Trust fundamentals: Duties, trust deed clauses and trust deed variation

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1. Introduction

1. This paper looks at some of the fundamental topics relating to trusts and trust deeds. The main areas covered by the paper are:

   (1) Trustee duties and remedies for breach of duties;
   (2) Essential clauses to be included in a trust deed;
   (3) Variation of a trust deed.

2. Trustee duties

2. The relationship between trustee and beneficiaries is a fiduciary one.[1] A fiduciary has no positive legal duty to act in the interests of the beneficiary.[2] A fiduciary duty is proscriptive, forbidding a conflict of interest and duty, and any unauthorised profit from use of position, property or confidential information.[3]

3. In addition to the no-conflict and no-profit rules, a trustee also has other specific duties including:

   (1) The duty to comply with the terms of the trust deed;
   (2) The duty to keep accounts and provide them to the beneficiaries;
   (3) The duty to act personally and not fetter their discretion.

Remedies for a breach of duty or possible breach of duty by the trustee

Judicial advice and direction when sufficient power in the trust deed

4. Sometimes a trustee will contemplate a particular course of action, but it will be unclear whether the course of action is within power. For example, there may be ambiguity in the trust deed and the trustee may be unsure as to the correct interpretation to be placed on a particular provision of the deed.

5. In that scenario, a trustee has the option to seek advice and/or directions from the Court about the interpretation of a trust deed and/or the actions that they can or should take. Order 54.02 of the *Supreme Court (General Civil Procedure) Rules 2015* gives that power. The Order reads as follows:

   (1) A proceeding may be brought for any relief which could be granted in an administration proceeding and a claim need not be made for the administration or execution under the direction of the Court of the estate or trust in respect of which the relief is sought.

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[1] See, for example, *Hospital Products Ltd v US Surgical Corporation* (1984) 156 CLR 41 at 68.
[2] *Breen v Williams* (1996) 186 CLR 71 (***Breen***) at 113 and 137-138.
[3] *Breen* at 82-83, 93-94 and 112-113. And see *Chan v Zacharia* (1984) 154 CLR 178 198-199.

(2) Without limiting paragraph (1), a proceeding may be brought for—

(a) the determination of any question which could be determined in an administration proceeding, including any question—

(i) arising in the administration of an estate or in the execution of a trust;

(ii) as to the composition of any class of persons having a claim against an estate or a beneficial interest in an estate or in property subject to a trust; or

(iii) as to the rights or interests of a person claiming to be a creditor of an estate or to be entitled under the will or on the intestacy of a deceased person or to be beneficially entitled under a trust;

(b) an order directing an executor, administrator or trustee to—

(i) furnish and, if necessary, verify accounts;

(ii) pay funds of the estate or trust into court; or

(iii) do or abstain from doing any act;

(c) an order—

(i) approving any sale, purchase, compromise or other transaction by an executor, administrator or trustee; or

(ii) directing any act to be done in the administration of an estate or in the execution of a trust which the Court could order to be done if the estate or trust were being administered or executed under the direction of the Court.

6. The power can be exercised only if the applicant can point to the existence of a question in respect of the administration of the trust property, or in relation to an interpretational issue which arises under the trust deed.[4] It allows a Court to advise and direct trustees in relation to the performance of the trust, but also, to approve the entering into and performance of transactions by trustees.[5]

7. There is otherwise no implied limitation on the power and no limitation on the discretionary factors that the Court can take into account in exercising the power.[6] The Court is, however, confined by the limits of the trust deed.[7]

Absence of power in the trust deed

8. If there is no power under the trust deed to undertake a particular act, then section 63 of the *Trustee Act 1958 (Vic)* may assist. Section 63 reads as follows:

[4] See, for example, *Fast & Ors* [2015] VSC 780 at [11].
[5] See, for example, *Hornsby v Playoust (No 2)* [2005] VSC 125 at [10].
[6] See, for example, *Re Primary Securities Ltd* [2016] VSC 536 at [5] and the authorities cited therein and *Fast & Ors* [2015] VSC 780 at [10] and [13].
[7] *Gonzales v Claridades* (2003) 58 NSWLR 211 at 218.

63. Power of Court to authorize dealings with trust property

(1)Where in the management or administration of any property vested in trustees, any sale, lease, mortgage, surrender, release or other disposition, or any purchase, investment, acquisition, expenditure or other transaction, is in the opinion of the Court expedient, but the same cannot be effected by reason of the absence of any power for that purpose vested in the trustees by the trust instrument (if any) or by law, the Court may by order confer upon the trustees, either generally or in any particular instance, the necessary power for the purpose on such terms and subject to such provisions and conditions (if any) as the Court thinks fit and may direct in what manner any money authorized to be expended, and the costs of any transaction are to be paid or borne as between capital and income.

(2) The Court may from time to time rescind or vary any order made under this section, or may make any new or further order.

(3) An application to the Court under this section may be made by the trustees, or by any of them, or by any person beneficially interested under the trust.

9. Under s 63(1), the Court has powers which are expressed in very wide and beneficial terms and which must be liberally construed without restriction by any implications.[8]

10. The Court can exercise its powers under s 63(1) if the relevant transaction is:

    (1) "in the management or administration" of property vested in the trustees;
    (2) "expedient"; and
    (3) not otherwise able to be effected because of an absence of power.[9]

11. The third condition is the absence of any power vested in the trustee by the trust instrument or by law. It is therefore a jurisdictional requirement that the trustee must not already have the power it seeks. [10]

12. Under s 63(1), a Court is only empowered to authorise a disposition or transaction that is expedient in the management or administration of trust property.[11] That is, the words "in the management or administration" have a limiting effect on the power.

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[8] *Ballard v Attorney-General for Victoria* [2010] VSC 525 at [27]; *Riddle v Riddle* (1952) 85 CLR 202 at 214 and 220; *Royal Melbourne Hospital v Equity Trustees Ltd* (2007) 18 VR 469 at 476[12] and 500[148]; *Norman v Australasian Conference Association* [2008] VSC 573 at [16].
[9] *Ballard v Attorney-General for Victoria* [2010] VSC 525 at [29]; *Royal Melbourne Hospital v Equity Trustees Ltd* (2007) 18 VR 469 at 500[149].
[10] *Royal Melbourne Hospital v Equity Trustees Ltd* (2007) 18 VR 469 at 487[77] relying on *Riddle v Riddle* (1952) 85 CLR 202 at 214 and 219.
[11] *Ballard v Attorney-General for Victoria* [2010] VSC 525 at [31]; *Royal Melbourne Hospital v Equity Trustees Ltd* (2007) 18 VR 469 at 501[151]; *Municipal & General Securities Co Ltd v Lloyds Bank Ltd* [1950] Ch 212 at 223.

13. The following principles apply in relation to this phrase:
    (1) "management" refers to the management of trust property in the commercial or practical sense;[12]
    (2) "administration" encompasses all of the legal powers and duties which might be possessed by a trustee in respect of trust property; [13]
    (3) the phrase "management or administration" is of wide import and picks up everything that a trustee may need to do in practical or legal terms in respect of trust property; [14]
    (4) "management" and "administration" may overlap, but the terms are not necessarily synonymous and an unduly narrow interpretation should be avoided. [15]

14. For s 63(1) to apply, the transaction must be, in the opinion of the Court, "expedient". The following principles are relevant:

    (1) "expedient" takes it ordinary meaning of advantageous, desirable, suitable to the circumstances of the case; [16]
    (2) expedience is a criterion of the widest and most flexible kind; [17]
    (3) in deciding whether a disposition or transaction is expedient, the Court must consider whether it is expedient in the management or administration of the trust property as a whole; [18]
    (4) in the case of a charitable trust, the question of expediency must be determined by reference to the objects or purposes prescribed in the trust instrument. [19]

15. Section 63 is considered subsequently in this paper in the context of amending a trust deed where there is no power of amendment in the deed.

Declaration

16. When judicial advice is sought, it may also be desirable to seek a declaration from the Court, for example, about whether a particular course of action is within power.

Injunction

17. A beneficiary or other person with rights in respect of a trust or trust property may seek an injunction to prevent a potential future breach of trust. For example, to restrain a trustee from

[12] *Ballard v Attorney-General for Victoria* [2010] VSC 525 at [32]; *Hornsby v Playoust* (2005) 11 VR 522 at 527[18],[19]; *Royal Melbourne Hospital v Equity Trustees Ltd* (2007) 18 VR 469 at 500[150].
[13] *Ballard v Attorney-General for Victoria* [2010] VSC 525 at [32]; *Hornsby v Playoust* (2005) 11 VR 522 at 527[18],[19]; *Royal Melbourne Hospital v Equity Trustees Ltd* (2007) 18 VR 469 at 500[150].
[14] *Ballard v Attorney-General for Victoria* [2010] VSC 525 at [32]; *Royal Melbourne Hospital v Equity Trustees Ltd* (2007) 18 VR 469 at 500[150].
[15] *Ballard v Attorney-General for Victoria* [2010] VSC 525 at [32]; *Hornsby v Playoust* (2005) 11 VR 522 at 526[17] and 527[19]; *Royal Melbourne Hospital v Equity Trustees Ltd* (2007) 18 VR 469 at 500[150].
[16] *Ballard v Attorney-General for Victoria* [2010] VSC 525 at [34]; *Riddle v Riddle* (1952) 85 CLR 202 at 221-2.
[17] *Ballard v Attorney-General for Victoria* [2010] VSC 525 at [34]; *Riddle v Riddle* (1952) 85 CLR 202 at 214.
[18] *Ballard v Attorney-General for Victoria* [2010] VSC 525 at [35]; *Riddle v Riddle* (1952) 85 CLR 202 at 220; *Royal Melbourne Hospital v Equity Trustees Ltd* (2007) 18 VR 469 at 501-2[154]-[157].
[19] *Ballard v Attorney-General for Victoria* [2010] VSC 525 at [37]; *Freeman v A-G (NSW)* [1973] 1 NSWLR 729 at 735; *Norman v Australasian Conference Association Ltd* [2008] VSC 573 at [27].

distributing trust property, or to prevent a transaction such as a sale of land. A real-life example of this type of situation is discussed further below.

Removal of the trustee and vesting orders

18. The power to remove a trustee pursuant to statute or under the trust deed is considered subsequently in this paper.

19. The Court has inherent jurisdiction to remove a trustee and appoint a new one.[20] The Court also has a statutory power to appoint a new trustee in addition to, or in substitution for, an existing trustee pursuant to s 48(1) of the *Trustee Act 1958* (Vic). That power can be exercised whenever it is expedient to do so and where it is found inexpedient difficult or impracticable to do so without the assistance of the Court.

20. The meaning of "expedient" in this type of context was explained in *Porteous v Rinehart* (1998) 19 WAR 495 at 507 as follows:

> *... conducive to advantage in general, or to a definite purpose; fit, proper, or suitable to the circumstances of the case ... In the context of appointing a new trustee in substitution for an existing one, I take it to mean then conducive to, or fit or proper or suitable having regard to, 'the interests of the beneficiaries, to the security of the trust property and to an efficient and satisfactory execution of the trusts and a faithful and sound exercise of the powers conferred upon the trustee'.*

21. The key considerations in deciding whether to appoint are the welfare of the beneficiaries and the preservation of trust property.[21]

22. Some of the relevant factors include:

    (1) The wishes of the settlor – either made clear from the express terms of the trust deed or implicit in the terms of the trust or the identity or description of the original trustee;

    (2) That a trustee should not be appointed in order to promote the interests of some beneficiaries contrary to the wishes of the settlor or the interests of other beneficiaries. This has its basis in the rule of avoiding conflicts of interest. The Court has a preference not to appoint beneficiaries or relatives of beneficiaries as trustees, but that is not an absolute rule;

    (3) Regard should be had to whether the appointment would promote or impede the execution of the trust.[22]

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[20] See, for example, *In the Will of Tunstall* [1921] VLR 559.

[21] See *Porteous v Rinehart* (1998) 19 WAR 495; *Titterton v Oates* (1998) 143 FLR 467; *McLauchlan v Prince* [2002] WASC 274 at [14]; *Trojan v Nest Egg Nominees Pty Ltd* [2004] SASC 182; *Mann v Grantham* [2004] VSC 156; *Hill v Fry & Ors* [2008] VSC 13; *Elovalis v Elovalis* [2008] WASCA 141 at [30] (Martin CJ); *Montevento Holdings Pty Ltd v Scaffidi Holdings Pty Ltd [No 2]* [2010] WASC 180 at [40] – [41]; *Deutsch & Ors v Deutsch & Ors* [2011] VSC 345 at [13].

[22] *Mustica Holdings Pty Ltd v Lotus Almonds Pty Ltd* [2015] VSC 531 at [7].

23. Beneficiaries may consider approaching the Court where it is not otherwise possible to remove a trustee, but the trustee has breached their duties or is otherwise unfit to act.

24. If a new trustee is appointed or, for example, where it may be expedient due to a risk to trust property, the Court may make an order vesting trust property in a new person.[23]

Account of profits / compensation / other restitution and remedies

25. If there has been a breach of trust by a trustee leading to loss then the trustee may be liable to pay equitable compensation.

26. Alternatively, if a trustee has profited from a breach of trust (eg made an unauthorised profit in breach of the no-profit rule), then an account of those profits may be sought.

27. There may also be other types of action, for example, in equity that may need to be considered if trust property finds its way into the hands of a third party in breach of trust.[24] This paper does not detail all possible actions, only some of the main ones.

Illustrations: breach of duty to comply with the terms of the trust and duty to account

28. A failure to comply with the terms of the trust does not just have to be deliberate. I have come across many examples where trustees have inadvertently breached the trust deed because they have either not read the terms of the deed or, more commonly, their accountants have failed to read the deed.

29. This is an area where lawyers can add real value to clients by working with accountants to ensure that the trust deed is complied with. Accountants will usually act at the "coal face" by determining who distributions of income and capital are made to and how much is distributed to them. Often, accountants will draft their own trust resolutions or minutes of trust meeting which can cause problems if the terms of the trust have not been properly considered.

30. I will provide two examples of situations I have come across in practice where there have been breaches of trust due to a failure to either read or understand the trust deed.

31. The first example involved a discretionary trust deed with a wide class of beneficiaries. Distributions had been made over 2 or 3 years to Person A. Person A did, prima facie, fall within the wide class of beneficiaries. Person A was, however, also a trustee of the trust. There was another provision of the trust deed that excluded trustees unless they were specifically named in the schedule to the trust deed. Person A was not specifically named and so was excluded from being a beneficiary even though they fell within the general class of beneficiaries. The distributions to Person A had therefore been made in breach of trust.

32. The second example also involved a discretionary trust. The trustee's accountant took responsibility for the decision to draft trust distribution resolutions and to decide who should receive the distributions of income. Over many years the accountant had distributed income

[23] S 51 and s 52, *Trustee Act 1958* (Vic).
[24] See, for example, *Re Diplock* [1948] Ch 465.

to a corporate beneficiary in breach of trust because the trust deed did not permit distribution to corporate beneficiaries.

33. From the trustee's perspective, these types of inadvertent breach can be catastrophic. Under trust law, the trustee had no power to distribute the relevant income to the person who was not, in fact, a beneficiary of the trust. Depending on the terms of the relevant income distribution resolution, the income may:

    (1) properly belong to another beneficiary, for example, if there was a default beneficiary clause in the distribution resolution; or
    (2) even worse, because the resolution to distribute to the person who was not a beneficiary was invalid, the distributed income may be income to which no beneficiary had a present entitlement. The trustee can be taxed on such income at the highest marginal tax rate.

34. The trustee also has a duty to maintain accurate accounts so, in cases like the above where errors arise in the accounts due to a breach of trust, the trustee would be obliged to engage an accountant to remedy the errors. Further, the trustee would, generally, be under a duty to attempt to recover the overpaid distributions.[25]

Illustrations: breach of duty, failure to account, and removal of trustee

35. Conflict between beneficiaries and trustees does not just arise in the context of family discretionary trusts. Private unit trusts can also give rise to conflict and breaches of duty, particularly where one faction controls the trust and another person is a mere minority unitholder. Two real-life examples illustrate this point.

36. The first matter involved a unit trust which carried on a tourism business (**TU Trust**). Mr X had an equity investment in the trust. The controller of the trustee promised him periodic distributions from the unit trust. Despite receiving confirmation from the controller that the distributions would be paid, no payment was received, nor were financials for the trust provided.

37. Mr X also believed that the controller had sold units that Mr X held in another unit trust without consent and reinvested them in the TU Trust.

38. The matter gave rise to potential breaches of trust including:

    (1) A breach of the duty to account.
    (2) A breach of the trust deed and a breach of fiduciary duties by failing to pay out distributions that were owed and, potentially, from an unauthorised sale of units and reinvestment.

39. The second matter involved a property development unit trust. The corporate trustee of the trust was effectively controlled by one of the unitholders who was managing the property

[25] See, for example, *Re Horne* [1905] 1 Ch 76 in the context of beneficiaries who are overpaid by a trustee. And see *Re Robertson, Deceased* [1953] VLR 685.

development (**Controlling Unitholder**). One of the other unitholders was only a passive investor and had a minority interest in the unit trust (**Minority Unitholder**).

40. The relevant property development involved the construction of multiple apartments. During the course of the development over several years, Minority Unitholder consistently asked for financial accounts for the trust. On each occasion he was told the project was on track to be profitable, but was not given any accounts.

41. Due to funding difficulties, contributions of funds were made to the unit trust by the Minority Unitholder at various stages during the project. No documentation was provided to make it clear whether those additional contributions were loans or equity contributions (eg receipts, loan documentation, unit certificates etc). Many of these contributions were made by cheque in the personal name of the Controlling Unitholder, rather than the trustee's name.

42. As apartments started to be completed, the Minority Unitholder continued to request financial accounts but was met with excuses each time. The Majority Unitholder continued to give verbal indications of the projected profit, but with no supporting documentation.

43. After completion of the project, the Majority Unitholder offered the Minority Unitholder a choice of taking his profit share in the form of some of the apartments, or otherwise waiting until all of the apartments were sold.

44. The Minority Unitholder agreed to a distribution of 3 of the completed apartments. Despite frequent requests, those apartments were not distributed. The Majority Unitholder did, however, distribute several apartments to himself and an associate. It turned out that the Majority Unitholder was having financing difficulties in respect of a number of other projects that he was carrying on.

45. The case did, eventually, settle but raised an issue about whether the corporate trustee should be removed on the basis that, amongst other things:

    (1) The controller of the corporate trustee was not acting in the best interests of *all* the beneficiaries by failing to honour a commitment to transfer title of 3 apartments to the Minority Unitholder, but distributing apartments to others.

    (2) The trustee had not provided the Minority Unitholder with financial accounts for the trust for many years, in breach of the duty to account. It was unclear what the financial situation of the unit trust was without that information.

    (3) The controller of the corporate trustee, when distributing apartments to himself and an associate, had a conflict of interest. He was putting his own financial interest and difficulties above those of the Minority Beneficiary.

Illustration: fiduciary duties of a trustee of an SMSF

46. An interesting question arises as to what fiduciary duties are placed upon a trustee, or a director of a corporate trustee, of a self-managed superannuation fund (**SMSF**). In order to remain an SMSF, by definition, other than for single member funds:[26]

    (1) If the trustees are individuals, each individual trustee must also be a member of the fund;
    (2) If the trustee is a corporation, each director of the corporation must also be a member of the fund.

47. A legal personal representative of a deceased member of a fund can also be a trustee or director of a corporate trustee after death until death benefits start to be payable in respect of the deceased member.

48. The issue that arises is whether a trustee (or director) of an SMSF will breach the no-conflict rule of a fiduciary relationship if they exercise a discretion or power in their own favour as a member (given that they *must* be both trustees/directors and members under the rules).

49. There is an exception to the no-conflict rule that has been recognised in *Mordecai v Mordecai* (1988) 12 NSWLR 58 where a testator or settlor, with knowledge of the facts, imposes a duty on a trustee which is inconsistent with a pre-existing interest or duty which the trustee has in another capacity. The trustee can, in that scenario, act under the trust and is not prohibited from doing so by the no-conflict rule.

50. There is United Kingdom authority, in the context of pension funds, that suggests that the no-conflict rule should not extend to a trustee of a pension fund who is also a member of the fund due to regulatory requirements.[27]

51. In *Edge v Pensions Ombudsman*,[28] the Court stated that:

    The member trustees are placed by the rules themselves in the position of conflict between interest and duty to which the Pensions Ombudsman referred. The rules require the body of trustees to include employee members. The rules contemplate that, as trustees, the employee members will from time to time have to exercise discretions in which their duty and interest may conflict. In these circumstances there is, in my judgment, no rule of equity that requires them to account for the benefits that an entirely proper exercise of discretionary powers may produce for them.

52. There is, however, no Australian authority that has considered this issue. The closest the Australian authority comes is to consider an executor's potential conflict of interest in respect of payment of a superannuation death benefit where there had been consent to the breach of fiduciary duty for a period of time: see *Brine v Carter* [2015] SASC 205.

53. In Australia, there is authority that fiduciary duties are not the same in their application to all facts and circumstances. The particular fiduciary duties are "moulded" to the context in

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[26] S 17A, *Superannuation Industry (Supervision) Act 1993*.
[27] *Edge v Pensions Ombudsman* [1998] Ch 512; [2000] Ch 602 (upheld on appeal). And see *Re Drexel Burnham Lambert UK Pension Plan* [1995] 1 WLR 32 at 40–41.
[28] [1998] Ch 512.

which they apply: see *Howard v Commissioner of Taxation* (2014) 253 CLR 83. Accordingly, the fiduciary obligations of an SMSF trustee should be moulded to the particular legislative framework that governs such trustees (i.e. the *Superannuation Industry (Supervision) Act 1993*).

54. A case that I acted in provides an illustration of how these issues can arise. The case involved a corporate trustee of an SMSF which had a husband and wife as the directors (they were also members of the fund). The husband died leaving the wife as the sole director of the corporate trustee. The wife, together with the solicitor, were the executors of the deceased estate.

55. There were substantial death benefits that needed to be distributed. Under the trust deed, the corporate trustee had discretion as to who the death benefits could be distributed to. There had been a binding death benefit nomination made several years beforehand, however, that nomination had lapsed. That lapsed nomination expressed a preference for the death benefits to be paid to the husband's estate.

56. The husband's family situation was complicated. He had many adult children from a previous marriage. He had one step-child from his current marriage who was within the class of persons to whom the death benefits could potentially be distributed.

57. The adult children of the previous marriage were concerned that the wife would distribute all the death benefits to herself, or herself and her son. They wanted the death benefits to be distributed to the estate, in which case they would benefit.

58. The wife recused herself from acting in respect of the death benefits in her capacity as executor, leaving the other solicitor-executor to act. She was, however, still a director of the corporate trustee in her own right.

59. The adult children applied to the Supreme Court for an injunction to prevent the death benefits from being distributed. They also sought various alternative forms of final relief to ensure that the wife did not make the decision about where the death benefits should be distributed (eg preventing the corporate trustee from exercising the discretion and putting the decision into the hands of an independent person). The rationale was that there was a conflict of interest as the wife, a director of the trustee, was also a member of the superannuation fund in whose favour the discretion to distribute the death benefits could be exercised.

60. At the time, the corporate trustee had not *actually* exercised the discretion, nor had the wife given any indication as to how the discretion might be exercised. Nonetheless, the adult children still obtained an injunction to prevent the discretion from being exercised. The matter squarely raises the issue as to whether a trustee of an SMSF can exercise a discretion in favour a member, notwithstanding the conflict of interest. The matter resolved so, unfortunately, the Supreme Court was not given the opportunity to provide some clarity on this issue.

61. Another interesting aspect of the case was the adult children's reliance upon the lapsed binding death benefit nomination to support their view that the death benefits should be paid to the estate. The nomination referred to the death benefits being paid "to my estate". In *Munro v Munro* [2015] QSC 61, the Court found that similar wording ("trustee of deceased

estate") was invalid. Under the relevant regulations[29], the nomination needed to specify that it was the legal personal representative or executor receiving the death benefits, or it had to name the relevant person.

Illustration: duty to act personally

62. Trustees are under a duty to exercise their powers personally. As part of this duty, trustees have a duty not to fetter their discretion.[30] A fiduciary cannot bind him or herself as to the future exercise of a discretion by an antecedent resolution or a contract with a third party or beneficiary.

63. A few examples assist in illustrating this point.

64. In *Re King* (1902) 8 Argus Law Reports 19, the trustees of a deceased estate sought an order for postponement of the sale of property referred to in a will for a period not exceeding six years. The Court declined to make the order and found that the trustees should, as far as possible, keep their discretion open and not put it for a definite period out of their power to sell the property.

65. *Re Stephenson's Settled Estates* (1906) 6 SR (NSW) 420 involved trustees entering into a lease of trust property in which it was agreed that the lessee had the option of purchasing the property for a fixed sum at any time prior to a particular fixed date. The Court held that it was a breach of trust for trustees with a power of sale of trust property to enter into a contract binding them or future trustees to sell the trust property at a future date at a price fixed in the present without the trustees, at that future date, exercising any judgment as to whether a sale at that price would be beneficial to the trust.

66. *Re Vestey's Settlement* [1950] 2 All ER 891 involved the trustees of a discretionary trust making a resolution that, until further resolution, the income of the trust would be appointed to particular beneficiaries in designated proportions. The Court held that the resolution, as an attempt to control future distributions of income, was not an effective exercise of discretion.

67. There may, however, be instances where a discretion can be exercised despite the fact that the transaction or thing covered by the discretion will not occur in the future.[31] The issue comes down to what is the proper time to exercise the discretion. If the discretion itself does not specify when it can be exercised then an exercise of interpretation must be undertaken to determine what is the proper time for exercising the discretion. A fetter for a short period of time and in reasonable circumstances is more likely to be a valid exercise of power.[32]

68. I have come across a number of situations in practice where trustees of discretionary trusts wish to make resolutions to distribute capital or income in advance, usually, in the case of blended families where there is some future event which makes it desirable to exercise a discretion in advance. Putting aside the obvious issues about whether a discretion is being

[29] Regulation 6.22, *Superannuation Industry (Supervision) Regulations 1993*.
[30] See, for example, *Watsons Bay & South Shore Ferry Co Ltd v Whitfield* (1919) 27 CLR 268 (not a trusts case).
[31] See, for example, *Thorby v Goldberg* (1964) 112 CLR 597 at 605-606.
[32] See, for example, *Rousset v Antunovich* [1963] WAR 52.

exercised in the best interests of the beneficiaries and in line with fiduciary duties, the question arises whether such an exercise of discretion will place an impermissible fetter on the discretion.

69. One example is where two trustees wish to make a resolution as to how the trust income for the *next* income year will be distributed (and there is nothing in the trust deed specifying when an income resolution must be made, other than that it must be made prior to the end of the income year). A large amount of trust income is expected to be made in a future year. The trustees' reason for wanting to make this resolution is that one of the trustees is going to pass away in the near future and a hostile beneficiary will then become the sole appointor of the trust. The hostile appointor could then remove the remaining trustee from their position and take control of the trust.

70. It is clear from *Re Vestey's Settlement* [1950] 2 All ER 891 that an open-ended resolution as to how income is distributed would be an impermissible fetter on the trustee's discretion. Less clear is whether a resolution to distribute income for a single income year would be valid if made prior to the start of that income year. It may be that, if not specified in the trust deed, the correct time for exercising a discretion to distribute income is during the relevant income year. Alternatively, in the right circumstances, there may be valid arguments in favour of an exercise of a discretion to distribute income if it only occurs a short time before the commencement of the relevant income year.

71. Another example is where a resolution is made to sell trust property and, at the same time, a resolution is made to distribute the capital from that sale when it takes place. Is the correct time for the exercise of the discretion to distribute capital after the sale has taken place, or otherwise?

Fiduciary duties and guardians

72. Often trust deeds appoint a guardian or protector to a trust. The role of a guardian is discussed subsequently in this paper.

73. In the recent case of *Blenkinsop v Herbert* [2017] WASCA 87, the Western Australian Court of Appeal considered whether a guardian's power to consent to the appointment of income and capital and the advancement of capital to beneficiaries was a fiduciary power.

74. The Court held that simply being a guardian under a trust deed does not automatically mean that the guardian is a fiduciary. Determining whether they are a fiduciary depends upon a construction of the trust deed and whether the particular power(s) are fiduciary in nature. In that particular case, the guardian did not occupy a fiduciary position as, amongst other things, they were entitled to act in their own interests in deciding whether to consent and did not have any obligation to the other objects of the trust to consider whether to grant consent.

3. Essential clauses

Defining beneficiaries and their entitlements

75. This part of the paper looks at some of the essential clauses that are commonly included in a trust deed. A consideration of every essential clause is beyond the scope of this paper. The focus is on discretionary trusts, although many of the observations are pertinent to trust deeds in general.

76. Critical to the operation of the trust is the manner in which beneficiaries are defined. For discretionary family trusts generally the trend has been to define the possible class of objects very widely to give maximum flexibility. This would usually include:

    (1) A very broad definition of the family which extended to lineal descendants and broader family members; and

    (2) Private corporations and trusts in which family members have any kind of interest, or a minimum threshold interest.

77. Flexibility must, however, be balanced against the need to give effect to the settlor's wishes. Defining the class of beneficiaries too broadly can mean that the scope of potential beneficiaries is a lot wider than envisaged by the settlor (eg a very remote relative who was not even known to the settlor may become a potential beneficiary).

78. Drafters should also consider the settlor's wishes in drafting limitations on the potential beneficiaries. For example:

    (1) If one specifically names a spouse as a beneficiary in the trust deed then that person will continue to be a spouse after divorce or ending of a de facto relationship. It may be more prudent to avoid specifically naming the person and instead simply referring to a specific person's spouse, including de facto partner. Former spouses and de facto partners could then be excluded from the class of beneficiaries.

    (2) The settlor might want to specifically exclude step-children from the potential class of beneficiaries to ensure that trust capital and income is preserved for his or her natural progeny.

79. When drafting the class of potential beneficiaries it is also important to keep in mind possible tax consequences. NSW, Queensland, South Australia, Victoria and Western Australia have now all either introduced or will be introducing foreign purchaser duty surcharges for purchases of residential property. Taking Victoria as an example, its surcharge can apply, broadly, when residential property is transferred to a foreign trust. A foreign trust is a trust in which a foreign natural person, a foreign corporation, or a trustee of another foreign trust holds a substantial interest.[33]

80. A person has a substantial interest in a trust if they have a beneficial interest of more than 50% of trust capital. For a discretionary trust, there is a deeming rule that can deem discretionary objects to have a beneficial interest in trust capital. The deeming rule will apply if a trustee has power or discretion to distribute trust capital to a particular person or member of a class of beneficiaries. In that scenario, each potential beneficiary of the power will be

[33] s 3(1), *Duties Act 2000* (Vic).

deemed to have a beneficial interest in trust capital (eg if they could receive 100% of the trust capital if the power were exercised in their favour then they would be deemed to have a 100% interest in the trust).

81. In most discretionary trusts, the trustee has a broad power to appoint capital to the beneficiaries of the trust. For deeds with such a power, there is a risk that there may be a foreign resident beneficiary of the trust who could potentially benefit from the exercise of a power to appoint trust capital (eg a distant relative who was a foreign resident). The consequence would be that the foreign resident would be deemed to have a 100% interest in the trust capital and hence a substantial interest. That would make the trust a foreign trust and, if it purchased Victorian property, the foreign purchaser duty surcharge would apply.

82. This issue can be resolved by appropriately defining the class of beneficiaries when drafting the trust deed to exclude persons treated as foreign purchasers under the duties legislation.

General powers of trustees

83. The *Trustee Acts* in each jurisdiction generally give quite wide powers to trustees.[34] Whilst it is not strictly necessary to repeat these powers in the trust deed, often drafters will include a comprehensive list of specific powers. This can alert the trustee to the powers which are available, as well as extending the powers beyond the limits of the trustee legislation.

84. Some common powers which one finds in trust deeds include (but are not limited to) powers to:

(1) Sell property by auction or otherwise;
(2) Insure property;
(3) Lease or hire property;
(4) Mortgage or otherwise encumber property;
(5) Open and operate bank and similar accounts;
(6) Give receipts;
(7) Grant and deal with negotiable instruments and other securities;
(8) Grant annuities;
(9) Borrow and lend and guarantee liabilities, including to beneficiaries and for no security;
(10) Allow beneficiaries to use land of the trust (eg to live in), including for no rent;[35]
(11) Give receipts for money or property;
(12) Delegate power;
(13) Employ persons and engage agents, including for remuneration and to take advice;
(14) Carry on business;
(15) Develop land;
(16) Accept additional sums to form part of trust property (eg gifts);
(17) To have accounts prepared and audit them;
(18) Purchase property jointly;

[34] Eg *Trustee Act 1958* (Vic).
[35] See the specific power in s 11, *Trustee Act 1958* (Vic) which permits a trustee to use trust funds for the purchase or rent of a dwelling house for a beneficiary provided it does not unfairly prejudice the interests of other beneficiaries.

(19) To deal with shares and securities (eg vote as a shareholder);
(20) Appoint custodians or nominees;
(21) Charge a fee as trustee if a professional trustee;
(22) Appropriate assets for use for any purpose;
(23) To settle litigation and give indemnities;
(24) To take advice from counsel on the interpretation of the trust deed;
(25) Provisions which allow income or capital that is owed to a minor child or other person under a legal disability to be paid, instead, to a parent or guardian;
(26) Acquire assets that do not generate an income;
(27) A general power of management or disposal of trust property.

85. One of the more important powers is the power of investment. The *Trustee Act 1958* (Vic)[36] contains a very broad power to invest trust funds in any form of investment and, at any time, vary such an investment unless expressly prohibited by the trust deed.

86. It is common practice to include a broad power of investment in the trust deed along similar lines to the legislative power. That gives trustees a very broad power to invest in different classes of assets and to vary those investments at any time. The trust deed can, however, be drafted to limit the classes of assets in which the trustee may invest (eg to exclude particular types of assets such as derivatives). A trustee generally has a duty to invest prudently so if the trust is being set up to make speculative investments there would need to be a specific power to permit that.

87. Section 8 of the *Trustee Act 1958* (Vic) requires a trustee to have regard to certain matters in exercising the power of investment (eg the desirability of diversifying trust investments). These factors can be modified in the trust deed should the settlor consider it desirable.

Powers to appoint and remove trustees and appointors/guardians

88. The Victorian *Trustee Act 1958* contains statutory powers to appoint or remove trustees. These powers can be exercised by a person nominated in the trust deed (i.e. an appointor), or if no one is nominated or willing and able to act then the surviving trustees or the personal representatives of the last surviving trustees.[37]

89. The Victorian legislation allows appointment of a replacement trustee for an old trustee who:

(1) is dead;
(2) remains out of Victoria for more than one year without having properly delegated the execution of the trust;
(3) desires to be discharged from office;
(4) refuses to act, is unfit to act, is incapable of acting or is a minor.

90. There is also statutory power to appoint an additional individual trustee.[38]

[36] See section 5.
[37] Section 41, *Trustee Act 1958* (Vic).
[38] Provided that there are not more than 3 such trustees already and no trustee company.

91. As a matter of good practice, trust deeds should provide a procedure that:

    (1) Sets out when trustees can be removed or are automatically removed (eg on bankruptcy or insolvency).
    (2) Sets out who can appoint an additional trustee, a replacement trustee or remove a trustee. This would usually be an appointor named in the trust deed (or their successor).
    (3) Specify how the procedure is carried out (eg by deed, in writing etc).

92. The statutory powers of appointment and removal can be used as a guide to drafting powers in the trust deed, with any desired modifications.

93. The identity of the trustee and the appointor is important because it can have other implications for the relevant individual. The individual may be seen as having control of the trust which can have family law implications (eg *Kennon v Spry* [2008] HCA 56); insolvency implications (eg *ASIC In the Matter of Richstar Enterprises Pty Ltd v Carey (No 6)* [2006] FCA 814) and tax consequences.

94. As well as choosing trustees, an appointor's role can be extended to giving consent to the exercise of particular powers by the trustee (eg the power to amend the trust deed).

95. Sometimes trust deeds provide for both an appointor and a guardian. This may be done, for example, to separate some of the functions and to provide additional protection to beneficiaries. For example:

    (1) An appointor might solely have the power to appoint and remove trustees and a guardian might have other functions such as approving the exercise of particular powers by the trustee;

    (2) A guardian might have some residual powers, for example, to appoint a new appointor where there is a vacancy in that office.

Trustee decision making and liability

96. Most deeds permit multiple trustees to be appointed. Under the general law, multiple trustees must act jointly and can only make decisions with unanimous consent. That makes it necessary for the deed to contain a provision to deal with trustee disputes and deadlock. For example, if there are more than 2 trustees the deed could contain a provision to permit trustee decisions to be made by a majority vote of trustees.

97. A deed can also define the scope of the trustee's right of indemnity out of the trust fund and, if appropriate, limit the scope of a trustee's liability, for example, for negligence.

Defining income and distribution of income

98. For discretionary trusts, the trustee's power to distribute income is particularly important, as is the definition of what constitutes trust income. Equally important is the role of trust distribution resolutions. The income tax consequences of trust distributions have an impact on how trust deed provisions and resolutions are drafted.

99. Beneficiaries of a trust not under a legal disability who are presently entitled to a share of the "income of the trust estate" include in their assessable income "so much of ***that share*** of the net income of the trust estate" as is attributable to a period when the beneficiary was a resident (if not a resident, then attributable to sources in Australia).[39]

100. The above assessment provision relies on two concepts to determine how much assessable income is attributable to a particular beneficiary:

(1) The income of the trust estate; and
(2) "That share" of the net income of the trust estate.

101. The "net income" is essentially the total assessable income of the trust (assuming it were a resident taxpayer) less all allowable deductions with some exceptions.[40] "Income of the trust estate", however, is not defined. This led to a debate as to whether that phrase referred to taxable income, or to trust law income. The answer to that question could affect the quantum of trust taxable income assessed to a beneficiary.

102. The High Court resolved that issue in *Commissioner of Taxation v Bamford* (2010) 240 CLR 481 (***Bamford's*** **case**) and held that:

(1) Income of the trust estate meant trust law income and that trust law income could be defined in the trust deed; and

(2) The proportionate approach to beneficiary taxation is the correct one.[41]

103. The proportionate approach means that beneficiaries are assessed on a percentage of the trust's taxable income. The percentage is determined as their percentage share of the trust law income. Assume that a trust has trust law income of $100 and taxable income (i.e. net income) of $150. Beneficiary A is presently entitled to $10 of trust income (i.e. a 10% share of trust income). Beneficiary A will therefore be assessed on 10% of the trust's net income (i.e. 10% x $150 = $15).

104. The starting point in drafting a trust deed is to define what constitutes income. It is possible to do this without being restricted to the trust law meaning of income: see *Cajkusic v Commissioner of Taxation* (2006) 155 FCR 430 and *Bamford's* case. There are a number of approaches that can be taken:

(1) Some trust deeds use the expression "income" or "net income", but do not define what the terms mean. In those cases, the terms mean income according to ordinary concepts and accounting principles.[42]

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[39] Section 97, ITAA36.
[40] Section 95, ITAA36.
[41] See also TD 2016/19 and TD 2012/22.
[42] *Bamford v Commissioner of Taxation* (2009) 176 FCR 250 at [43]; *Confidential and Commissioner of Taxation* [2012] AATA 178; *Re Ryan v Commissioner of Taxation* (2008) 72 ATR 498.

(2) The term "income" or "net income" could be specifically defined as either:

   a. Income according to ordinary concepts and accounting principles. If this approach were taken then capital gains should also be specifically included as part of the definition, otherwise they will not form part of the income of the trust estate for distribution. Although capital gains are not normally income under general trust law, it is permissible to define them as part of distributable income in the trust deed to override the general law (subject to the further comments in this paper below)[43];

   b. Net income of the trust estate within the meaning of section 95 of the ITAA36;

(3) Giving the trustee a broad power to determine the income of the trust estate with a default definition of income in the event the power is not exercised. This approach allows the trustee flexibility to determine income and, if they fail to do so, provides a back-up mechanism to automatically define income.

105. One problem with defining trust income as net income under s 95, ITAA36 is that there can be mismatches between the accounting treatment and/or cash available for distribution and the distributable income for trust purposes, for example:

(1) If a capital gain is made for which a CGT discount is available then the net capital gain included in net income under s 95 may be lower than the cash or accounting capital gain made by the trust;

(2) Exempt income which will be excluded from s 95 net income. If income is defined by reference to s 95 net income that exempt income will not be available for distribution to beneficiaries;

(3) Timing and permanent differences between accounting and tax amounts (eg amounts that are non-deductible for tax purposes, but expensed for accounting purposes);

(4) Notional income and expenses for tax purposes (eg deemed dividends) will be included in s 95 income but are only statutory fictions for tax purposes (i.e. they may not be included in accounting income or expenses and notional income will not be supported by any underlying cash available for distribution). The Commissioner has released a draft view that notional income amounts will only form part of trust distributable income to the extent that they are matched by notional expense amounts (eg deductions for depreciation which may exceed any depletion of the trust capital). The Commissioner is of the view that, to the extent that notional income exceeds notional expenses, then the excess cannot form part of trust distributable income.[44]

106. One way of dealing with such issues is to include an income equalisation clause that adjusts s 95 income to, for example, exclude notional amounts. The most common types of notional tax amounts include:

[43] See *Bamford v Commissioner of Taxation* (2009) 176 FCR 250 at [52].
[44] TR 2012/D1.

(1) Deemed dividends under Division 7A, Part III, ITAA36;
(2) Franking credits;
(3) Controlled foreign company attributable income (or other similar attributable income);
(4) Amounts included in net income pursuant to the transfer pricing rules;
(5) Amounts included in net income pursuant to the anti-avoidance rules in Part IVA, ITAA36;
(6) Amounts that are deemed to be capital gains due to the operation of the market value substitution rules.

107. Once "income" has been defined, it is also necessary to ensure that beneficiaries are presently entitled to all of the income. A beneficiary will be entitled to a share of trust income if:

(1) The beneficiary has an interest in the income which is both vested in interest and vested in possession; and
(2) The beneficiary has a present legal right to demand and receive payment of the income, whether or not the precise entitlement can be ascertained before the end of the relevant income year and whether or not the trustee has funds available for immediate payment.[45]

108. Importantly, if no beneficiary is presently entitled to all or part of the income of the trust estate then the trustee will be taxed on that income at penal rates.[46] This can give rise to problems if there is no trust income, but there is net income (i.e. taxable income of the trust). In that scenario, there will be no beneficiary presently entitled to the trust income and the trustee will be taxed on any taxable income of the trust. This type of scenario might, for example, arise where there are prior year trust losses. Where trust income is defined by reference to trust law concepts and expressly or by implication prior year trust losses need to be made good out of profits in a later year[47] then a scenario could arise where all current year trust income is set off against prior year trust losses. That could result in nil trust income, but net income which is assessed to a beneficiary. A simple way of avoiding that problem is to include a specific provision in the deed which provides that there is no requirement for past year trust losses to be recouped from future profits.[48]

109. For discretionary trusts, the deed should be drafted in a manner requiring the trustee to deal with the income each year to ensure that beneficiaries are presently entitled and the trustee is not taxed. Typically such a power would:

(1) Permit the trustee to accumulate all or part of the trust income to be added to the trust capital, or to distribute it. If income is accumulated as trust capital then the trustee will be taxed on that income;

(2) Permit the trustee to choose which beneficiaries to pay the income to and in what proportions;

[45] See *Harmer v FCT* (1991) 173 CLR 264 at 271.
[46] Sections 99 and 99A, ITAA36.
[47] See *Raftland Pty Ltd v FCT* [2008] HCA 21; ATO Decision Impact Statement (*Raftland Pty Ltd v FCT*).
[48] ATO Decision Impact Statement (*Raftland Pty Ltd v FCT*); *Gow v Forster* (1884) 26 ChD 672 at 676.

(3) Permit the income to be paid, applied or set aside (eg in the accounts of the trust), to enable the trustee to retain income to which a beneficiary is presently entitled rather than pay it out immediately;

(4) Include a clause which provides that income which is set aside for a beneficiary but is not paid will not form part of the trust capital and, instead, be held on a separate sub-trust for that beneficiary absolutely. Usually such a clause would give the trustee a power to invest or otherwise deal with or apply that sub-trust capital and income (this could be done on the same or similar terms to the principal trust). Such a clause has assumed more importance now because the ATO has taken the view that unpaid present entitlements to trust income owing to a private company can be treated as loans for the purposes of Division 7, Part III, ITAA36. If certain requirements are met this could result in a deemed dividend being included in assessable income. The ATO adopts this approach where the trustee fails to hold the funds representing the unpaid present entitlement on a separate sub-trust for the benefit of the private company beneficiary.[49] Including a sub-trust clause in the trust deed is one way of dealing with this issue.[50]

(5) Include a default distribution clause. That is, a clause which provides that in the event that the trustee does not exercise the power to accumulate or to distribute all or part of the income then the undistributed or unaccumulated income will automatically be distributed to named default beneficiaries. Often, the named primary beneficiaries will be the default beneficiaries in equal shares although the deed can, of course, name other persons as default beneficiaries. The aim of a default beneficiary clause is to ensure that there is no income that is not dealt with by the trustee and that might, for example, be taxed to the trustee even if the trustee does not wish to accumulate the income to trust capital. In drafting a power to distribute, it is important to make sure that the decision to distribute or accumulate must be made by the end of the income year. A failure to do so could result in the default distribution clause being ineffective because it would not operate until after the end of the income year as in *BRK (Bris) Pty Ltd v FCT* (2001) 46 ATR 347.

110. The trust deed is not the only key document that drafters must get right in the trust income distribution process. Equally important are the determinations or resolutions by which the trustee exercises its discretion to distribute income or to determine what constitutes income. A trust deed can prescribe the manner in which a determination or resolution *must* be made, or can be permissive, but not prescriptive of the method to use (eg a distribution resolution *may* be made in writing).

111. Where a trust deed does not prohibit particular means for making a determination or resolution then less formal means can theoretically be adopted (eg an oral resolution).[51] That method is not, however, desirable because it will not result in appropriate evidence that may be required in any future dispute with beneficiaries or third parties such as tax authorities.

[49] See TR 2010/3 and PS LA 2010/4.
[50] There are other methods of dealing with the issue set out in PS LA 2010/4.
[51] See *FCT v Vegners* (1989) 20 ATR 1645.

112. Similarly, there is some authority that the treatment of amounts in signed accounts of a trust can evidence an act of the trustee in exercising trust powers (eg in exercising a power to treat capital amounts as income): see, for example, *Clark v Inglis* [2010] 79 ATR 447. That is also not best practice for the same reason that oral resolutions are undesirable.

113. Written resolutions to record the trustee's decision are preferred for evidentiary purposes. Often this is done in minutes of the meeting of the trustees (or trustee's directors) during which the resolution is made. Where a corporate trustee is involved, any procedures for making resolutions provided for in the constitution of the company should be followed.[52]

114. It is very important to ensure that a resolution to distribute trust income is made *prior* to the end of the income year. For tax purposes, beneficiaries need to be presently entitled to the trust income during the income year and that requires a resolution prior to year end. If a resolution is made after the end of the income year it will not give the beneficiary a present entitlement as at the end of the income year.[53] That means no beneficiary will be presently entitled to that income and the trustee will be taxed on it at the penal rates (in the absence of a default distribution clause in the trust deed).

115. Under no circumstances should lawyers and accountants be advising their clients to backdate resolutions to give the appearance that they were made during the income year. Such behaviour can raise professional conduct issues for practitioners, as well as possible tax penalty and criminal consequences.

116. Usually the accounting income and tax income of the trust will not be known by year end as financial statements and tax calculations are not done until well after that time. Previously the ATO had an administrative practice where they would accept the validity of resolutions made during a limited period after the end of the income year. That practice is no longer applied in light of *Colonial First State Investments v FCT* (2011) 192 FCR 298. That can create problems if a trustee simply resolves to distribute particular amounts of income to particular beneficiaries, for example:

The trustee resolves to pay, apply or set aside the income of the trust estate for the year ended 30 June 2017 as follows:

Beneficiary A *$500*
Beneficiary B *$200*

117. In light of *Bamford's* case, the easy solution to this problem is simply to resolve that particular percentages of the total trust income be distributed to particular beneficiaries:

The trustee resolves to pay, apply or set aside the income of the trust estate for the year ended 30 June 2017 in the following proportions:

To Beneficiary A *20% of the income of the trust estate*

[52] See also s 251A, *Corporations Act 2001* (Cth) which contains requirements regarding minutes of meetings of directors.
[53] *Colonial First State Investments v FCT* (2011) 192 FCR 298 at 309.

To Beneficiary B *40% of the income of the trust estate*
To Beneficiary C *40% of the income of the trust estate*

118. Another common method for making resolutions is to distribute particular amounts to beneficiaries with the balance to go to another named beneficiary, for example:

The trustee resolves to pay, apply or set aside the income of the trust estate for the year ended 30 June 2016 in the following amounts:

The first $200 to Beneficiary A
The next $300 to Beneficiary B
The balance to Beneficiary C

119. Particular issues can arise where the Commissioner issues an amended assessment after the end of the income tax year to increase the net income of a trust. If such an amended assessment does not alter the trust income (eg because trust income is not defined by reference to net income) then the beneficiary's percentage share of trust income (and hence net income) will remain the same.

120. Where, however, the amended assessment also alters the trust income then the operation of the relevant distribution resolution can become important:

(1) Where a distribution resolution simply refers to amounts of trust income without referring to the balance of that income and there is no default distribution clause in the trust deed then no beneficiary will be presently entitled to that increased amount of trust income. That will result in the trustee being taxed on a proportion of the trust's net income (i.e. taxable income);

(2) Where the distribution resolution resolves to distribute all trust income by reference to percentages then an increase in trust income will not alter those percentages. The beneficiaries will continue to be taxed based on those percentages;

(3) Where the distribution resolution has a "balance clause" then the additional trust income, on the ATO's view, should be dealt with effectively in accordance with that clause.[54]

(4) One method by which trustees have previously attempted to deal with amended assessments is to provide that if there is an increase in trust income due to the Commissioner amending an assessment then the increase will be deemed to be distributed to a particular beneficiary. The ATO does not accept that such a clause is effective.[55] This is because the clause provides for a contingent distribution to a beneficiary. Such a contingency will prevent the beneficiary having a present entitlement to the income as at year end because the beneficiary would not have a vested interest in the income. The interest would not be vested until the contingency was met.

[54] See TD 2012/22.
[55] See TD 2012/22.

121. Solicitors can add value to accountants by properly advising them on the powers of distribution in the trust deed and on making appropriate distribution resolutions. I have seen many examples of accountants who do not understand trust law and have made trust distributions for clients without even reading the trust deed to ascertain the trustee's powers and who the appropriate beneficiaries might be. This can lead to disaster if it causes the trustee to act in breach of trust. I have given two examples of such scenarios earlier in this paper.

Powers relating to capital of the trust versus income

122. Under the general law (as with tax law), there is a distinction between trust capital and trust income. The trust deed should be drafted to include appropriate powers to give the trustee flexibility in dealing with income and capital of the trust.

123. First, the trust deed should contain a clause giving the trustee power to pay expenses out of income *or* capital. This gives the trustee flexibility to decide what funds to use to pay trust expenses without risking a breach of trust.

124. Secondly, the trust deed should contain a clause giving the trustee power to treat receipts as income or capital.

125. There is some uncertainty as to whether such a clause will be effective to treat something that is, at law, income as capital and vice versa. In *Forrest v Commissioner of Taxation* (2010) 78 ATR 417 the Court found that such a clause, in the context of the relevant trust deed, gave the trustee only an administrative power to honestly classify receipts as either income or capital according to law.

126. Importantly, however, that decision was based on the particular settlor's intention in the case determined by the context of the deed as a whole. The settlor's intention in that case was to create a fixed trust of income, not capital gains. That intention would have been defeated if the power was interpreted as an unfettered discretionary power to recharacterise income or capital. The ATO accepts that there may be other trust deeds where a power of recharacterisation would be valid.[56]

127. Further, *Forrest's* case was decided before the High Court's decision in *Bamford*. *Bamford's* case had a trust deed which included a clause empowering the trustee to determine whether any receipt was or was not to be treated as being on income or capital account. The High Court did not specifically address the question whether such a clause would be effective to recharacterise something in a different manner to how it would be treated under the general law. There are, however, some comments in the case that may suggest that such a clause in the trust deed could override the general law rules regarding apportionment between capital and income of receipts and outgoings and losses (or at least there is nothing in the decision that prevents such a conclusion).

[56] ATO Decision Impact Statement (*Forrest v Commissioner of Taxation*).

128. There are also *obiter* comments in *Clark v Inglis* (2010) 79 ATR 447 at [52] that support the proposition that an amount that is capital at law can be validly treated as income under such a power.

Streaming of income and capital

129. Trust deeds commonly contain clauses that:

(1) Permit trustees to classify and record in the accounts income and capital according to its type/source or its tax characterisations (eg franked dividends);

(2) Permit trustees to allocate expenses to income and capital based on type/source;

(3) Purport to give trustees the power to distribute income and capital to particular beneficiaries according to its type/source (eg interest income to particular beneficiaries and franked dividends to different beneficiaries).

130. This process of distributing particular types of income (or income from particular sources) to specific beneficiaries is known as streaming. Historically, streaming was permitted by the ATO on the basis of the High Court decision in *Charles v FCT* (1954) 90 CLR 598.

131. After *Bamford's* case, the ATO took the view that streaming was no longer possible. This was because of the proportionate approach taken in *Bamford's* case. The ATO's view was that, as a consequence of the proportionate approach, each beneficiary was assessable on an undissected lump sum and so streaming was not possible.

132. The ATO's view was reinforced after the decision in *FCT v Greenhatch* (2012) 203 FCR 134. In that case, the Full Federal Court was dealing with the interpretation of a particular statutory streaming provision for capital gains in s 115-215, ITAA97 when assessing trust beneficiaries on capital gains. The Full Federal Court found, in this context, that the trust assessment provision in s 97, ITAA36 included in assessable income a proportionate share of amounts having no single character (i.e. streaming of capital gains in this context was not possible).

133. The ATO now takes the view that streaming is not possible unless there are specific statutory provisions which allow it.[57]

134. Streaming clauses should, however, still be included in trust deeds for the following reasons:

(1) There are statutory provisions that allow streaming of franked dividends and capital gains (see below);

(2) There is always the possibility that further statutory provisions to permit streaming of other classes of income may be introduced in the future;

[57] ATO Decision Impact Statement (*Greenhatch v Commissioner of Taxation*).

(3) *Greenhatch's* case involved the interpretation of a specific statutory provision. The correctness of the ATO's view of the case's wider implications may not be established until there is further case law in this area.

Streaming of franked dividends and capital gains

135. Following *Bamford's* case there were statutory provisions introduced to enable trustees to stream franked dividends and capital gains. Streaming clauses are required in the trust deed to take advantage of these legislative provisions.

136. For franked dividends, these provisions notionally allocate franking credits to beneficiaries of a trust based on the entity's share of the franked distribution.[58] Franked distributions are notionally allocated between beneficiaries based on the amount that the beneficiaries are specifically entitled to. This specific entitlement, in turn, depends broadly on the beneficiary's proportionate share of the financial benefit referable to the franked distribution after the trustee allocates expenses directly relevant to that franked distribution.

137. In order for the provisions to apply:

(1) The trust deed must contain a power to stream; and
(2) An amount for that beneficiary "must be recorded in its character as referable to a franked distribution in the accounts or records of the trust no later than the end of the income year". That is, one must actually record an amount as a franked distribution allocated to a particular beneficiary by the end of the income year (usually 30 June) in order to stream franked distributions. Out of an abundance of caution, it is probably best for trust deeds to contain a specific power for this to be done.

138. There are also statutory provisions that allow the streaming of capital gains.[59] Once again, these provisions look at whether a beneficiary is specifically entitled to a capital gain. That concept, in turn, depends on their share of the net financial benefit (i.e. the financial benefit that the beneficiary has received or is reasonably expected to receive which is referable to the capital gain). As with franked distributions, an amount for a particular beneficiary "must be recorded in its character as referable to the capital gain in the trust's accounts no later than 2 months after the end of the income year" (by 31 August if the income year ends on 30 June).

Capital distribution prior to vesting – powers of advancement and appointment and powers of resettlement

139. There are various types of powers that can be included in a trust deed to either settle the existing trust property on a new trust (or a varied trust) or to distribute trust capital to the beneficiaries. The most common types of powers are:

[58] See Subdivision 207-B, ITAA97 and Division 6E, Part III, ITAA36.
[59] Subdivision 115-C, ITAA97.

(1) A power of resettlement which permits the trustee to transfer some or all of the trust property of an existing trust to be held on terms under a new and separate trust. This power could, for example, be used to create an entirely new trust. The exercise of such a power may, however, have tax consequences if the trust is resettled (see further below).

(2) A power of appointment which permits the trustee to appoint trust capital to be held for the benefit of particular beneficiaries on terms determined by the trustee. Provided that it is drafted widely, a power of appointment is flexible and can be used in different ways. It could be used to distribute capital to beneficiaries by appointing it to them absolutely, or, for example, it could be used to effectively vary terms upon which trust capital is held. Some caution must be exercised in using the power of appointment for that second purpose. There is some case law that suggests that, in the right circumstances, the exercise of a power of appointment could result in a trust resettlement: see *Oswal v Commissioner of Taxation* [2013] FCA 745; *Commissioner of State Revenue v Lam & Kym* (2004) 58 ATR 60.

(3) A power of advancement which permits the trustee to transfer trust capital/property to a beneficiary or apply it for their benefit (there are statutory powers of advancement in the *Trustee Acts* in each jurisdiction). Such a power can be used, for example, to make capital distributions to a beneficiary.

140. The above powers can often be used to achieve similar effects, however, trust deeds usually contain all three types to give maximum flexibility to trustees.

141. When exercising such powers, the mechanism by which the powers are exercised can also be important. The High Court decision in *Fischer v Nemeske Pty Ltd* [2016] HCA 11 provides a good illustration. In that case, a trust deed contained the following power of advancement:

the Trustee may from time to time exercise any one or more of the following powers....:

(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....

142. The trustee made the following resolution in exercise of the power of advancement:

RESOLVED that pursuant 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 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:-
[2 individuals] as joint tenants.

143. The key issue in the case was whether this resolution was a valid exercise of the power of advancement under the trust deed. The resolution, of course, refers to a distribution being made out of the asset revaluation reserve which is a mere accounting entry.

144. The High Court was split as to whether the resolution was effective. The majority (French CJ and Bell J in one judgment and Gageler J in a separate judgment) found that the resolution was effective. French CJ and Bell J found that the resolution and the trust accounts showed an intention for a debt to be created owing by the trustee to the beneficiaries and that was sufficient for a valid exercise of the power of advancement. Gageler J's decision was based on similar reasoning and Gageler J also held that a change in beneficial ownership of specific trust assets was not necessary for the power of advancement to be validly exercised. A trustee could exercise the power by resolving to allocate trust property unconditionally and irrevocably to the benefit of a beneficiary.

Governing law

145. The deed should specify a governing law which is the law of the jurisdiction which will govern the trust and its administration and interpretation. For example, if NSW was chosen as the governing law then one would look to its *Trustee Act* and other legislation in respect of the trust.

Vesting of the trust

146. For Victorian trusts, the trust deed must contain a vesting clause which places a limit on the life of the trust (i.e. provides that the trust fund must vest within a specified period). This is required so that the rule against perpetuities is not infringed. In Victoria, a period of up to 80 years can be specified.[60] A failure to include such a provision risks the trust granting interests which could vest outside the perpetuity period resulting in an invalid trust. The trust does, however, remain valid during a statutory "wait and see" period until it becomes established that the vesting must occur after the end of the perpetuity period.[61]

147. Greater flexibility can be provided in the trust deed by giving the trustee a power to bring forward the vesting date (this power might, for example, only be exercised with the consent of the appointor). Sometimes vesting will occur on the happening of a specified event such as the death of a particular beneficiary.

148. The trust deed must contain provisions to specify what happens with the trust fund on vesting of the trust. There are many options available. The trust deed might, for example, provide for specific property or all property to pass to particular beneficiaries or their deceased estates.

149. The more common type of vesting clause will give the trustee a power to determine who takes the trust capital. In default of the exercise of that power, the clause will provide for a priority list of takers in default of appointment. The list might, for example, specify that

[60] See s 5, *Perpetuities and Accumulations Act 1968* (Vic).
[61] s 6, *Perpetuities and Accumulations Act 1968* (Vic).

certain family members are to take in default and, if they are all deceased, that a charitable institution is to take or funds are to be used for charitable purposes by the trustee.

4. Varying trust deeds

150. When drafting a trust deed it is prudent to include a power of amendment to give flexibility to the trustee to change the deed in the future. An unfettered power of amendment would, however, give the trustee enormous power over the trust. For that reason, often powers of amendment have restrictions built into them to prevent abuse by the trustee. Common restrictions may include:

(1) Prohibitions on particular key clauses being amended (eg relating to the rights of beneficiaries);
(2) A restriction on the amendment clause itself being amended;
(3) A restriction on amendments that are prejudicial to beneficiaries' rights, or that benefit, for example, the trustee or settlor;
(4) Limitations on the categories of amendments. For example, the power of amendment might permit new powers to be given to the trustee but might not allow amendment of existing powers;
(5) Amendments requiring the consent of an appointor or guardian.

151. The manner in which a power of amendment is drafted can have real impacts on the scope of possible amendments. See, for example, *Mercanti v Mercanti* [2015] WASC 297; [2016] WASCA 206 (on appeal).

Tax consequences of amendments

152. Whenever amendments are made to a trust deed one must be cognisant of the possible income tax and stamp duty consequences. If the amendments result in the trust being resettled and a new trust being created then there can be adverse tax consequences:

(1) If an existing trust has capital gains tax assets then a resettlement could potentially trigger a capital gains tax event;[62]

(2) If the trust holds dutiable property then a trust resettlement may result in a dutiable transaction. For example, in Victoria declarations of trust over dutiable property and changes in beneficial ownership of dutiable property are dutiable transactions. A change in beneficial ownership can include dutiable property becoming the subject of a trust or ceasing to be the subject of a trust.[63]

153. In *FCT v Commercial Nominees of Australia Ltd* (1999) 43 ATR 42, it was recognised that for a trust to not be resettled there needed to be continuity of:

(1) The trust property;
(2) The beneficiaries; and

[62] See CGT Events E1 and E2: s 104-55 and s 104-60, *Income Tax Assessment Act 1997*.
[63] See s 7, *Duties Act 2000* (Vic).

(3) The constitution of the trust (eg trust deed).

154. The decision of *Commissioner of Taxation v Clark* (2011) 79 ATR 550 appears to have narrowed the situations in which an amendment of a trust deed may result in a resettlement of the trust. In light of that case, one must look at whether the trust continues in existence. If the trust deed contains a power of amendment and that power is validly exercised then, so long as there is *some* degree of continuity of trust property, trust membership and the regime of trust obligations (eg the trust deed) that will be sufficient. *Clark's* case must, however, be treated with some caution because it was dealing with the specific context of trust tax loss recoupment. Whilst the case probably does have broader implications for trust resettlements, there is still some risk regarding its broader scope.

Absence of a power of amendment in the trust deed

155. In the absence of a power of amendment in the trust deed, it is still possible to amend with Court approval. Section 63 of the *Trustee Act 1958* (Vic) can be used for that purpose (in certain circumstances Rule 54.02 of the *Supreme Court (General Civil Procedure) Rules 2015* may also be useful).

156. Section 63 has been discussed earlier in this paper.

157. Where there is no power of amendment in the trust deed then section 63 permits the Court to approve a proposed amendment if the prerequisites are met. Importantly, the Court will only do so where "expedient". The author, for example, has run a successful Supreme Court application based on s 63 to replace inadequate provisions of a charitable will trust with a comprehensive trust deed. There are many other examples of Courts accepting that the replacement of a trust deed of a charitable trust with a model deed that meets tax requirements can be a "transaction" that is expedient in the "management or administration" of trust property within the meaning of s 63(1) of the *Trustee Act 1958*.[64]

Administrative changes to the trust deed

158. For discretionary trusts, it is common to include a specific power for the trustee to add beneficiaries or classes of beneficiaries. This provides flexibility but can be a dangerous power if unchecked because it could be used to channel funds to persons who were not in the contemplation of the settlor (eg where a split in a family occurs). Restrictions can be placed on such a power by, for example, requiring the consent of an appointor or guardian for its exercise. It is not always necessary to have a specific power to add beneficiaries to achieve that result. A general power of amendment can be used to add beneficiaries, but only if drafted in a sufficiently broad manner: see *Kearns v Hill* (1990) 21 NSWLR 107.

[64] *Ballard v Attorney-General for Victoria* [2010] VSC 525 at [33]; *James N Kirby Foundation Ltd v Attorney-General (NSW)* (2004) 62 NSWLR 276 at 280[14]-[17] referring to the equivalent NSW provision to s 63 and see *Re Bowmil Nominees Pty Ltd* [2004] NSWSC 161 at [15]-[16] and *Hornsby v Playoust* (2005) 11 VR 522 at 526[16] referring with approval to *Kirby's* case; *Royal Hutchinson & Ors v Attorney-General for the State of Victoria* [2009] VSC 551 at [7]-[9].

159. Discretionary trusts often include a power for the trustee to exclude persons as beneficiaries. Strictly speaking a trustee can effectively exclude a person as a beneficiary anyway by not exercising their discretion to distribute to the person. There may, however, be other circumstances in which such a power is useful to exclude persons entirely from being beneficiaries. For example, to exclude foreign beneficiaries in the context of the Victorian foreign purchaser duty surcharge.

160. The Commissioner of Taxation generally accepts that the addition of beneficiaries to a class of beneficiaries of a discretionary trust, or the exclusion of beneficiaries, pursuant to a valid exercise of a power to amend a trust deed will not result in a trust resettlement.[65]

161. Similarly, mere changes to a trust deed's administrative powers or procedural provisions would not, generally, result in a resettlement of the trust.

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[65] See *TD 2012/21*.