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Controlling a family trust when you die

SUCCESSION PLANNING FOR FAMILIES

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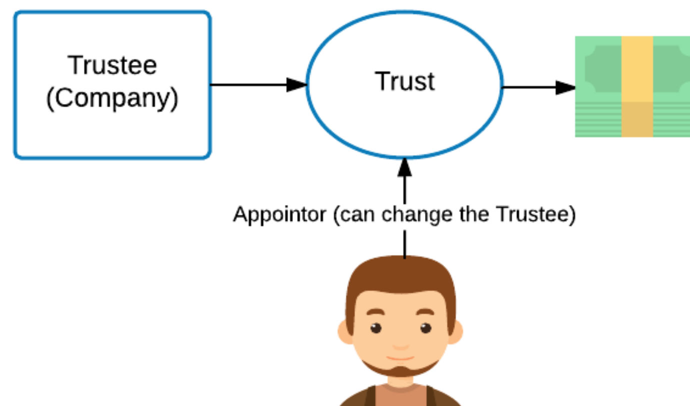
Who controls your family trust and its assets?

A 'family trust' involves two important roles: the **trustee** and the **appointor**.

The **trustee** manages the trust day-to-day. A key feature of a discretionary family trust is that no one has a 'fixed interest' in any of the income or assets of the trust. This means the trustee can decide who gets what from time to time. This is why these trusts are called 'discretionary' trusts.

The **appointor** decides who acts as trustee. This allows the appointor to remove the existing trustee and replace them with a new trustee. The appointor can appoint themselves as trustee, or appoint a company they control. The new trustee can then elect to distribute all the trust's income and assets where the trustee pleases, including to themselves or an associate. Therefore, the appointor has **ultimate control** of the trust and its underlying income and assets.

In summary, the trustee controls who receives the income and assets of the trust, and the appointor chooses who acts as trustee. Both of these roles are therefore critical to determining who ultimately benefits from the trust's income and capital.



Who controls your family trust when you die?

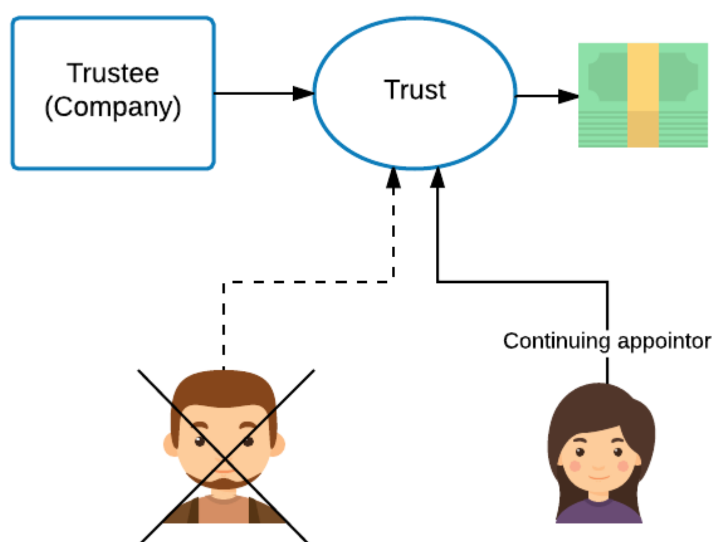
As noted above, the appointor is the person with the '**ultimate control**' of your trust, because they can choose who acts as the trustee.

The role of appointor is not an 'asset'. When you die your role as appointor simply ends. Who then takes your place as the ultimate controller of the trust depends on the terms of the **trust deed**. The trust deed is the document that initially sets up the trust, and then

regulates how it is administered. A trust deed can be amended over the life of the trust, so you need to ensure that you have a complete version of the trust deed, together with any amending deeds.

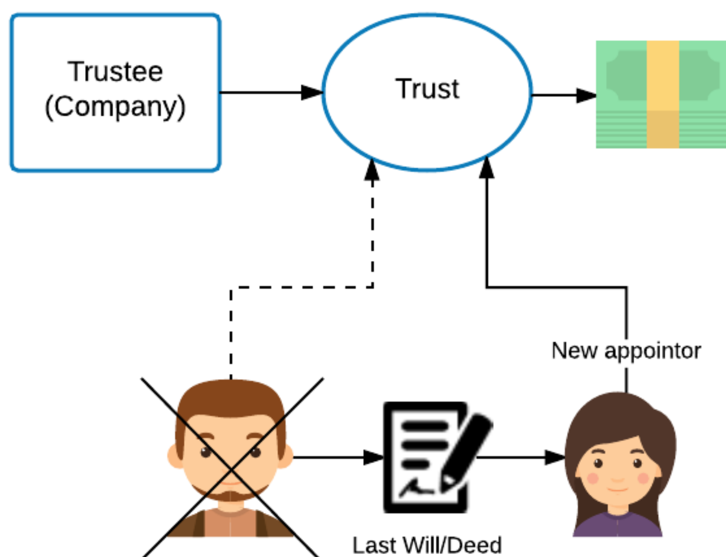
If you were one of **several appointors** before you died, then the **surviving appointor**(s) will continue in this role. The surviving appointor(s) can then decide who is the trustee of the trust after you die. They can appoint themselves or a company they control as trustee, and then give 100% of the trust income and assets to themselves.

For example, if you and your spouse are appointors of a trust and you die, then your spouse will continue on as the sole appointor of the trust, with ultimate control over the income and assets of the trust. If your spouse re-partners and does not take care to ensure that control later passes to your children, control of the trust may inadvertently pass to your spouse's new partner (or their children).



If you were the **sole appointor** before you died, then in most cases the trust deed allows you to nominate a **replacement appointor**. You can do this in a deed or often through your Will. But if you have not done this, then either no one will be the appointor (which may

require court involvement), or either the trustee itself, or your executor, will become the replacement appointor by default.



Once again, whoever becomes the appointor can appoint a new trustee, and that new trustee will have complete discretion to distribute the trust's income and assets to whomever they wish. Therefore, the new appointor could decide to give 100% of the trust to themselves.

You do not want this power of appointment falling into the wrong hands.

How do you give 'fixed percentages' to your children?

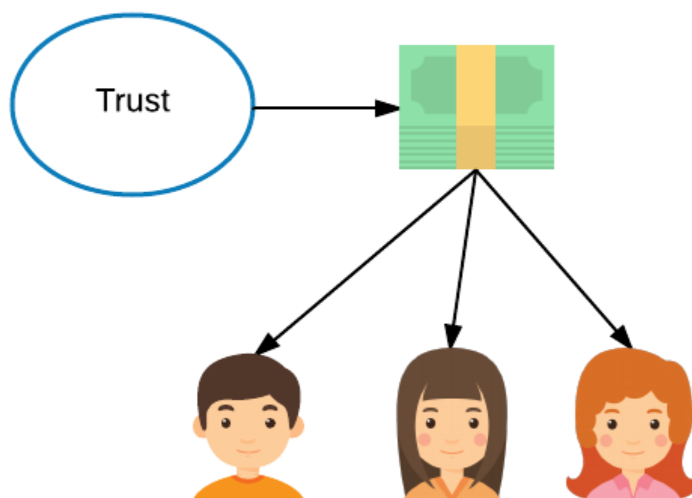
As noted above, no one has any 'fixed interest' in the trust's income or assets. The trustee gets to decide who gets what, from time to time.

If you currently control a discretionary trust, and want to give your children a '**fixed interest**' in the assets of the trust when you die, for example an 'equal interest', then you need to put in place a strategy to overcome the 'discretionary' nature of the trust.

To do this, you need to carefully deal with the roles and authorities of the trustee and appointor. There are a number of things that can potentially go wrong when trying to create 'notional' fixed interests in a discretionary trust.

Distributing assets from the trust on your death

One simple solution would be to exercise your control over the trust's assets before you die to require the trustee to **distribute a fixed interest in the trust assets to your children** following your death.



Distributing the assets to your children will trigger a 'disposal' of those assets by the trust to your children, and this is likely to have significant tax consequences. In particular, it is likely to trigger potential (and likely significant) income tax and capital gains tax on the trust's assets. There may also be stamp duty consequences. Depending on how this is done, you could actually trigger the adverse tax consequences *when you are still alive*, i.e. now, rather than when you die.[1]

Furthermore, the assets will no longer benefit from being held in the trust.

In short, unless you want to bring the trust to an end when you die, pay any accrued tax, and distribute the actual assets to your family, then this is not a practical strategy.

[1] This is because the relevant event is likely to be when you make the resolution, and not when the resolution is put into effect.

Putting in place a 'control structure'

For tax and asset protection purposes, most people want:

- The assets to **stay in the trust** when they die;
- But for **'control'** over those assets to be **shared among their children** in a fair manner.

To achieve this, you need to put in place an appropriate '**control structure**' for your trust that is effective after you die.

The control structure needs to deal with the roles of trustee and appointor. But because the appointor has ultimate control of the trust and its assets (and has the ability to replace the trustee), it is particularly critical that the **role of appointor** is effectively dealt with.

Dealing with a 'role' (that is not an asset) as part of your estate planning, requires careful planning.

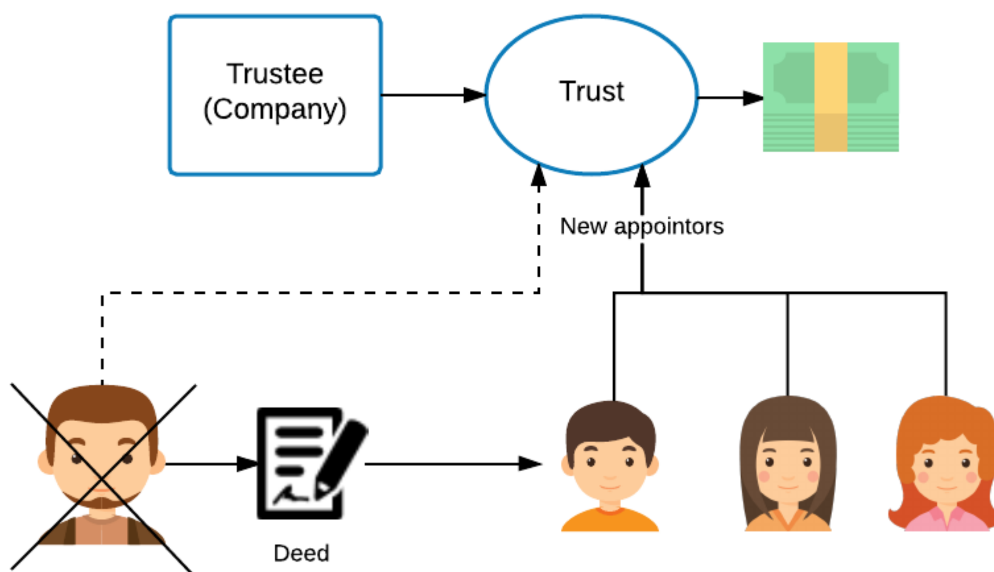
Appointing your children as replacement trustees and appointors.

A simple control strategy is to execute **Conditional Deeds of Appointment** that, effective as from the date of your death:

- Appoint your children as replacement co-appointors;
- Ensure your children participate equally in the control over the trustee; and
- Require any decisions of your trustees and appointors to be **unanimous**.[2]

If all of your children are made an appointor, and all of your children are either appointed as trustees or given equal control over a company trustee, then this would give each of your children an 'equal say' in the day-to-day decisions of the trustee, as well as who is the trustee. This would effectively give them joint control over the trust's income and assets.

[2] This may require an amendment to the trust deed.



There are several risks and limitations with this strategy.

This strategy does not actually confer any fixed interest in the trust's income and assets among your children. It merely requires your children to unanimously agree on how the trustee exercises its powers over the trust's income and assets, as well as who ultimately acts as trustee.

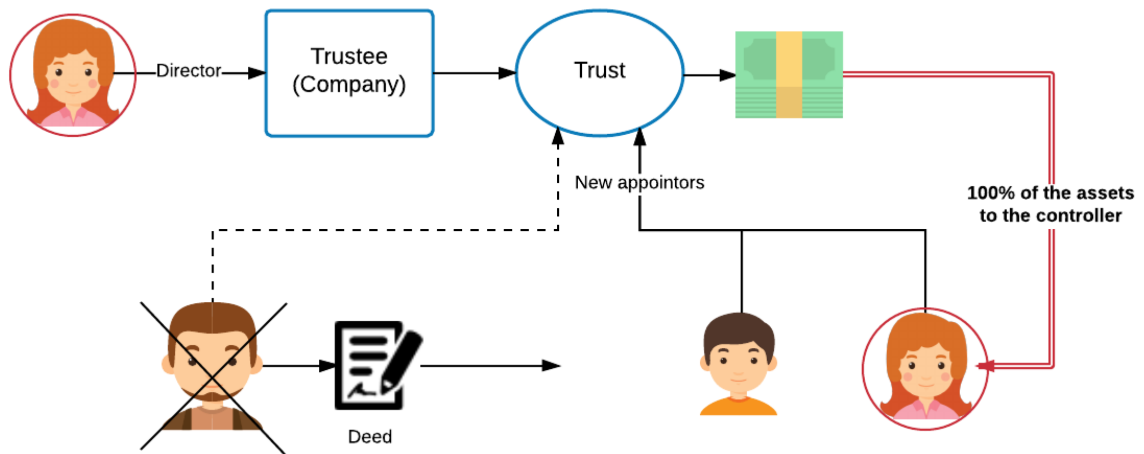
The idea is that if a majority of your children attempted to exclude a child, that child could simply refuse to participate in the decision – which would lock up the trustee and appointor. This is why it is critical that the trust deed and constitution of the trustee require decisions of the appointor and trustee to be **unanimous**.

You also need to be careful about who the trustee of the trust is immediately following your death. You need to ensure that each of your children participate equally in the control over the trustee.

If the trustee is one or more individuals prior to your death, then you need to ensure that each of your children are appointed as co-trustees. If the trustee is a company, then you need to ensure that each of your children are immediately appointed as a director of the trustee and end up with shares in the trustee that entitle them to appoint and maintain a directorship.

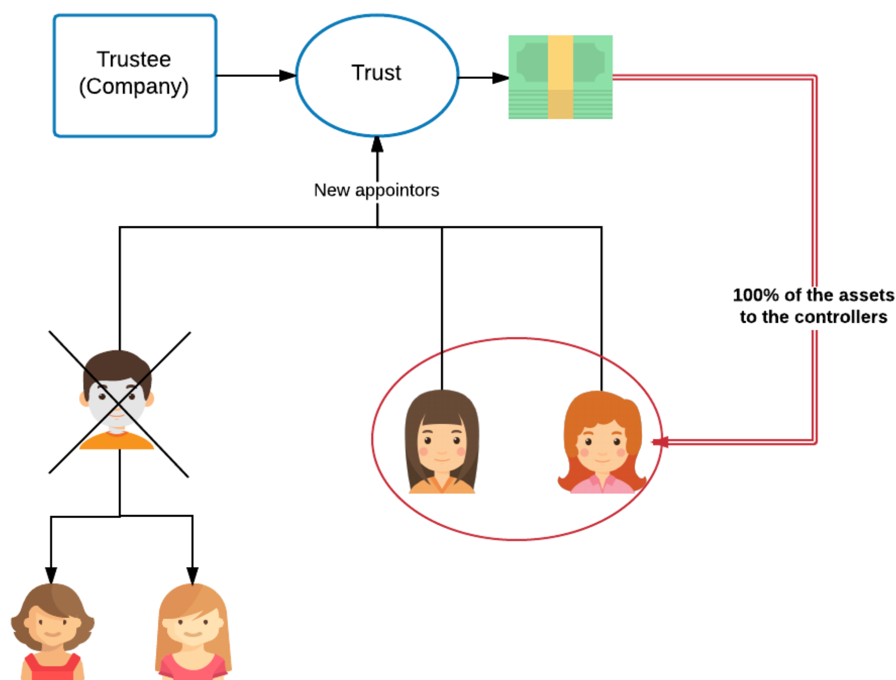
If you don't get this right, then one or more of your children may end up controlling the trustee, with the ability to exclude any other children from benefitting.

For example, if you have two children, and only one controls the current trustee, the child in control can withhold their consent to the appointor changing the trustee – so their sole control of the trustee is locked-in. They can then exercise their sole control as trustee to distribute 100% of the trust assets to themselves (or their associates), and nothing to your other child.



If you have two or more children, and one of them dies after you (or even before you), then their role as an appointor will end, (just like it does when you die). This will leave your other

children in ultimate control of the trust. If the child who has died has children of their own (i.e. your grandchildren), then they will have no say in the ongoing control of the trust.



This means that the interest in the trust that you intended for each child **will not** be passed down their family line when one of your children dies. The interest of your child in the trust will come to an end when that child dies – and your remaining children will then control the trust and its assets. This is often not what is intended, i.e. you intend for your grandchildren to benefit from their parent's share if their parent dies. So, this control strategy is really only good for one generation, i.e. to pass control to your children, and does not adequately deal with what happens when one of your children dies.

You could draft the conditional deed of appointment to appoint your grandchildren if their parent dies. However, you would then end up in a situation where the appointor and trustee comprises many individuals from different generations. Each grandchild would then exercise the same control participation as their uncles and aunts.

So, to make this strategy work you must:

- If you are an individual trustee: ensure that each of your children are appointed as a **replacement individual trustee on your death**. Alternatively, you may appoint a replacement company trustee before or on your death, with each of your children participating equally in that company as a shareholder and director;
- If you have a company trustee: ensure that **each of your children gets an equal number of shares in the company trustee** and is also **appointed as a director**. It is not enough that they simply receive an equal number of shares, because the company acts through its board of directors, and directors can generally only be appointed by a *majority* of shareholders. So, you can have a situation where one of your children is not a director and the majority shareholders will not appoint them. The majority could then control the company trustee to exclude that child from benefitting;
- Ensure that each of your children are appointed as a **replacement appointor**;
- Ensure that decisions of the appointor must be made **unanimously**; and
- Consider including provisions in these documents that give the children or your children (i.e. your grandchildren) similar participation rights as would have been enjoyed by their parent. This can be very difficult to draft (if not impossible in some circumstances[3]).

For the reasons noted, this strategy is often only partially effective. It would be appropriate where you intend the trust to only last a relatively short time after your death.

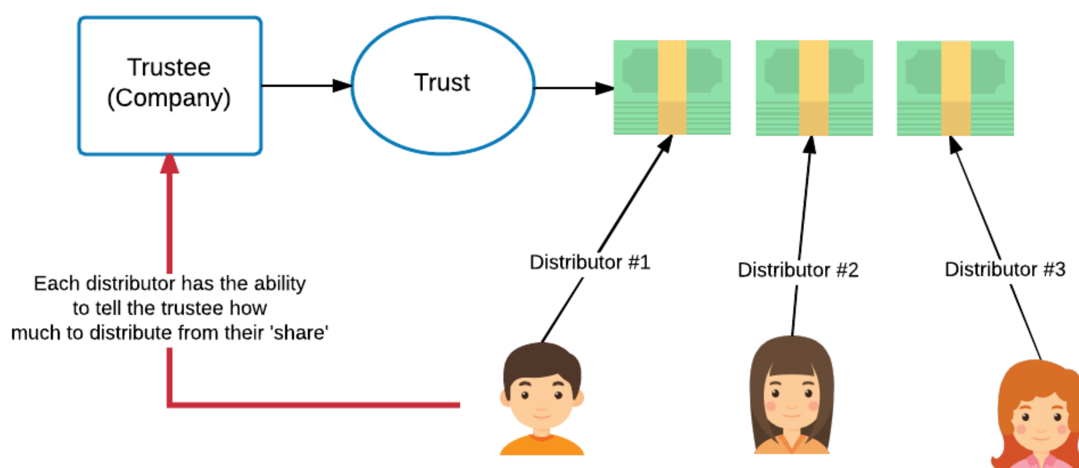
Amending the trust deed to create 'distributor' roles

Another strategy is to amend the trust deed for your trust to include a further role, namely that of '**distributors**'. A distributor is given the right to **direct the trustee** how they must deal with a certain percentage of the annual income and capital of the trust.

You can then appoint each of your children as a distributor over a given percentage of the trust's income and capital. For example, if you had three children, you could appoint each a

[3] Generally, you will want each child to have an 'equal' participation in the control of the trust. Assuming you have three children, and one of those children has two children of their own, i.e. two grandchildren, you will want the two grandchildren to have the same representation as each of your other children, i.e. collectively one third. However, because the role of appointor is a 'personal role' is it not easily divisible in this manner. So, if the two grandchildren are also made an appointor, then they will have two out of five votes.

distributor over one third of the income and capital. This effectively moves the discretion in relation to distributions away from the trustee and into the hands of each distributor.



These provisions need to be **very comprehensively drafted** to deal with many possible eventualities.

First, you need to ensure that the existing trust deed gives you the power to amend the deed to include these provisions. These provisions will impact many aspects of the existing trust deed, so the amendment power needs to be very broad. Ideally such powers would have been built in to your deed (which is the case with Andreyev Lawyers' deeds).

Secondly, the new provisions need to be drafted in a manner that does not give rise to a '**resettlement**' of the trust. A resettlement is triggered if the amendment fundamentally changes the rights and obligations of the class of beneficiaries. If a resettlement is triggered, then capital gains and a liability for stamp duty may be triggered for some or all of the trust's assets at the time of the amendment. Whether a resettlement is likely will depend on how the existing trust deed has been drafted, which generally depends on how old the trust is. This can be a complex question to answer.

Thirdly, the new provisions need to be drafted in a manner that does not trigger a complete or partial **vesting** of the trust at the time the amending deed is executed. In other words, the provisions must not create a 'fixed interest' in a portion of the income or assets from the outset – the discretionary element must be maintained, but then constrained by the rights of the distributors.

Fourthly, you need to consider what happens to the rights of a distributor should they die. Just like a trustee and appointor, the 'role' of a distributor comes to an end when the distributor dies. You need to include provisions that allow the distributor to effectively pass that role on to their children. This can be complex in itself, because your child will often want their children (i.e. your grandchildren) to participate equally in the parent's participation right. The most effective way to do this is to enable each distributor to nominate one or more persons to take over their rights in one or more shares, i.e. so the distribution right is effectively split between the relevant grandchildren.

Finally, you need to consider how the rights of the appointor are to tie in with this new role. The ultimate control of the appointor is watered-down by the rights of the distributors. However, the right to remove and replace the trustee is still significant. Generally, this question is answered by nominating each of the distributors (from time to time) as co-appointors, or you say that distributors with at least x% have the right to appoint the appointor.

So, to make this strategy work you must:

- Review the trust deed and ensure you have **sufficient powers to amend** the deed to include distributors;
- Draft amendments to the trust deed to allow for the:
    - **Appointment of distributors** over income and capital; and
    - Rights of distributors to be passed down their own family line, so that this entitlement is preserved when your children die;
- Ensure that the amendments do not trigger a **resettlement** or **vesting** of the trust;
- Include provisions in your Will, or in a separate Deed, that actually appoint your children as distributors over the relevant share of trust income and capital; and
- Consider what happens to the roles of trustee and appointor on your death – including ensuring that each distributor (and their family) is adequately represented in these roles.

This strategy can be effective, particularly if the distributor provisions have been written into the trust deed at the time the trust was originally set up. It is possible to amend an existing deed to include these provisions, but it takes careful drafting.

‘Corporatising’ the role of appointor

Another strategy is to effectively 'corporatise' the control and administration of the trust, so that it acts more like a company than a discretionary trust.

To achieve this, you must:

- Have a **company acting as the trustee** of the trust (rather than individual trustees);
- Appoint the same (or a different) **company as the appointor** of the trust; and
- Ensure your children participate equally in the control over the trustee and appointor company(s).

Most trust deeds allow for a company to take on the role of appointor, but you need to make sure that this is the case with your trust.

When a company is appointed as the trustee and the appointor, the company then exercises **day-to-day** and **ultimate** control over the trust's income and assets. The company is controlled by the board of directors, and the board of directors are appointed by the shareholders. You can then give each of your children an equal number of shares in the company, and they can participate in the role of appointor via these shares.

This strategy can work quite well – provided it is properly implemented. There are a number of things that can potentially go wrong.

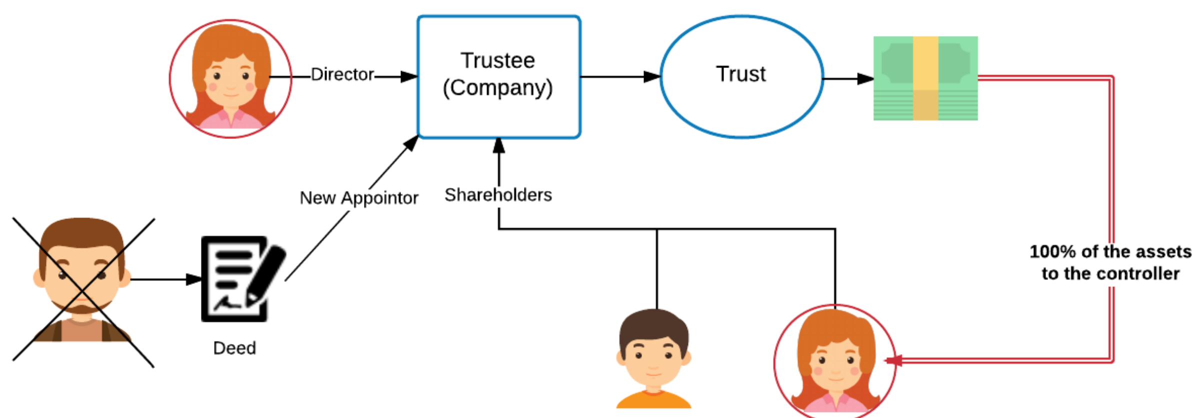
For most companies, decisions of the company are made by a ***simple majority* of the board**, so in effect, this board majority then exercises day-to-day control over the trust’s income and assets. In turn, the directors are appointed by the shareholders. Once again, decisions of the shareholders, including appointment of directors, are generally made by a ***simple majority* of shareholders**. (The ‘simply majority’ decision provisions are what you see in most ‘off-the-shelf’ company constitutions. It is also what the Corporations Act specifies if you have adopted the Replaceable Rules rather than having a constitution.)

If you have three children, two of them will be able to exercise this *majority* control over the company. First, they will be able to decide who is appointed to the board, in which case they can appoint themselves and leave one child out. Alternatively, if all children get a seat on the board as a director, decisions of the board can then be made by two of the three children, not taking into account the interests of the third.

In each case, a **majority** of children can act to **exclude the minority** from any benefit.

The same thing can happen with only two children, if only one child is on the board when you die. In this case, the child already on the board can refuse to exercise their voting powers in the company to appoint their sibling to the board, (the appointment and removal of a director generally takes *more than* 50% of the shareholder votes). In which case the

child already on the board can continue and control the company to distribute all the trust income and assets to themselves.



Interestingly, any child who is excluded from benefitting can do little about it. This is because the company is acting as trustee of the trust and there is no requirement for the directors to take into consideration the interest of any minority shareholders – the value is in the trust, not the company. Furthermore, the discretion of the company in its role as trustee is generally absolute under the terms of the trust deed, i.e. the company can do what it wishes with the trust's income and capital, including excluding one of your children from benefitting.

To address these concerns, we recommend that the **Constitution** of the company be updated so that:

- Each child receives a distinct class of shares (e.g. A, B and C, etc);
- Each class of share entitles the holders to collectively appoint a director to the board;
- Any decisions relating to distributions of income or capital require the consent of each class of share;
- Any decision relating to the exercise of the power of appointment held by the company requires the consent of each class of share; and
- Any decisions relating to the acquisition and disposal of key assets, etc, requires the consent of a certain majority of the directors. For example, a simple majority or a special majority.

This then gives the holders of each class of shares direct participation in the day-to-day and ultimate control of the trust's income and assets.

Each child can pass their shares down their own family line in whatever manner they wish. This takes with it a right to participate in the control of the trust. Each family group can set the rights attaching to their share class as they wish to achieve their own succession planning objectives.

There are a couple of asset protection issues that also need to be considered with this strategy:

First, the role of appointor represents a **valuable right** now held by the company, i.e. the right to ultimately control who gets the income and assets of the trust. If the company is sued or gets into financial difficulty, and an external administrator is appointed to the company, they can potentially exercise the appointor power to benefit creditors. For this reason, you should **not** use a company that carries on an active business or does other things that could cause financial strain for the company. In this scenario, it is better to set up a separate fresh company to act as appointor of the active trust.

Secondly, the role of appointor also has the effect of **increasing the value of the shares** in the company – once again, because the role of appointor represents a valuable right now held by the company, and the shares represent an interest in this value. If someone outside the family were to get their hands on the shares, they would then be able to participate in the control of the trust. For this reason, we recommend that the shares in the company pass into a protective 'testamentary trust' set up for each of your children through your Will. In this way, the value of the shares is then also protected.

So, to make this strategy work you must:

- Identify a company that does not carry on an active business, or any other risky activities. If such a company cannot be identified, then you may need to set one up, either now or by your executors immediately following your death;
- **Amend the Constitution** of the company to:
  - Require the prior consent of all directors, and/or the holder of each class of shares, before decisions can be made that impact the trust (e.g. exercise of appointor powers, distribution of income and/or capital); and
  - Empower the holder of each class of shares to appoint a director to the board;[4]
- Implement a **Deed of Appointment** to appoint the company as appointor of the trust, either now or on your death;
- Put in place arrangements to **appoint your children as directors** of this company, either now or on your death;

[4] We note that a constitution of this nature can amount to a 'fetter' on the discretion of the company trustee for trust law purposes. For this reason, we also recommend that the trust deed be amended to allow for this fettering in accordance with equitable principles.

- Split the shares in the company into a higher number (usually 3,000+), and create a separate class of share for each child; and
- **Amend your Will** to leave a separate class of share to each child, and ensure that the shares pass into a protective testamentary trust for each child.

Using a 'Control Deed' over the trust

Another strategy, that may be implemented in conjunction with one or more of the above strategies, is to have the various people and entities associated with the trust (other than the trustee) enter into a legally binding '**control deed**' that **regulates how the trust will be administered**.

For example, the parents and children within a family group may agree to exercise all of their power and influence over the trust (whatever form that takes) to ensure that each child (and their children) receive an agreed interest in the income and assets of the trust. They may also agree that if they receive any income and assets that are inconsistent with the agreement, then they will account to the other family members for that.

This would contractually require each family member to exercise their trustee, appointor, director and shareholder rights and powers consistent with the deed. This is really a 'fail-safe' contractual mechanism to protect against a failure of one of the above 'structural' control strategies.[5]

Any family members under 18 (e.g. children and/or grandchildren) or who have not yet been born, will not be able to be a party to this deed. Therefore, it needs to be drafted in a way that confers rights on these persons other than by being a party to the contract. While this can be done, it is tricky to draft, and is potentially open to challenge.

Furthermore, when a family member dies and an interest in the trust structure (e.g. shares in a trustee) pass to their executor and beneficiaries, it is debatable to what extent the deed can impose obligations on these assignees.

Finally, it is also difficult to anticipate in advance all of the possible scenarios the family may face over time. Any change to the terms of the deed would ordinarily require the agreement of **all** interested parties, which may be very difficult to obtain in practice.

For these reasons, this strategy is often used in conjunction with one of the other 'structural' strategy outlined above.

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[5] Once again, we note that a document of this nature can amount to a 'fetter' on the discretion of the company trustee for trust law purposes. For this reason, we also recommend that the trust deed be amended to allow for this fettering in accordance with equitable principles.

Time to take action

No matter what the current control structure of your family trust, it is critical that you take action now to ensure that control passes to your spouse, and then to the next generation, as you intend.

If left to chance, the most likely outcomes are disappointment and dispute.

If it is too late, and you find yourself in the position of being excluded from participating in a family trust, then call us to discuss what remedies may be available to you. We have recently acted in a number of cases where parents have not taken the time to ensure that control of their trust passes neatly to the next generation. While it is messy and expensive, there are things we can do.

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