Creating entitlements in discretionary trusts

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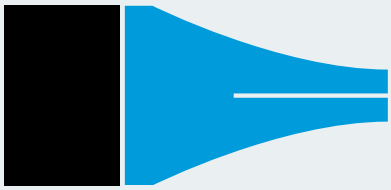


Strategies for enlarging the estate of a testator who has insufficient personal wealth to make gifts under their will but who has control of significant trust assets.

Introduction

In *Fischer v Nemeske Pty Ltd* (*Fischer*),[1] the High Court considered the effect of a resolution of a trustee of a discretionary trust that purported to make a capital distribution.

By a majority of three to two, the High Court upheld the decisions of the Supreme Court of New South Wales and Court of Appeal (unanimous) that the resolution of a trustee of a discretionary trust to distribute an amount equal to the value of shares owned by the trustee to a beneficiary (Nemes) was an effective exercise of the trustee's power and created a debtor/creditor relationship between the trustee and beneficiary. Consequently, after Nemes' death, the executor of Nemes' will was entitled to demand payment of the debt and enforce their claim for payment against the trustee.

The strategy adopted by Nemes enabled Nemes as testator to access trust assets to pay gifts under his will.

There are many circumstances where use of such a strategy may be recommended. For example, a testator may wish to access some trust assets to provide for a minor child while vesting control of the remaining trust assets in adult children. A credit entitlement or loan created in favour of a testator as beneficiary of a discretionary trust they control may be called up after death by the testator's executors as a debt due to the testator's estate. Advantages of this strategy include:

- trust distributions to a minor from a deceased estate are taxed at adult marginal rates whereas those from inter vivos discretionary trusts are subject to penalty tax; and
- adult children could benefit from and control the trust assets. This is an especially important consideration when the trust operates a business or holds business property and at least one of the adult children is engaged in the business.

Another example is when the testator wishes to benefit, after their death, persons who are not beneficiaries of the discretionary trust they control and the testator has insufficient personal wealth to make gifts to those persons.

Cautionary note

Prior to *Fischer*, a "black letter" approach had been taken to the interpretation of trust deeds because the source of a trustee's powers is the trust deed.[2] The strong dissenting judgments given separately by each of Kiefel J and Gordon J of the High Court highlight the continued importance of ensuring trust documents refer to the powers contained in the trust deed (or at law) pursuant to which the trustee purports to act and the necessity to ensure the actual wording is, and any conditions set out in the trust deed are, complied with.

The *Tax Laws Amendment (2011 Measures No. 5) Act 2011* (Cth) (TLA 2011 Act) introduced provisions to restrict the streaming of capital gains, for tax purposes, to circumstances where a beneficiary has a "specific entitlement" to the "net financial benefit" of a capital gain. If the events in *Fischer* were to occur now, the trustee would be liable to penalty tax on the capital gain made on the disposal of shares to pay the debt because by then Nemes had ceased to be a beneficiary. Consequently, had it been necessary for the High Court to determine an issue relating to the trustee's right of indemnity out of trust assets (one of the five issues on appeal), then, because it is unlikely the trustee and Nemes' executor would have agreed (as they did) that the documents reflected the trustee's intention, the decision in *Fischer* may have been different. That is, the courts may have construed the resolution and trust documents in the same way as Kiefel J and Gordon J.

What happened in Fischer

The trust was the Nemes Family Trust (the trust), the assets of which were the settled sum of $1,000 and 10 B class shares in Aladdin Limited (the shares).

In 1994, the shares were revalued and an asset revaluation reserve of $3,904,300 was created in the balance sheet of the trust as at 31 July 1994.

In September 1994, the directors of Nemeske Pty Ltd (the trustee) resolved as follows (the resolution):

> "RESOLVED that pusuant [sic] to the powers conferred on the Company as Trustee in the Deed of Settlement of the Nemes Family Trust:-
>
> That a final distribution be and is hereby made out of the asset revaluation reserve for the period ending 30th September, 1995 [sic] and that it be paid or credited to:- the beneficiaries in the following manner and order:
>
> The entire reserve if any, to be distributed to:-
>
> [Mr and Mrs Nemes]
>
> as joint tenants."

The balance sheet of the trust as at 30 September 1994 was as follows:

	BENEFICIARIES FUNDS	
1,000	Settlement Sum	1,000
	REPRESENTED BY	
	INVESTMENTS	
	Shares in Public Companies at Cost [sic]	
1,000	Aladdin Ltd 10 "B" Class Shares of $1 Fully Paid	3,904,300
	NON-CURRENT LIABILITIES	
	Loan – Secured	
–	E.G. & M. Nemes	3,904,300
1,000	NET ASSETS	1,000

A charge over the shares was later given by the trustee as security for payment to Mr and Mrs Nemes of $3,904,300.

No money was paid to Mr or Mrs Nemes pursuant to the resolution. Instead, the executors of the estate of Mr Nemes called for payment nearly 20 years later.

The issues raised were:

(1) whether the "capital distribution" the resolution purported to make and the entries in the accounts of the trust were an effective exercise of the trustee's powers under the trust deed to advance and apply capital for the benefit of certain beneficiaries; and

(2) whether the resolution and the entries in the accounts of the trust showing a loan of $3,904,300 effectively created a debtor/creditor relationship so that Mr and Mrs Nemes would have been entitled to bring an action against the trustee for payment.

The power that the trustee purported to exercise was in the following terms:[3]

> "4 … The Trustee may …
>
> (b) At any time or times to advance or raise any part or parts of the whole of the capital or income of the Trust Funds and to pay or to apply the same as the Trustee shall think fit for the maintenance education advancement in life or benefit of any of the Specified Beneficiaries …"

It was not in dispute that the resolution was "badly worded".[4] It purported to make a "final distribution" in reliance on a power "to advance or raise" and "to pay or apply" and to create an entitlement to a sum of money out of an asset revaluation reserve.

There was no fund represented by the asset revaluation reserve from which to make a distribution to give effect to the resolution.[4]

The dissenting judges were critical of the resolution and accounts:

> "50. The question whether the power given by cl 4(b) was exercised is a question which requires investigation of the intention of the Trustee, which can be gleaned from the terms of the Resolution and the circumstances in which it was made. Regard may also be had to how the Trust property was dealt with following the Resolution, as evidence of what was intended to occur …
>
> 52. The Resolution does not identify cl 4(b) as the source of the power which is sought to be exercised by making it. It does not identify the purpose of the power purporting to be exercised as one for the 'advancement in life or benefit' of Mr and Mrs Nemes, which could be the only purpose in cl 4(b) relevant to them as adult Specified Beneficiaries. Indeed, the Resolution does not mention the purpose of what is sought to be undertaken save that a "final distribution" is to be made.
>
> 53. The Resolution does not say that this 'distribution' is to be made out of the capital or income of the Trust, but rather out of the 'asset revaluation reserve'. This does not identify any property of the Trust as the subject of the exercise of any power. As previously explained, the 'asset revaluation reserve' does not represent any asset of the Trust as such, but merely the accounting treatment of the increase in value of the Shares at the time a new revaluation was undertaken.[5]
>
> …
>
> 88. None of the terms of the Resolution, the circumstances surrounding it or the conduct of the Trustee thereafter support an inference that the powers given by cl 4(b) of the Trust Deed were intended to be exercised by the Trustee. In particular, there was no setting aside or allocation of any property for Mr and Mrs Nemes which would amount to an application of capital or income within the meaning of that clause. The Trust property remained just that at all times, as the Trust accounts confirm. The importance of the accounts, not only for those having an interest in the Trust and its property, but also for third parties who may need to deal with the Trustee or rely upon Trust records, should not be lost sight of.[5]
>
> …
>
> 154. But did the 1994 Resolution 'advance or raise any part or parts of the whole of the capital or income of the Trust Funds' and then 'pay or … apply' that capital or income of the Trust Funds for the maintenance, education, advancement in life or benefit of Mr and Mrs Nemes? The answer is no.
>
> 155. Resolution of this appeal depends on recognising that there is a real and radical difference between an *asset* and its *value*. The conclusions reached by the primary judge and the Court of Appeal and the Executors' argument in this Court depended upon treating the two – *asset* and *value* – as interchangeable concepts. They are not.[6]"

It is important to note, though, that all judges agreed that an application of moneys or property under a power of advancement enables trustees to provide some payment or distribution to a beneficiary which may be postponed through the exercise of this power. Although, Kiefel J observed that the power of advancement is not to be equated with a payment or distribution to the beneficiary.[7]

Notwithstanding the above, the majority of the High Court found that the resolution disclosed a clear intention to create a debt due by the trustee to Nemes to the extent of the amount shown in the accounts of the trust relating to the asset revaluation reserve.[8] The advance was made by the resolution and applied when the relevant entries were made in the books of account of the trust and supported by the covenant in the deed of charge (the deed).[9]

But, in so doing, the High Court (Gageler J with whom French CJ and Bell J agreed on this point[10]) held the power conferred by clause 4(b) should be read in light of ancillary powers conferred by other provisions in the trust deed.[11] That is, regard must always be had to the terms of the trust deed.

Two further issues were raised on appeal to the High Court, namely, whether:

- the covenant in the deed imposed a binding obligation on the trustee to pay the amount of the advancement; and
- the trustee was estopped by the deed or representation from denying the existence of the debt.

Although the majority did not find it necessary to determine the above issues, the observations of Gordon J as to why, in particular, the deed was without legal effect are worth noting.[12]

Considerations for clients

Clients should be educated as to the value in retaining advisers with the skills to assist them to achieve their objective without giving rise to other issues (for example, unanticipated tax consequences). In particular, if trust documents are poorly drafted and accounting records not correct, protracted and costly litigation may be necessary to determine the validity and enforceability of rights under the documentation.

The role of advisers

When determining the appropriate strategy to achieve a client's objectives, advisers should consider other issues which may arise, such as:

- Would the strategy be effective in achieving the client's objective?
- What are the tax consequences of implementing the strategy?
- Would implementation give rise to GST or duty consequences?

- Could the transactions be set aside by aggrieved parties such as trust or will beneficiaries?

Division 7A implications

Clearly, before making any trust distribution, regard must be had to the accounts of the trust to ensure that the distribution will not trigger a deemed dividend under Div 7A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36). For example, if a company has an unpaid present entitlement (UPE) in a trust, then a payment made by the trustee to a shareholder in that company, or an associate of that shareholder, that is wholly or partly attributable to an amount that is an unrealised gain may constitute a deemed dividend.[13]

Even when assets are not revalued, the creation of a debt in favour of another beneficiary for no consideration may constitute a deemed dividend if a company has a UPE in the trust.[14]

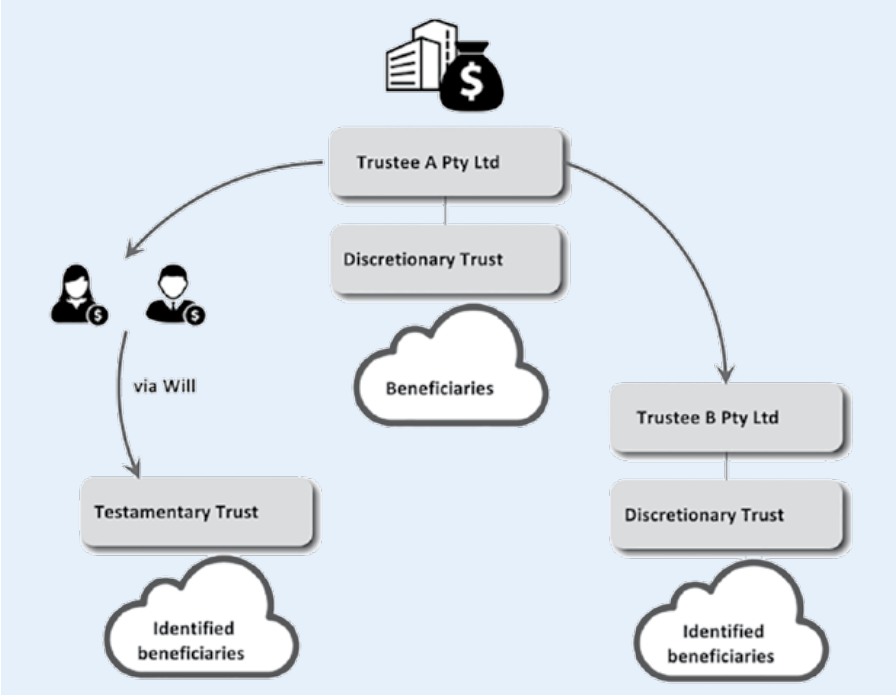
Preserving access to the 50% CGT discount

Example 2.3 of the explanatory memorandum (EM) to the Bill that became the TLA 2011 Act clarifies that the financial benefit to the trust (must be) over the life of the relevant asset, not just in the year of the CGT event.[15] That is, if the person who received a net financial benefit from the anticipated capital gain (Nemes) dies before the asset giving rise to the capital gain is disposed of, then they may not be made specifically entitled to the gain, for tax purposes, because, by reason of their death, they are no longer a beneficiary of the trust. Consequently, the trustee of the trust may be liable to tax on the gain and, without the benefit of the Div 115 of the *Income Tax Assessment Act 1997* (Cth) general 50% discount, at the top marginal rate.

But the trustee may not be assessable for the capital gain if an entitlement were created in favour of the deceased estate (or another trust) instead of the testator personally and that estate (other trust) is a beneficiary of the trust (see Diagram 1). As then the estate (or a living beneficiary of the other trust) would benefit from the general CGT 50% discount[16] because they would be specifically entitled to the capital gain.

In example 2.3 of the EM, each year, the trustee revalued property that it held on trust, classified the accretion in value as income, and distributed and paid that income to various trust beneficiaries. On the sale of the property, the trustee derived a capital gain. But one of the persons to whom income had been distributed was no longer a beneficiary of the trust at the time of sale, such that to the extent only of the capital gain represented by the financial benefit received by that person, the trustee was liable to tax.[17]

Diagram 1: Segregating trust assets



Conclusion

Strategies for the appointment of capital/creation of entitlement are most useful and sometimes necessary to enlarge a person's estate and provide for family members after death. But the practical, commercial and tax issues of doing so must be considered. In particular:

- advisers should pay careful attention to the strong, dissenting judgments in *Fischer* if they intend to implement similar strategies in the future; and
- consideration needs to be given to: the liquidity of the assets held by the trust; the validity of the entitlement created; the provisions of the trust deed in either permitting or prohibiting the structure; CGT considerations; and Div 7A implications (among others).

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Acknowledgment

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References

1 *Fischer v Nemeske Pty Ltd* [2016] HCA 11.

2 Although, where the terms of the trust are silent or deficient, the powers necessary to enable a trustee to administer a trust for trust law purposes (as distinct from tax law purposes) have long been contained in legislation. For example, *Trustee Act 1958* (Vic), *Trustee Act 1925* (NSW), *Trustee Act 1936* (SA), *Trusts Act 1973* (Qld), *Trustees Act 1962* (WA), *Trustee Act 1925* (ACT), *Trustee Act 1898* (Tas) and *Trustee Act 1980* (NT).

3 *Fischer* at [5].

4 *Fischer* at [32] per French CJ and Bell J.

5 Per Kiefel J.

6 Per Gordon J.

7 *Fischer* at [49].

8 The majority judgment relied on the form of words used in the resolution, being those appropriate to the declaration of a dividend which create debts due to their shareholders [32].

9 *Fischer* at [34].

10 *Fischer* at [32].

11 *Fischer* at [102].

12 *Fischer* at [186].

13 S 109XA(1) ITAA36.

14 S 109XA(2) ITAA36.

15 Para 2.55 of EM.

16 Based on the law at the date of this article.

17 This conclusion was reached because the amount equal to the accretion in value had actually been paid. Had it not been, then perhaps the debt could have been forgiven and that financial benefit paid to another.