WILLS & ESTATES BULLETIN – ISSUE #16

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Inside this issue:

The use of corporate appointors in 2nd generation family trusts

Background

1. The appointor (sometimes called principal) of a family trust has the power to appoint and dismiss the trustee. The appointor is the ultimate controller of the family trust.

2. The appointor rarely has substantial other powers within a family trust and as such is only occasionally involved in trust management. This is generally if the family trust is being restructured for corporate, business, taxation purposes or for succession planning for generational change.

3. This article explores the concept of expanding the role of the appointors within a family trust and utilising a corporate structure for that appointor, particularly with respect to 2nd or 3rd generation family trusts.

Why use a corporate appointor?

4. Typically, a family trust does not require a corporate appointor. The usual advantages of a body corporate when using them as a trustee or a business structure are not required for the role of appointor. Those advantages might be summarised as:

   (1) perpetuity (provided the company is not inadvertently deregistered!); and

   (2) asset protection for the shareholders and directors of the company.

   Practically, these advantages are unnecessary if the only purpose and activity of the appointor is to hire and fire the trustee once every couple of decades. The appointor does not trade, does not own property and has no liabilities in its role.

5. The ability to use corporate decision-making processes is the key feature of an appointor structured as a body corporate. This can have practical benefits in the administration of a family trust for the 2nd or 3rd generation of the family when there are more people involved than just Mum and Dad.

6. If the appointor has broader scope of responsibility and takes on guardianship responsibilities as well within the trust, then the arrangement changes. In that instance a corporate appointor is certainly the best structure. In essence, the use of a corporate appointor/gurardian will allow for the structural separation of operational managers and what becomes the board for the family group. The directors of the trustee are effectively the executive, and then the directors of the corporate appointor are the board. In this situation the trustee is obliged to report to the appointor/guardian and seek the consent of the board of the corporate appointor/guardian for a variety of matters (as thought appropriate in the circumstances) which could include such things as:

   (1) annual distributions of income;

   (2) distributions of capital;

   (3) loans to beneficiaries;

   (4) addition or removal of beneficiaries;

(5) decision to change major trust assets;

(6) buying a business or winding up the trust;

(7) appointment of new beneficiaries; and

(8) variations of the trust deed.

7. In this way the family members who are not involved in the day-to-day running of the business, but effectively have a notional ownership in the family business, can supervise the family business through their role as one of the board of the corporate appointor/guardian.

8. The arrangement is usually tied together with a single guiding document called a "family constitution".

9. The directors of the trustee have a much more hands-on role in the business and would therefore need to be remunerated appropriately. Whilst every family is different, some families decide that those directors, because they have sometimes a fulltime role in the business, would receive a salary and perhaps slightly higher distributions in the family generally.

10. The most difficult aspect of a family arrangement such as this is working out how to deal with someone exiting the business and family law events. There is also the issue as to whether family members are entitled to compete with the family business and use what might be considered family intellectual property (such as long-standing customer relationships) in their own personal business. Usually this is prohibited in the deed as it is considered to be family property rather than the property of any one individual.

11. A family agreement or family constitution must be prepared in a way which does not inadvertently constitute a variation of the trust. Such a variation could have stamp duty or capital gains tax consequences (**CGT**) (although CGT consequences are less likely).

12. In the case of *Dagenmont*[1], a written agreement by a trustee of a discretionary trust to pay a particular amount of income to a certain beneficiary in future years was held not to be a fetter on the exercise of discretion by the trustee but instead a variation of the trust deed. This variation effectively varied the trustee's powers as to future income and was binding on the parties.

13. Typically the situation in *Dagenmont* would want to be avoided. Therefore, the family agreement would set out a process for coming to decisions on distributions e.g. decisions the trustee may make by itself and what decisions need to be approved by the board of the corporate appointor.

14. The use of corporate appointors and family constitutions is on the rise in New South Wales for 2nd and 3rd generation family businesses.

[1] *Dagenmont Pty Ltd -v- Lugton* [2007] QSC 272

Gift and loan-back strategy – interesting comments by the Supreme Court of Queensland

Re Permewan [2021] QSC 151

1. The gift and loan-back-strategy is widely employed in estate planning and asset protection scenarios. The essence of the strategy is as follows:

   (1) The principal (who wishes to protect their assets) gifts a substantial sum, equivalent to the net value of the asset they are trying to protect to a safe entity; typically a discretionary trust established just for this purpose.

   (2) The gift is sometimes cash-flowed and is sometimes made by way of a promissory note or cheque.

   (3) Contemporaneously with the gift, the safe entity lends the value of the gift back by loan agreement.

   (4) The safe entity takes security over the principal's assets by way of a mortgage over real property or PPSR security interest over personal property in order to protect its position as lender.

   (5) The outcome is the principal has retained their assets, but now has net equity of $0 and has a secured debt to the safe entity which they control. This reduces the likelihood of claim against the principal.

2. There have always been detractors of the gift and loan-back strategy. It has been described as a "sham" or a "legal fiction" concocted by persons who wish to obtain the asset protection features of giving away their property without actually giving away their property. This is an unconsidered and uninformed view of the arrangement. Case law is quite clear that this arrangement could not be described as a sham or legal fiction and does not have any of the essential characteristics of those arrangements. Shams and legal fictions are arrangements where the parties never intended them to be legally binding. It is quite clear that the parties to a gift and loan-back strategy intended the arrangement to be binding.

3. The detractors next attack the gift by saying that it is not effective at law because value is not truly passed to the safe entity. Such criticism is certainly not valid if the gift is cash-flowed. At times it is appropriate for the principal to borrow the funds from an external source, cashflow the gift, receive the loan back, and then repay the external party.

4. The use of promissory notes to transfer the value of the gift to the safe entity is open to more criticism because promissory notes are an ancient legal and financial instrument and are not well understood. Our view and the view shared by practitioners who endorse the strategy, is that the use of a promissory note is perfectly enforceable as a means of transferring value. Promissory notes have a very long history and case law attests to their effectiveness. Of course it is important that arrangements comply with the Commonwealth *Bills of Exchange Act 1909* which regulates the use of promissory notes in Australia. There is no set form of a promissory note but there are some essential characteristics[2]; namely:

[2] Section 89

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(1) A promissory note is an unconditional promise in writing made by one person to another, signed by the maker, engaging to pay, on demand or at a fixed or determinable future time, a sum certain in money to or to the order of a specified person, or to the bearer.

5. The statutory rules for a promissory note are:

(1) The promissory note must be endorsed by its maker.

(2) A promissory note must be delivered to the payee or to the bearer.

(3) The note must be presented for payment within a reasonable time of the endorsement.

Atia -v- Nusbaum

6. The gift and loan back strategy was considered in the Supreme Court of Queensland in the case of *Atia -v- Nusbaum* [2011] QSC 44. In this case the plaintiff had entered into a gift and loan-back strategy with his mother. The Supreme Court examined the strategy in detail. In that situation the security was a registered mortgage. The plaintiff pleaded that the arrangement was a sham and that he had not intended to be legally bound by it when he entered into the strategy.

7. The Supreme Court was not convinced and found it was binding. It is notable that the Court made no adverse comments about the fact that the strategy was quite plainly set up for asset protection purposes.[3]

Bankruptcy Act

8. One vulnerability of the strategy relates to claw-back periods under the *Bankruptcy Act*. The principal who makes the gift is entering into a transaction which is subject to the claw-back periods under the *Bankruptcy Act*. Section 120 provides that a transfer to a related party for less than market value is subject to being clawed back for a period of 4 years after the date of transfer if the transferor becomes a bankrupt. Therefore, the gift and loan-back strategy is subject to the principal remaining solvent for a period of 4 years.

9. Section 121 of the *Bankruptcy Act* provides that a transfer of property by a person who later becomes bankrupt is void against the trustee-in-bankruptcy if the main purpose in making the transfer was to prevent, hinder or delay the property becoming payable to their creditors. There is no time limit to how far back in time the trustee-in-bankruptcy can seek to have a transaction overturned under this section. Therefore, if a gift and loan-back strategy is undertaken with a particular debt or creditor in mind that the principal is trying to defeat, then it is likely that the transaction is susceptible to being undone by the trustee-in-bankruptcy if the principal later becomes bankrupt. Therefore, once someone has received a claim from a particular creditor, and at that time the person's solvency is dubious, attempting to avoid the debt by entering into a gift and loan-back strategy may not be effective, even if it is some years later that the creditor finally seeks to enforce the debt.

[3] The amounts given and lent in this arrangement appear to have been cash-flowed rather than by use of a promissory note.

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10. The situation is different where the principal undertakes the strategy having no reasonable expectations of becoming insolvent or a bankrupt in the foreseeable future. In such a case, the gift and loan-back strategy is not being entered into for the purpose of defeating any particular creditor but instead is being entered into as prudent asset protection arrangements. It is akin to paying dividends out of a company regularly to ensure that if a claim ever comes against the company in future, the losses are limited to what is in the company at that date.

11. The Courts have recognised that parties are able to undertake prudent asset structuring and estate planning in order to provide asset protection for themselves in the event they later become a bankrupt. This is permissible and, indeed, advisable. The issue only arises if someone does so with a particular claim in mind they wish to defeat.

Permewan

12. Turning to the comments made by the Supreme Court in *Permewan*, in this case Prudence Permewan entered into a gift and loan-back strategy. Part of that strategy was a promissory note in the amount of $3M payable to its bearer.

13. A company of which Ms Permewan was director, Zalerina Pty Ltd, signed receipt of the note as trustee for the Lotus Trust. Zalerina Pty Ltd lent the money back to Ms Permewan on the same day by a loan agreement. The loan was secured by a mortgage over real property and security interest over shares.

14. The first thing to note is that the parties alleged that the promissory note did not meet the definition of the *Bills of Exchange Act*. We recommend that when using promissory notes they meet the *Bills of Exchange Act* definition.

15. The Court described the arrangement as "*an elaborate web of documents*" with "*no commercial purpose but were designed only to avoid the existence of a fund from which a family provision application could be made*"[4]. These comments do not inspire confidence that the Court will take an impartial view of the arrangement. In discussions with Counsel, his Honour emphasized that the executor, at least arguably, had an obligation to consider attempting to set aside the gift and loan-back strategy which had been made by the deceased.

16. The Court did not have cause to consider whether the strategy was effective or not, and was instead commenting on it in the context of an application for removal of an executor of the estate, who had an interest in the strategy being upheld.

17. Despite the obviously adverse comments by Davis J, the decision is not a precedent for the enforceability or otherwise of the gift and loan-back strategy. However, it will be interesting to see if litigation continues and the Court is required to make any final decision on the strategy.

18. Our view remains that the strategy is valid and enforceable. The *Bankruptcy Act* will not apply in the case of a family provision claim in any event because the trustee-in-bankruptcy is not involved. There is no creditor at the table; it is instead a child, or other relative, making an application for provision out of an estate which is not bankrupt but instead has modest assets.

[4] At paragraph 43

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19. We recommend now, as we always have, that the gift in the gift and loan-back strategy be cash-flowed wherever possible as it removes the perhaps slightly weaker link of the promissory note.

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The High Court rules limitation periods may be waived - relevance for family loans

Price -v- Spoor [2021] HCA 20

Background

20. In this case the High Court ruled that a person can waive their right to a statutory limitation period.

Facts

21. A borrower had granted a mortgage in 1998 to be repaid in the year 2000. The mortgage was not repaid and in 2017 the mortgagee brought an action for possession of the mortgaged properties and repayment of the loan and damages. The mortgage document included a term that provided that the borrower would not try to rely on any statutory limitation period defence.

22. In New South Wales a loan is ordinarily statute barred 6 years after the cause of action arose for the lender to have the loan enforced (usually being the repayment date). There is a further limitation period of 12 years in relation to a transaction effected by a deed, or proceedings for the recovery of possession of land.

23. The Court refused to allow the mortgagor to rely on the usual 6 year limitation period for the loan and mortgage, and held that it is valid for parties to a contract to waive their rights to statutory limitation periods.

How does this affect succession planning?

24. It is common in succession planning for long term loans to be entered into. These are usually loans from the bank of Mum & Dad to one of their children. The loan might be for say 20 years and the parties enter into the loan expecting that it probably won't be repaid and in fact their will might forgive the loan. They enter into the loan for asset protection purposes, so that if the child becomes bankrupt or has a separation from their spouse, the parents can then reclaim the money lent to the child.

25. The problem has often arisen when the parents attempt to enforce their loan when a particular crisis arises affecting their child. Mum and dad find that the loan is statute barred because 6 years has elapsed since the repayment date. This was more of a problem in times gone by when many family loans were repayable on demand and did not have another repayment date at all, meaning the 6 year limitation period commenced on the day the loan was advanced. Modern practice has almost extinguished the use of loans repayable on demand for this very reason and instead long term repayment dates are included, say a 20 or 30 year loan timeframe. Making the loan a long term loan means that the statute of limitations does not begin to run until that 20 year period has expired.

26. However, now we know that a child can waive their right to a statute of limitations applying. Therefore we expect that all loan agreements from the bank of Mum & Dad will now include a term whereby the child agrees not to enforce any defence for the recovery of money under the loan which relies on a limitation period.

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27. It has yet to be seen whether all commercial contracts will now include this waiver of the statute of limitations by all parties to the agreement. There are good policy reasons why the statute of limitations was adopted by Parliament.

28. In relation to consumer contracts, there has already been commentary that it is unlikely a contract between a corporation and a consumer could properly include a waiver of limitation periods. This is because the unfair term provisions of the Australian Consumer Law prevent the enforcement of a term in a standard form contract with the consumer where that term is unfair.

Cameron Cowley

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