WILLS & ESTATES BULLETIN – ISSUE #5

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Inside this issue:

Beneficiary "controlled" testamentary trust or beneficiary "caged" testamentary trust?

Background

1. Most lawyers practicing in estate planning can provide their clients with a testamentary trust will. That is, a will whereby beneficiaries do not receive their inheritance directly, but, instead receive through a discretionary trust structure. The benefits of testamentary trusts are well known and include:

   (1) taxation advantages through being able to split income between beneficiaries and thereby take advantage of each beneficiary's marginal taxation rate. Further, beneficiaries who are minors can receive trust income and be taxed as adults instead of being taxed as the highest marginal rate after the first $416 of income as usual for a family trust;

   (2) a properly drafted discretionary trust provides significant asset protection for the primary beneficiary. In the event of the primary beneficiary's bankruptcy, the assets of the trust ought to be retained by the trust and not be available to the trustee-in-bankruptcy or their creditors; and

   (3) estate planning and succession advantages.

2. Whilst the drafting and design of discretionary trusts can come in all the colours of the rainbow, the control and benefit structure of the trust necessarily comes down somewhere on the spectrum of what we call, the "*beneficiary controlled testamentary trust*" or the "*third party controlled testamentary trust*".

3. The inflammatory title of this article demonstrates the potential disadvantage of a testamentary trust controlled by someone other than the primary beneficiary.

Beneficiary controlled testamentary trust

4. A beneficiary controlled testamentary trust is designed to be a structure which allows the primary beneficiary full control and enjoyment of their inheritance. They are to have full control over their inheritance, yet still enjoy the asset protection (see comments on family law below), taxation and succession planning advantages of the trust.

5. The concept is that the beneficiary controlled testamentary trust is used in place of giving the inheritance directly to the children. You are not trying to "raise your hand from the grave" and limit your children's enjoyment of their inheritance. It does not protect them from their own bad decisions. It merely gives them the best possible framework for them to enjoy what would have been theirs absolutely, if the will-maker hadn't chosen the beneficiary controlled testamentary trust.

Control structure of the beneficiary controlled testamentary trust

6. The desire for freedom of choice by the primary beneficiary is reflected in the control structure for the beneficiary controlled testamentary trust. Generally speaking, the

primary beneficiary will also be trustee (or controller of the trustee if the trustee is a company as shareholder and director) and will be the sole appointor during their life. They will also have the ability to choose who they want to control the trust after their own death or incapacity. This is not set by the will-maker but, instead, is left to the discretion of the beneficiary on the understanding that this inheritance has been handed over to them and they can leave the control of it to their spouse or their children as they see fit in their own will.

7. Naturally even beneficiary controlled testamentary trusts need to be designed to allow control to pass to the beneficiary when the beneficiary is of the appropriate age and maturity to receive control. For example, they may have co-control with another older, wiser head until they reach an age of 25, 30 or such other age as the will-maker thinks appropriate, at which time they can receive sole control of their inheritance.

3rd party controlled testamentary trust

8. The other end of the spectrum brings us to testamentary trusts which have a large degree of control removed from the beneficiary and placed in the hands of other persons. The lifeless pages of a will cannot control the trust and hence the will-maker must choose individuals to have that responsibility placed on them in preference to their own children.

9. The will-maker typically appoints a third party, i.e. an uncle or aunt, an accountant, lawyer or other person, to be that controller. Sometimes this is done by way of appointing a company established by a professional firm, whose directors are the principals of that firm, to be the appointors of the trust.

10. This means in practice that the beneficiaries may not be able to, except with the consent of the third party:

    (1) withdraw capital from the trust;

    (2) declare distributions of income;

    (3) appoint a new trustee or appoint new beneficiaries; or

    (4) appoint a successor controller after their death or incapacity.

11. These tight control regimes are appropriate in particular circumstances where there is an imminent risk of attack by another party against the inheritance. That attack may come from:

    (1) a spouse or de facto of the beneficiary; or

    (2) the beneficiary's creditors.

12. There are of course structures which walk a middle path, allowing the beneficiary some control but with restrictions on particular matters. This allows for structures to be designed with the unique circumstances of the family and the assets in mind.

13. Where there is no real risk of attack on the trust a third party controlled testamentary trust (compared to a beneficiary controlled testamentary trust) will merely be a costly obstacle to beneficiaries enjoying their inheritance.

Risks of third party controlled trusts

14. Without wanting to seem alarmist, the risks are:

    (1) fraud;

    (2) mismanagement;

    (3) dispute; and

    (4) delay.

15. Once control of a testamentary trust is taken away from your child, it is not easily returned to them if necessary. This makes the choice of who that third party is as controller, critical. Ideally if there is a third party controller, they should have a co-controller with them to reduce the risk of fraud or mere mismanagement of a child's inheritance.

16. It must be remembered that, for private trusts, there is no audit regime, there is no regulator and taxation and financial statements are all self-prepared and self-assessed. This means that when the controller of a trust does the wrong thing or mismanages trust property, it can be years before the beneficiary finds out and at this time the horse is likely to have bolted in terms of recovering the funds.

17. We have seen some egregious examples where third party controllers (not professional firms) have either mismanaged or misappropriated moneys (and it is often difficult to tell when there are very few records and information is not forthcoming as to whether diminution in trust property was caused by mismanagement or misappropriation) leaving the beneficiary with very little chance of recovering their inheritance.

18. When a child does not have control of their inheritance there will almost certainly be dispute between them and the controller. The child will be resentful at having to approach someone else cap in hand to receive what they consider to be rightfully theirs (despite not having earned it!). This quickly leads to litigation and cost.

19. Lastly when managing a trust for another person, without pay, there is little incentive to manage it comprehensively and in a timely fashion. This risks financial and taxation affairs being attended to with inappropriate delay.

20. When the controller is a professional it is likely it will be done on time, but with associated professional costs.

21. The primary advantage of a third party controlled testamentary trust (compared to a beneficiary controlled testamentary trust) is that children have less control of the trust and thus have a reduced ability to lose their inheritance through their own poor management or wastefulness. This advantage must be considered in light of the potential disadvantages.

Family law

22. A full discussion of how testamentary trusts can attempt to protect a child's inheritance from an attack by their spouse on separation is beyond the scope of this article. At the risk of severely over-simplifying matters, generally speaking, where a beneficiary of a testamentary discretionary trust:

    (1) is the sole primary beneficiary; or

    (2) has control of the trust; or

    (3) is the only person to have received distributions from the trust during the life of the trust;

    the Family Court is highly likely to treat it as a financial resource of the beneficiary when considering what an appropriate division of property between the beneficiary and their former spouse might be. It is also possible (depending upon the finer detail of the circumstances) that the Family Court will be able to make an order over the asset if they thought it necessary to create a just and equitable outcome.

23. If, however, none of the foregoing applies, it may be possible that the beneficiary can convince the Family Court that the testamentary trust is not their financial resource and no order should be made over its assets. However, if the beneficiary's interest in that testamentary trust is so diminished you begin to wonder whether they received an inheritance at all.

Vulnerable beneficiaries

24. Beneficiary controlled testamentary trusts are not appropriate when beneficiaries have vulnerabilities that mean there is a risk their inheritance will not be enjoyed by them if they are in sole control of it. This may be, for example, if the child has an unhealthy addiction or a debilitating mental illness or is highly susceptible to the influence of other parties who do not have their best interests at heart.

25. In these circumstances the same overall testamentary trust is a useful inheritance vehicle, with appropriate control measures in place (i.e. a third party controlled testamentary trust), to allow you to provide for your vulnerable child in a secure way.

Our view

26. Each family and their estate plan must be considered on its merits and it cannot be said that a beneficiary controlled testamentary trust or a third party controlled testamentary trust is preferable or more competent than the other. Each has a valuable role for particular families.

27. We recommend that will-makers carefully consider third party controlled testamentary trusts and employ them after consideration as to how they will work in practice; what it means for the beneficiaries.

28. If the will-maker wants to leave an inheritance to their child in a superior structure, but does not want to limit that child's ability to control their own destiny, we recommend a beneficiary controlled testamentary trust.

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Bare Paternity and contesting a will

What is "bare paternity"?

1. Bare paternity is the term that the Courts use to describe a situation where the only relationship that a father has with their child is to contribute to their conception (but does not include sperm donors). After the birth of the child the father has no meaningful contact or relationship with the child.

2. Bare maternity would the same situation but with the mother replacing the father. The principles from a legal perspective would remain the same, but in this area of law most cases involve bare paternity, in fact I cannot recall a bare maternity case in NSW at all. What that says about our society is probably best left to another day.

Bare paternity in Family Provision Claims

3. The first hurdle in bringing a claim for provision from a deceased estate is to show the Plaintiff is within a category of "eligible person".

4. There are a few classes of eligible persons, but a child is clearly set out as one. A "child" does not include step-children, which is why blended families produce their own unique issues from an estate planning perspective – something for another article or series of articles.

5. Accordingly, a claim from a child, even where they had no relationship whatsoever with their deceased parent, easily clears the first hurdle.

6. The next hurdle is to show that the child did not receive "adequate" provision for their "proper" maintenance, education and advancement in life. In determining this, the Courts are provided with an extensive list of factors to take into account, including the nature and duration of the relationship between the child and the deceased.

7. Cases of bare paternity provide an awkward set of circumstances for the Court. Society expects a parent to look after their child until they're no longer a minor, assist tertiary education and mabye give them a start in life via a house deposit (at least that's what the Courts think is the "community standard"!)

8. But what are the community standards where the parent may not have even met their child?

9. Since the 1980s**,** the Courts have struggled to deal with cases of this nature and there were some conflicting decisions about whether there was a moral duty from the deceased to make provision for a child that they had no contact with. In 2007 there was a decision in the Court of Appeal in NSW (*Nicholls v Hall*) which has provided a

clear indication that the Courts are willing to make provision from a deceased estate even where there was no relationship between the deceased and the child.

10. As you will appreciate, disinheriting any child is inherently fraught. There are some estate planning strategies to overcome these issues but they are not without their own issues and concerns.

The latest case - Kohari v NSW Trustee & Guardian

11. This case involved a claim by a 39-year-old man, Robert Kohari, on his late father's Estate.

12. His father, Paul Kohari, died at age 67, leaving behind an Estate worth about $1M.

13. Paul Kohari was also survived a long-time de facto spouse, Julia, which for the purposes of the litigation was treated as if they had been married in accordance with the existing precedent.

14. Paul left his entire estate to Julia in his will.

15. Robert had not seen Paul since he was 18 months old and had no memory of him. Apart from writing a letter to Paul, which was marked "return to sender", Robert had not made any real attempt to form a relationship with his father and did not even attend his funeral or make any enquiries as to where it was going to be held.

16. Paul had always maintained that Robert was not his child and had even told his own parents that this was the case. When Paul's own mother passed away, she left her estate to be divided between her "grandchildren" – which notably did not list Robert as being one of those persons.

17. It is also worth noting, that Paul made a claim (successfully) on his own Mother's estate as a result of her gift above.

18. Robert made a claim on the Paul's estate as a child, fitting the appropriate category of a child of the deceased – although this was initially disputed by Julia (in line with Paul's assertions) and it was not until the Court ordered a paternity test that the issue was laid to rest.

19. Despite the practically non-existent relationship between Paul and Robert, the Court ultimately made an order that $100,000 be paid to Robert from the Estate.

Importance of Need

20. Robert had not worked in a paid capacity since his early 20s. The Court was not impressed by his excuses for this, but accepted that he relied on Centrelink benefits and had very little to his name apart from a $1,000 motor vehicle. He had four children with his wife and they lived in rented premises on the outskirts of Sydney.

21. In addition to his limited financial means, Robert suffered from health issues as a consequence of his obesity. His wife was also obese and suffering from health complications as well.

22. Obviously, Robert had financial need. This is crucial to any claim for provision.

23. The testamentary intentions of Paul were important, but as with other cases of this nature it is not determinative. Paul had clearly not wanted to make any provision to Robert, and the notes from the lawyer that drafted the will showed that he had considered that Robert had been provided for in the property settlement he had with Robert's mother in the 1980s.

24. The Courts are not always willing to take from a long-term spouse and give to adult children, and usually try to ensure that a wife or long-term de facto will be able to live a life to which they are accustomed (if the size of the estate permits).

25. It is relevant to note that as Robert was not a child of Julia, he would not have had any claim to her estate. This case would have been treated very differently if Robert was Julia's child and he would have retained the possibility of making a claim on her estate upon her death.

26. Paul's estate, although not extensive was still sizeable enough to ensure that his de facto spouse (Julia) could receive an adequate amount even if some provision was made for Robert.

27. The Court decided that Robert would not be entitled to an amount to purchase a house outright in the circumstances, but an amount for a house deposit would be reasonable. In deciding that $100,000 was the appropriate figure, the Court considered the Estate of Paul's mother, which would have given Robert about $90,000 if Paul had acknowledged to his parents that Robert was in fact his son.

Lessons

28. What can we learn from this latest decision?

    (1) Disinheriting a child is always fraught, no matter how minimal the relationship is that exists;

    (2) Need is crucial, even if it is self-inflicted to a (large) extent;

    (3) The costs of taking this matter to a trial would have likely been much more than the amount ordered. Taking a commercial approach to settlement of litigation is lower risk and often provides better financial outcomes.

29. How can will-makers avoid these types of claims? There are strategies for minimising the success of claims. From gift and loan-back arrangements, to transferring control and ownership of assets there are options available. But specialist advice should always be sought as saving a few thousand in legal costs whilst you are alive does not make sense if it results in legal costs of $250,000 or more in litigation when you pass away, not to mention the stress and anxiety for the loved ones left behind.

Richard Morris

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Our Estate Planning Team

Cameron Cowley

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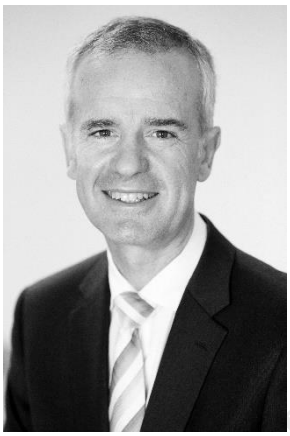
- Testamentary trusts
- Trusts
- Superannuation including SMSFs
- SMSF nominations
- Taxation issues of estate planning
- Deeds of family arrangement
- Corporate succession



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- Powers of Attorney
- Appointment of Enduring Guardians
- NCAT Reviews
- Farm succession
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- Corporate succession
- Aged Care Law
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