some assets in a trust will effectively be vested in a new trust that is structured so that designated beneficiaries can take control of the new trust on the death of the clients.

While the capital gains exemption for trust cloning has effectively been revoked by the Government, this strategy may still provide an effective estate planning solution if the assets that are to be vested in the separate trust are pre-CGT assets or active assets and the clients can access the small business CGT concessions in Division 152 of the *Income Tax Assessment Act 1997* (1997 Tax Act).

This strategy is particularly attractive in Queensland, as transfers of assets from one trust to another will not be subject to stamp duty if the trusts have the same trustee and default beneficiaries\(^{29}\) – even if the trusts differ in other respects (for example if they have different appointors).

The stamp duty exemption only requires that the default beneficiaries of the two trusts are the same. Therefore a client who wanted to split the existing assets in a single trust into two asset pools could establish a new trust with the same default beneficiaries and have the trustee declare that they hold designated assets on trust for the second trust.

However the trust deeds for the two trusts could then be structured so that each trust has a different appointor. On the death of the client principals, the beneficiaries who have been designated to take control of each trust would be able to appoint new trustees (either by agreement or unilaterally) in order to implement the client wishes that each beneficiary takes control of the assets in their own trust.

Trust splitting provides a similar outcome but one that is not as effective as trust cloning. The underlying objective is the same – namely to separate assets in a single trust into separate asset pools to allow for designated beneficiaries to take control of the different asset pools on the death of the clients.

Most modern trust deeds allow the trustee to vest the legal title to assets in the trust in a nominee or custodian entity. Therefore the clients could determine that specific assets held in the existing trust will in future be held by a new entity as nominee for the existing trust.

If the trustee transfers trust assets to another entity to hold as nominee, it may be possible to then pass effective control of the assets held by the nominee entity to particular beneficiaries under the estate plan.

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\(^{27}\) Example 3.2  
\(^{28}\) s109XA 1936 Tax Act  
\(^{29}\) s 53(2)) – *Duties Act 2001* (Qld)
However, the effectiveness of trust splitting from an estate planning perspective is questionable as, in order to avoid any stamp duty or CGT consequences, it is essential that the new entity only holds as nominee and that no new trust estate is created.

Also the ATO has indicated that it considers that the typical trust splitting restructure does trigger CGT event E1\(^30\).

This paper is only intended as a general overview of issues relevant to the topic and is not legal advice. If there are any matters you would like us to advise you on in relation to this paper, please let us know.

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