Sladen Legal

Balancing Super and Family Trust Issues in Blended Families

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1. Introduction

It is noted that the theme for this morning's presentations is "*Blended Families and other burning issues in Estate Planning*".

Following on from Stephen Burke's presentation of the High Court (**HC**) decision in ***Stanford & Stanford***,[1] it is important to reinforce the High Court's finding that the Family Court (**FC**) cannot override or ignore trust law principles in making orders in respect of matrimonial property settlements (**property settlement**). That is, "*palm tree justice*" must not apply. The power of the FC is not to be exercised by reference to any "*unguided judicial discretion*" or sense of "*moral obligations*". Instead, the FC must decide whether it is just and equitable to make an order having regard to the same legal titles and equitable principles as govern the rights of any two persons who are not spouses.

Consequently, it is now clear that *Kennon v Spry*[2] has not overturned basic trust principles.

As Justice White held in *Public Trustee v Smith*,[3] the principles relevant to determining what is property for the purposes of family law cases do **not** apply for the purposes of inheritance under a will or estate planning. Specifically, his Honour held that *effective control* of a trust or *de facto ownership* of trust property is not tantamount to beneficial ownership of trust property.

In ***Smith***, under her will Dr Ward gave a right to her friend, Ms Smith to reside in her home for 15 years provided she fed her cats. However, "her" home was not owned by the testator but by a trust which she controlled. Therefore, the gift to the friend failed.

The classic example of how **not** to Balancing Super and Family Trust Issues in Blended Families is the case of *Katz v Grossman*.[4] In *Katz v Grossman* a father, who had a son and a daughter, was the sole member of his self-managed superannuation fund (**SMSF**) after the death of his wife. In order to ensure that his SMSF complied with s17A of the *Superannuation Industry (Supervision) Act 1993* (**SISA**)[5] the father appointed his daughter to be a co-trustee.[6]

When the father died, the daughter was the sole surviving trustee.[7] Therefore, under the terms of the trust deed, the daughter, as sole trustee, had the sole discretion to pay the father's benefits. Although it was not recorded in the court's decision it is implicit that the daughter proposed to exercise her discretion to benefit herself, despite it being the wish of her father that his assets be divided equally between his children. The son (a co-executor with his sister of his father's will) brought an action against his sister on the basis that her appointment as a trustee was ineffective.

The court found that the daughter's appointment as trustee was effective under the SMSF deed. Therefore the daughter was left with the sole discretion to determine to whom her father's benefits would be paid.

The question of control of super and trust assets is therefore fundamental to this presentation.

If control is not with the members of the blended family the deceased person (**testator**) wishes to benefit then unless effective documentation has been put into place to bind the

[1] [2012] HCA 52

[2] [2008] HCA 56

[3] [2008] NSWSCA 397

[4] [2005] NSWSC 934

[5] i.e. that a sole member SMSF with individual trustees has 2 trustees, one of which is the member

[6] The daughter also became a member, although this appointment was found to be defective

[7] She later purported to appoint her husband as a co-trustee and member, although this was found to be defective

person(s) who control the super and trust assets, the testator's wishes are at risk of being circumvented.

Examples of relevant documentation are binding death benefit nominations (**BDBN**) and deeds of nomination of successive appointors.

In this paper, the expression **Blended Families** refers to the testator's spouses/partners and children and step-children. It is noted that divorce does not render a will void or invalid although marriage does. Further, a couple may divorce without effecting a property settlement and vice versa such that a person may have a spouse to whom they are legally married and be living with a new partner (**Second spouse**). Further, a person may have children from more than one relationship. The expression **children** refers to lineal descendants and includes adopted children but excludes step-children. Children born of the first relationship are referred to as (**First children**) and those born of the second relationship as (**Second children**).

2. Using reversionary super pensions for the Second spouse

Most clients have at least some superannuation and many will have very significant levels of superannuation. For some, superannuation will house the bulk of family wealth. This coupled with the ability in some circumstances to provide complete certainty on the question of where superannuation benefits are paid, makes superannuation a very useful piece in the blended family estate planning puzzle. Unfortunately, the rules applying to superannuation funds restrict the range of possible strategies and with the potential taxation consequences being very different, this will further complicate the issues under consideration.

Various strategies may be used to access superannuation benefits to provide for a blended family such as:

- Reversionary pensions
- BDBN – lump sum/pension to spouse and/or children
- BDBN – lump sum to estate
- Early withdrawal strategy and inter vivos gift
  (Session 12 of this conference entitled, ***Super Withdrawals from the Death Bed*** considers "last minute" withdrawal strategy).

Although beyond the scope of his paper, as the potential taxation consequences of each strategy are very different, they should be considered as part of the testator's estate plan depending upon what their priorities are (for example, certainty, tax, asset protection).

2.1. Reversionary pension for the Second spouse

Pensions cannot be paid to a deceased estate or to adult children who are not financially dependent on the deceased at the time of the deceased's death. But they can be paid tax free to a spouse or a death benefit dependant child (within the meaning of section 302-195 of the *Income Tax Assessment Act 1997)* if the testator was at least 60 years of age at date of death.

Consequently, a tax effective way of providing for the Second spouse is for a testator in receipt of a pension from their superannuation fund to nominate a spouse as the reversionary beneficiary of their pension. But whether this is desirable depends upon whether the non-superannuation assets of the testator (i.e. trust assets controlled by the testator and their personal assets) are sufficient to provide for the other members of their blended family.

There are few statutory provisions governing the operation of a reversionary pension. Although there a number of references to reversionary beneficiaries in the *Superannuation Industry (Supervision) Regulations 1994* (**SIS Regs**), they are mechanical in that they substitute requirements relating to pensioners to also apply to reversionary pensioners. The provisions relating to reversionary pensions will therefore be governed by the super fund trust deed and the pension agreement (if any).

The notion of a reversionary pension encompasses a pension in which, after the death of the original member, the pension continues to be paid to a nominated reversionary beneficiary. That is, the pension does not cease upon the death of the original pensioner but rather automatically transfers upon death to the reversionary pensioner as though that reversionary pensioner was the original pensioner.

In a blended family it is likely the testator may wish to apply his superannuation entitlements to benefit children and Second spouse. Therefore, because after the death of the reversionary pensioner any remaining capital must be paid to the beneficiary's SISA Dependants (within the meaning of section 10(1) of SISA) or legal personal representative, the option of a reversionary pension for the Second spouse may not be so attractive unless the Second spouse is the parent of a child of the testator (i.e. a second child).

However, session 11 of this conference entitled, ***Binding Death Benefit Nominations and Reversionary Pensions*** considers whether upon the death of the Second spouse, the remaining capital of the reversionary pension may be paid to the member's children or first children. This has the advantage that the initial member can ensure that their Second spouse is looked after during their life and that any remaining capital stays with the initial member's family.

3. Identifying appropriate family trust structures

The challenge for estate planners is to get the right combination of persons as trustees, directors, shareholders, appointors and beneficiaries and, in appropriate cases, to customise the terms of the trust deed and possibly also, the terms of the constitution of a corporate trustee or appointor in order to ensure that control of the trust passes to the person(s) who it is intended are to benefit from the trust upon the death of the original controller or testator.

3.1. Trust principles

The fundamental principles of trust law are as follows:

- A beneficiary of a discretionary trust does not have any proprietary or legal right or equitable entitlement to any trust asset or to a share in any trust assets;
- The only right a beneficiary has is an equitable right to the due administration of the trust by the trustee and to be considered by the trustee as a potential object of distributions of income or capital or powers which the trustee may exercise in relation to the trust such as the trustee's power to make loans to beneficiaries of the trust;
- Consistent with their right to the due administration of the trust, beneficiaries have the right to see certain trust documents principally limited to the trust deed, any variation thereto, deeds of appointment of trustee or appointor and the annual financial statements prepared by the trustee;
- Trust property, therefore, does not belong to "any one person" but is legally owned by the trustee and beneficially owned by the trust which, because it is not a legal entity (although taxation laws specify that trusts are a tax entity) cannot hold legal title to the property;
- But in certain circumstance there may be such a nexus between the trustee, the settlor of the trust and the appointor/guardian of the trust that a trust is merely the "alter ego" of a natural person individual such that in equity or under family law or statute law (for example, taxation law), the trust property becomes the property of the individual;
- Further upon the vesting of the trust (that is when the trust is wound up or terminates), subject to any prior resolution of the trustee distributing capital to another beneficiary, the primary beneficiaries are equally entitled to the capital and undistributed income of the trust; but prior to the trust vesting a primary beneficiary (sometimes referred to as a default, principal or capital beneficiary) has no greater right than an ordinary beneficiary to trust assets.

3.2. Issues in structuring

The series of steps that should be taken to ensure that the assets of the family trust will be available for use by or distribution to the desired family member(s) include:

- choosing your appointors carefully
- choosing your trustees carefully
- choosing your directors carefully
- ownership of corporate appointors
- ownership of companies acting as trustees
- width of classes of beneficiaries.

3.3. Ownership of companies acting as trustees

The use of companies provides for succession of trustees and appointors. In the case of:

3.3.1. **Trustees**: succession may be dealt with by ensuring ownership of the shares passes to the desired persons or perhaps, a "passive" trust.

3.3.2. **Appointors**: as well as ensuring succession of ownership of shares, the constitution of the company may provide for the appointment of directors. For example, the initial directors could be the controller (and/or their spouse) and/or an independent then after the death of both the controller (and their spouse) the controller's First children.

3.4. Use of an independent appointor

The appointor of a discretionary trust has the power to remove and appoint trustees. If their consent is also required to any capital distributions, winding up or variation of the trust, it becomes apparent that choosing the right appointor for a discretionary testamentary trust is critical.

To protect trust assets from a trustee in bankruptcy of a client and claims in respect of future or second marriages or relationships of the client or of their spouse or of their children's relationships, no one natural person should ever be a sole appointor. An independent person should be one of the appointors of the trust. However, the independent person must not be the alter ego of the client to avoid a finding by the court that the client controls the trust. Where an independent appointor has sole control of the trust, to ensure the trust is administered in accordance with the client's objectives, their intentions as to who should benefit from the trust over time can be provided for in a well drafted appointor clause.

The independent appointor:

- Must be independent of the relationship and business risks of the key individual.
- Must be able to turn their own mind to any matter to be determined by the appointor (such as whether to make a capital distribution) and to make a decision free from influence.
- Should be someone in whom the family has absolute faith and confidence to act in their best interests;
- Should not be significantly older than the existing appointors;
- May be a child of the existing appointors (but if more than one child recommend not be the child as this could give the child an unfair advantage over any siblings who are not appointors and could also give rise to a perception of undue influence when the existing appointors become older);
- May be a relative of either of the existing appointors such as a brother or sister;
- May be a trusted friend of the existing appointors;
- May be a professional adviser of the existing appointors such as an accountant.

3.5. Memorandum of wishes

It is often appropriate for the original controller of the trust to record in writing, their hopes and wishes for the future administration of the trust by their children especially where the trust operates or holds shares in a business.

Such a memorandum could include the controller's vision of where the business will be in say, 5 years and the roles each family member will play, if any, in the business. A "motherhood" statement may even be appropriate. For example, "I wish all my children to cooperate and stay together for the future growth of the business for the benefit of all of them" (or perhaps even, future generations).

Ideally, all matters included in any memorandum would be recorded in a family constitution. However, it is not always possible to obtain everyone's agreement on all relevant issues. Even when it is, it is possible an issue may arise in the future which is not dealt with in the family constitution as it was not thought relevant when the constitution was drafted.

Consequently, it is sometimes desirable for the prime controller of the family group to record their wishes so that matters which are not covered in the constitution (especially, if there is no constitution) may be determined by reference to the provisions set out in the memorandum which may either directly deal with the point in question or give other guidance or reflect the "***spirit***" according to which documents should be interpreted or the intentions of the controller in the light of which a solution may be reached by the surviving family members.

A memorandum of wishes may help the family to resolve any issues arising over the years and, in particular, may enable the family to avoid litigation. But if any family member were to cause legal proceedings to be instituted against another person or entity in the family group, the court may take into account the provisions of the memorandum in determining the dispute just as courts may take into account the explanatory memorandum a government minister may issue when introducing legislation into parliament so that the legalisation is interpreted in accordance with the spirit and intention evidences by the memorandum.

Another reason why a memorandum of wishes may be desirable is where the controller wishes to give confidential instructions to the trustee as to the administration of the trust. For example, it may not be appropriate in the circumstances of a particular family for such wishes to be included in the will or made known to all members of the family.

3.6. Effective control

The classic example of effective or indeed, absolute control of a family trust is that of ***Spry***.[8] Spry controlled the trust by reason that:

- he was:
  - the sole trustee; and
  - the sole appointor; and
- the trustee had absolute discretion:
  - to vary the terms of the trust and
  - to appoint all of the income and capital of the trust to one beneficiary to the exclusion of the other beneficiaries.

It is important to note that even though the majority of the HC considered the combination of the relationship of the husband as controller of the discretionary trust together with the right of the wife as a beneficiary to the due administration of the trust (the combined rights) as property of the parties of the marriage, the HC held the assets of the trust were not property of the parties to the marriage or of either of them.

[8] [2008] HCA 56 (see note 3 above)

4. Dividing up the capital to the children

4.1. Life interests

During her lifetime, Dr Ward had been the sole director and sole shareholder of the corporate trustee and also the sole appointor of the trust. That is, she exclusively controlled the trust. But that did not make the property of the trust her asset. Had Dr Ward wanted to ensure her friend Ms Smith could live in her property she could have gifted the shares in the corporate trustee upon trust to the executors of her will for 15 years at the expiration of which period the shares could revert to Dr Ward's residuary estate and made her friend an appointor for the first 15 years following her death.

The same principles as those set out above could be used to divide the capital between the second wife and the children.

5. Second spouse V the children

There are a number of tools to ensure the distribution of assets after death reflects the deceased's wishes. These mostly comprise formal agreements entered into by the husband and wife to ensure that property acquired prior to marriage passes to their respective children including:

- Mutual wills
- BFAs
- Family agreements.

If the documents are entered into by the parties:

- without duress;
- with each party understanding their rights and obligations under the documents;
- after seeking independent legal advice; and
- are properly witnessed;

then the courts will enforce those documents.

Further consideration of these types of documents is beyond the scope of this paper. However, the cases below illustrate how the documents may be used to "split" assets between the second spouse and First children.

5.1. Problems with documentation – seek legal assistance with preparation

Mr and Mrs Colosi were married for 20 years. It's the second marriage for both of them. They have no children together but both have children by their former marriages. The husband and wife signed a statement of intention three years into their marriage. This statement indicated that both husband and wife were to leave the entirety of their estates to their respective children only. Most of Mr Colosi's property was acquired before the statement of intention was signed. The wife was under the impression the statement only related to assets acquired before the document was signed, and not after it. (The court held that, on the terms of the document, this was a reasonable view to have taken).

Mr Colosi passed away. A month before he died, he made a will. Under the will everything was left to his two children and nothing to his wife, who is 68 years old at the time of her husband's death and had some problems with her health. Mrs Colosi signed a deed of release less than a week after the will was made. She did not read this document before signing it. The deed contained a clause suggesting that the parties were under no obligation to provide for each other.

Mrs Colosi has some property assets, but during her married life, she was dependent on her husband for income. Mr Colosi's children were well enough off not to "need" income from the estate as much as her.

Mrs Colosi claimed against the estate of her late husband for provision from property acquired after the statement of intention was signed and was awarded a portion of the estate.

The court held[9]:

- the statement of intention was not a legally binding document; and

- the deed of release was ineffective because it was:
  - badly drafted and contained oppressive clauses; and
  - not properly witnessed.

  The court also held the fact that Mrs Colosi had not read the deed before signing it was not detrimental to her as this behaviour was usual for her in the context of the marriage.

Principles from *Colosi v Colosi*:

- The court will look at the nature of a relationship when assessing claims by partners of deceased estates over children from a previous marriage or relationship.
- Deeds of release must be drafted carefully, must not obtain oppressive clauses and must be properly witnessed.
- Statements of intention are not necessarily legally binding and consideration of what the contracting parties believed at the time of signature is paramount.

6. His and her children

The use of mutual wills is highly relevant to this scenario if the testator wishes to ensure that their assets pass to their children and not their step-children. The mutual wills agreement may only relate to assets acquired prior to the marriage or to all assets.

It is submitted that had the husband in *Stanford* made a mutual wills agreement with his wife that dealt with his residence, his step-children would not have had any grounds to apply to the court for an order altering his interest in the residence.

7. First children v second children and Needs of adult children v minor children

7.1. Trust Splitting

A tool for enlarging the estate of a testator who has a family (or possibly a discretionary business trust) and insufficient personal wealth to provide for a minor child is to create a credit loan in the trust in favour of the testator as beneficiary which upon death may be called up by the testator's executors as a debt due to the estate. Such a strategy would enable the testator to access some trust assets whilst vesting control of the trust in say, the adult children.

The advantage of this strategy is that trust distributions to a minor from a testamentary trust are taxed at marginal rates whereas those from an inter vivos or family trust are not. Furthermore, this strategy also enables the adult children to benefit from and control the trust assets which is an especially important consideration if the family trust operates a business or holds business property and at least one of the adult children is engaged in the business.

In Fischer v Nemeske Pty Ltd[10] the trust assets comprising shares in private companies were revalued and an asset revaluation reserve of approximately $4million was created. The trustee purported to distribute the asset revaluation reserve to the original controller of the trust (Mr Nemes) and his wife jointly. By his will, Mr Nemes gifted the shares in the corporate trustee to the Fischers, being relatives of the Nemes who were not survived by any children and the remainder of his estate to other persons.

The Fischers challenged whether the trust was indebted to Mr Nemes' estate for several reasons including that the distribution was ineffective and in breach of the trust deed.

[9] *Colosi v Colosi* [2013] NSWSC 1892

[10] [2014] NSWSC 203

Debt from Trust to Estate established

Similarly, a credit entitlement in favour of the testator and left under his will to his spouse was found to be a debt due to the estate by the trust.[11] In ***Wood v Inglis***, the children had argued that the trust was entitled to the amount represented by the capital gain which would have reduce the testator's credit entitlement from approximately $1.3 million to $61,000.

8. Tools for assessing need: Cash flow projections

8.1. Minimum payment amount for a superannuation income stream

If a pension is to be paid to a tax dependant then the prescribed minimum payment amount for a superannuation income stream must be taken into account in determining whether the cash flow generated by the superannuation fund will be sufficient to pay the pension. Schedule 7 to the SIS Regs prescribes the minimum payment amount for a superannuation income stream.

The following table shows the minimum percentage amount of the pension account balance which must be paid annually to the pensioner.

Age	Minimum % withdrawal for the 2008–09, 2009–10 and 2010–11 income years for certain pensions and annuities	Minimum % withdrawal for the 2011–12 and 2012–13 income years for certain pensions and annuities	Minimum % withdrawal (in all other cases)
Under 65	2%	3%	4%
65–74	2.5%	3.75%	5%
75–79	3%	4.5%	6%
80–84	3.5%	5.25%	7%
85–89	4.5%	6.75%	9%
90–94	5.5%	8.25%	11%
95 or more	7%	10.5%	14%

In 2014, a review of the minimum annual income stream (pension) is to be undertaken by Treasury.

8.2. Average Super Returns

A tool for assessing cash flow projections are the reports prepared by the Australian Prudential Regulation Authority (APRA) in relation to the average returns generated by Australia's 200 largest super funds.

APRA is a government body that oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies, and most elements of the superannuation industry. In January 2014, APRA released a report in relation to the performance of Australia's 200 largest super funds over the past decade. Included in this

[11] *Wood v Inglis* [2009] NSWSC 601

report were average annual returns for these funds over a five and ten year period to June 2013.

The average rate of return was found to be 13.7% for the year ending June 2013. This was deemed to be a healthy rate and a strong improvement on the 0.6% rate for the year ending June 2012.

Average rates of returns were slightly different across different sectors. For example, corporate super funds delivered an average rate of return of 12.3%, whereas public sector super funds delivered an average rate of 14.2%.

Industry associations have criticised the data. The Association of Superannuation Funds of Australia (ASFA) has noted that the APRA findings do not provide much insight in relation to complex funds with multiple product and investment options.

APRA's report regarding the 2013-2014 financial year will be released in 2015. For more information see:

- The APRA report, "*Statistics: Superannuation Fund-level Rates of Return June 2013*" issued 8 January 2014: http://www.apra.gov.au/Super/Publications/Documents/2013%20Superannuation%20Rates%20of%20return.pdf
- Article discussing the APRA report: http://www.superguide.com.au/how-super-works/performance-history-of-australias-largest-200-super-funds

8.3. Yield on rental properties

Another tool for assessing cash flow projections are the rental yields published by another of organisations for property investors. The Real Estate Institute of Victoria, a peak professional association, publishes data on residential rental yields. This can be found at: http://www.reiv.com.au/en/Property-Research/Median-Prices-by-Size.[12]

For the 12 months ending December 2013, the gross rental yield for Melbourne on three-bedroom houses was 3.7%.
Gross rental yields are also posted by the ASX and can be accessed at: http://www.asx.com.au/asx/markets/propertyIndices.do.
Daily average property interest rates may be found at: http://www.apimagazine.com.au/api-online/rate-update.

9. Tools for assessing need: Longevity Risk

9.1. LIFE TABLES

The Australian Government Actuary (AGA) has published life tables which are used by various organisations to predict the life expectancy of men and women. The life tables offer a tool to predict the life expectancy of a surviving spouse.

However, the current life tables prepared by the AGA are the 2005-2007 Life Tables. These tables were based on data from the 2006 census, and were released in 2009. But as the life tables are updated every five years, new life tables are expected to be published in 2014.

By way of example, the current life tables reveal that a 65 year old woman can expect to live for a further 21.62 years; this is an increase on the figures in the 2000-2002 table which predicted 65 year old women were expected to live for a further 21.15 years. Curiously, however, there has been a decrease in the life expectancy for 80+ year old women. Five years ago a woman aged 85 years could expect to live another 7.28 years, on average. Five years later, the average life expectancy of an 81-year old woman is 7.08 years. This would suggest that it is difficult to accurately predict the nature of the 2014 tables, and that it is not necessarily the case that, as one would expect, life expectancies will increase across all ages.

[12] Yield figures can also be sorted by dwelling size and category.

The life tables are relevant to the determination of the amount of assessable income earned by a taxpayer from an annuity or superannuation pension. The "life expectation factor" referred to in section 27H of the *Income Tax Assessment Act 1936* (**1936 ITAA**) is calculated by reference to the Life Tables prescribed by the *Income Tax Regulations* 1936 (regulation 9).

The life tables are used by Centerlink to calculate the relevant number for certain asset-test exempt income streams. Section 9(1) of the *Social Security Act 1991* **(SSA)** defines "life expectancy" by adopting the meaning of "life expectation factor" under the 1936 ITAA (see also the guide to the SSA which sets out the relevant tables for different age groups).

The 2005-2007 Life Tables: http://www.aga.gov.au/publications/life_tables_2005-07/downloads/Australian_Life_Tables_2005-07.pdf
The use of the tables in the Social Security Act: see, for instance, here: http://guidesacts.fahcsia.gov.au/guides_acts/ssg/ssguide-4/ssguide-4.9/ssguide-4.9.5/ssguide-4.9.5.47.html
Article on changes in life expectancy http://www.superguide.com.au/retirement-planning/updated-life-tables-is-the-tide-shifting-for-australian-life-expectancies

10. Conclusion

Given (unfortunately) that disputes are more likely to arise between family members upon the death of a client in a blended family situation, it is most important that proper consideration be given to the client's estate plan and how to achieve their objectives.

Failure to implement an estate plan may also lead to intestacy which may disadvantage a Second spouse with minimal assets of their own and does not distinguish between minor and adult children.

This paper discusses a number of tools which may be used to implement an estate plan and to achieve the client's objectives.

Dealing with estate planning in a blended family situation is a balancing act between the needs and interests of all members of the family and between the provision made for those family members from superannuation, trust assets and personal assets.

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