WILLS & ESTATES BULLETIN – ISSUE #4

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Testamentary capacity and complex wills

1. The Supreme Court of New South Wales in the case of *MacArthur-Onslow v MacArthur-Onslow [2016] NSW SC 1831* was asked to decide on the validity of a complex will. The testator controlled significant wealth and much of that wealth was held by companies owned and controlled by her.

2. The complexity of her business and personal affairs had led her to having a complex will in order to properly deal with her various assets and interests. This is increasingly common.

3. The will itself was not impugned in the judgement. The issue was Lady Mcarthur-Onslow's capacity when she executed the will.

4. At the time of executing her will in 2004 she had dementia and alzheimers and had been regularly seeing a specialist neurologist since from 2002. It appears from the judgement that Lady Mcarthur-Onslow's solicitor was keenly aware of the steps necessary to demonstrate her capacity, and had advised her neurologist of this. The neurologist provided six monthly reports on her health which included express consideration of her testamentary capacity.

5. As a practitioner if I was able to persuade clients to have such regularly specialist and contemporaneous assessments of their testamentary capacity, I would be delighted. When testamentary capacity is alleged after death, frequently there is a dearth of contemporaneous relevant medical evidence. To have contemporaneous specialist medical capacity assessments, with an eye to testamentary capacity puts those trying to uphold the deceased's will in the strongest possible position.

6. The consistent assessment of the neurologist throughout the time leading up to and the approximate same time of Lady Mcarthur-Onslow entering into her will, was that despite her having some capacity challenges, the neurologist was confident that Lady Mcarthur-Onslow had testamentary capacity, with good knowledge and understanding of her family and her assets.

7. The neurologist's reports even appear to have been written with *Banks v Goodfellow* (the classic case on testamentary capacity) in mind.

Solicitor's evidence

8. The Court had significant evidence from the solicitor who prepared Lady Mcarthur-Onslow's will. The Court accepted that solicitor's evidence that he went through the entire will carefully with her at the time of her signing it and that she appeared to understand it and approve it.

9. Lady Mcarthur-Onslow's previous will from 1998 had divided the estate almost equally between her two children.

10. The effect of the current will was that there was not equality between her children. Instead one of her children, being Mr Mcarthur-Onslow was preferred because he obtained control of a discretionary trust which held substantial assets within the overall estate. In controlling that trust it was possible for him to prefer himself rather than his sister as to how income and capital of the trust were to be distributed. Therefore his sister had no guarantee of equality under Lady Mcarthur-Onslow's will, when the overall estate was considered i.e. including assets not owned by Lady Mcarthur-Onslow, but also by related trusts and companies.

11. An application was bought to Court by Mr Mcarthur-Onslow's sister, that part of the will which was disputed be severed and the remainder of the will be upheld.

Other evidence

12. There was other evidence produced and accepted by the Court, that Lady Mcarthur-Onslow had a general intention to treat her children equally. Her solicitor's evidence was that whilst she wanted her children to be treated equally she accepted that in order to prevent deadlock she must give control to one of her children only and that child was to be her son rather than her daughter. She then apparently accepted the risk that he would prefer himself to his sister when making distributions from that discretionary trust.

Court's decision

13. In a long judgement (641 paragraphs and 59,000 words!) the Court determined that whilst it accepted Lady Mcarthur-Onslow had testamentary capacity at the time she executed her will, the Court did not accept that she executed it with knowledge and approval of its entire contents. There is a presumption of law that a person with full testamentary capacity, knows and approves of the contents of a will that they sign.

14. Relying on the precedent of *Tobin v Ezekiel (2012) 83 NSWLR 757*, Court held that the circumstances of:

    (1) the complexity of the will and estate;

    (2) Lady Mcarthur-Onslow's dementia;

    (3) the protracted manned in which the instructions were taken by her lawyer for the drawing of her will. The will was prepared over an eight month process with instructions given on multiple occasions. (which is common for many complex wills); and

    (4) her brief consideration of the will before signing it;

    raised sufficient suspicion to displace the usual presumption of knowledge and approval of the contents of the will.

15. Once the presumption had been removed the Court then examined whether she actually knew and approved of its content i.e. that her son was going to obtain control of the discretionary trust in preference to her daughter.

16. There were some steps the solicitor did not take which might perhaps have strengthened the defence of the will. He did not give evidence that he ever positively explained to Lady Mcarthur-Onslow that her son would in practise have a larger share of her overall estate (including the discretionary trust) than her daughter.

17. He did not provide a draft of the will to Lady Mcarthur-Onslow prior to the meeting when it was to be signed. The Court considered that this did not allow her to have time to read and reflect upon the document, which was of some complexity.

18. Further, the Court noted that he "*did nothing of a positive nature to explore the true level of the understanding of the nature and effect of her will*". The draft in the will did not reconcile completely with the solicitor's evidence that the final instruction he received was to prepare a will which gave approximate equality of the distribution of her estate. Notwithstanding that, he also gave evidence that he had explained that her son would receive control of the discretionary trust.

19. (I am not being critical of the solicitor, but merely reporting the Courts findings. Complex estate planning is challenging under the pressure of practice. We can all learn from each published decision of the Court, including this one.)

20. Ultimately the Court was not satisfied that she knew and approved of the contents of her will.

21. The Court ultimately determined that part of her will which gave control of the discretionary trust to her son would be severed and the remainder of it would be admitted to probate.

22. This presumably had the practical effect of any assets fall into residue which would be shared between the children. (I say presumably because the judgement does not detail the estate assets).

Lesson

23. Ultimately the case presents a simple lesson for estate planning practitioners. Great medical evidence of testamentary capacity will not save a will if there is other strong evidence that the will doesn't embody what the testator actually wanted. The risk of this occurring is significantly higher in complex estates than in simple estates.

24. Where there is a complex estate plan clients should be given precis or summaries of their estate plan, laid out in a simple and easy to understand manner. The client should be given this explanation and the relevant documents with time enough to carefully consider them before attending the solicitor's office to execute them.

25. The time of clients arriving in a solicitor's office and immediately signing a 20 or 30 page will which they are seeing for the first time, should be well and truly behind us.[1]

[1] My apologies to Judge Robb and readers for a somewhat simplistic recount of a long and complicated case. Hopefully the moral of the story is apparent.

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Trust splitting – El Dorado or mirage?

Background

1. Trust splitting has been an El Dorado for estate planning practitioners for some years. It was regularly discussed as a potential option for restructuring discretionary trusts. However nobody had ever spoken to someone who had split a trust with full confidence as to the capital gains tax (**CGT**) and stamp duty issues and nobody was quite sure how it could be done. Commentators were in furious agreement that it would be a marvelous tool to add to the estate planning practitioner's toolkit, if the secret to it was unlocked.

2. The desire to split a trust arises from the nature of discretionary trusts. The trustee of a discretionary trust holds title to all the assets and controls how the income from the assets is distributed and, ultimately, how the assets are distributed between a range of beneficiaries. No one beneficiary has a fixed interest in the assets of the trust but relies on the trustee's determination. No beneficiary has a "share" in the trust.

3. Discretionary trusts are generally established by a prime mover within a family e.g. mum or dad or both and during their lifetime they control it for the benefit of themselves and their family. It is when the next generation takes control that governance becomes more complicated. Adult siblings will then be in control of the trust and must work together to manage it. Frustration can arise between these controllers where:

   (1) some members of the family want to get out of the trust but do not want to pay the CGT which would arise on the sale of assets to fund their payout;

   (2) different family members want to take different levels of risk or manage completely different businesses but the shared control structure means that everyone has to agree or come to some form of acceptable compromise;

   (3) some family members simply want to do things their own way.

4. Therefore, if a discretionary trust could be split so they each had a share of the trust, or were in control of particular businesses, assets or investments owned by the trust, it would be much more likely that the trust would survive for that next generation rather than being liquidated or entangled in a costly family dispute.

5. Trust splitting works as follows:

   (1) Say you have a discretionary trust, the Smith Family Trust, which owns a commercial investment property portfolio, an international equities portfolio and a trading business. There are 3 adult siblings in the Smith family and each of them has been managing their respective arms of the Family Trust and now wish to split the trust so they each have total control over their fragment of the trust. (I note some commentators use the term 'subtrust'.)

   (2) The trust would be split as follows:

(a) The 3 trustees would be appointed to the Smith Family Trust, one controlled by each sibling. The assets of the Smith Family Trust would be transferred to the respective trustee who is to control each asset.

(b) The adult children would be appointed as appointors of their respective fragments of the trust. The appointor/principal is the officeholder within a discretionary trust who is the ultimate controller, because they have the power to hire and fire the trustee. As a matter of control and governance, it would be necessary that each fragment of the trust has an appointor/principal from the intended primary beneficiary.

(c) The trustees would enter into a variation of the Smith Family Trust deed which provides that in the event of any of the fragments of the trust becoming insolvent, and the trustee for that fragment seeks indemnity out of the assets of the Smith Family Trust, that indemnity would be limited only to their particular fragment. This is critical. If the trustee's right of indemnity is not limited to their own fragment, the financial misadventures of any one of the 3 trustees would imperil the assets of the entire Smith Family Trust i.e. their siblings' fragments.

6. In operation, the Smith Family Trust would now look and feel like 3 family trusts. Each child would be able to control their fragment completely independently from their siblings.

7. The hesitancy of estate planning practitioners to split trusts arises from the risk of resettling the trust and the associated adverse CGT consequences i.e. assets are deemed to have been disposed of to the 3 trust fragments at market value.

Private ruling 1012921290075

8. Private ruling 1012921290075 provides significant clarity on how the Tax Office will approach trust splitting and notes the following actions will not cause a CGT event:

(1) The appointment of separate trustees for particular assets within the one discretionary trust.

(2) The appointment of separate principals/appointors for those fragments of the trust.

(3) Undertaking a variation of a discretionary trust deed to ensure that each separate trustee's right of indemnity out of the assets of the trust is limited to those assets of which they act as trustee.

9. The 3 issues above were the primary concerns of estate planning practitioners and this clarity now gives significant scope for using trust splitting in practice.

10. The private ruling even clarifies that each fragment of the trust would have separate books of account and separate bank accounts, which is a practical necessity.

11. That said, given that no new trust is created by splitting the trust, it follows that the trust would still have one tax return and one set of financials for the trust, notwithstanding the different trust fragments.

What trust splitting cannot achieve

12. The private ruling clarifies, as was our view, that you cannot, as part of the trust splitting process, change the beneficiaries so they align with each particular fragment and the controller of those fragments. The Tax Office states that their view is that this would result in the creation of new trusts i.e. each of the fragments would be a new trust and there is a CGT event when the assets of the first trust are transferred to those fragments. The CGT event is E1.

13. This makes sense. In the *Commissioner of Taxation –v- Clark* [2011] FCAFC 5, the Federal Court ruled (and I am paraphrasing this substantially!) that there is no resettlement of trust as long as:

    (1) there is a continuity of trust assets and beneficiaries; and

    (2) there is continuity in trust obligations.

14. Where a family trust is established by prime movers for themselves and their descendants, it seems clear that there is a severance of a continuity of beneficiaries if, when the trust is split into 3 fragments, the descendants of the prime movers are no longer the beneficiaries of each different fragment.

15. Therefore, whilst there will be separate trustees for each fragment, the listed beneficiaries will remain unchanged. This has no practical detrimental impact on the management of the trust however as it is always up to the trustee to determine who receives a distribution – not the beneficiaries.

Reduction of trustee's right of indemnity

16. Whilst the private ruling identifies the likely tax effect of amending a trust deed to remove a trustee's right of indemnity against trust assets, it does not mean that as a matter of law the indemnity can be reduced.

17. There are multiple statements in case law which state that on public policy grounds, a trustee is not able to exclude the right of indemnity through contract or by instruments of trust. The Court opined this view in *Moyes v J & L Developments Pty Ltd No 2*, i.e. the public policy of protection of creditors of the trust meant that the statutory provisions could not be contracted out of. Further, whilst not an unambiguous declaration of trust law, there are at least 2 references in judgments which provide that the Courts consider that a trustee's rights of reimbursement and exoneration cannot be excluded by a trust instrument: *Kemtron Industries Pty Ltd and Commissioner of Stamp Duties* at 589 per McPherson J and *JA Pty Ltd and One Others v Jonco Holdings Pty Ltd* [2000] NSWSC 147 at 87, per Santow J.

18. There are 2 factors which may limit the application of the case law:

    (1) In the trust splitting proposal above, the trustee is not entirely removing their right of indemnity, but merely reducing it commensurate with the assets they hold.

    (2) Trust splitting was not being considered in the cases.

19. That said, it would pay for parties to be cautious about the effectiveness of a trustee's indemnity being reduced to assets they hold until case law supports the concept.

Transfer duty

20. In addition to CGT, transfer duty must be considered. In trust splitting as described above, there is no resettlement of trust or declaration of trust which may cause a dutiable event.

21. There is a change of trustee when the trustee of each new fragment is appointed.

22. However, because there are no new beneficiaries and no change to underlying beneficial entitlement, the usual duty exemptions for the change of trustee within the various States' *Duties Acts* ought to apply.

23. If there was a transfer duty issue, it will, in many cases, be possible to leave the original trustee as trustee of the dutiable property e.g. real estate and have the non-dutiable property for the other fragments of the trust.

Terms of the trust deed

24. The private ruling makes it clear that the terms of the trust deed must allow for the various mechanics of the trust splitting. Whilst each trust deed is different and needs to be considered on its own terms, (precious snowflakes!) I expect that in most cases the usual power of variation given to the trustee will allow the trustee to provide itself the powers to undertake the trust splitting, if those powers do not already exist within the trust deed.

25. There will be other commercial reasons why trust splitting will not always be appropriate – even when there might be some factors agitating for a split.

Joint management not entirely removed

26. Despite a discretionary trust being split into separate parts, a level of cooperation and joint management by the separate trustees would still be necessary. This is because the trust still has 1 tax return and 1 set of financials, and the trustees would need to agree on trust distributions.

27. If the separate trustees come to any formal or binding arrangement in advance as to how distributions are to be made, there is a risk that the interests of the beneficiaries have been fixed (i.e. are no longer at the discretion of the trustees) and the trust is then resettled at law. This would defeat the purpose of using trust splitting because the CGT event would occur upon that agreement being made as to distributions. The interests of beneficiaries must not be changed as part of the trust splitting process.

28. This factor will reduce the times when trust splitting is appropriate. If siblings simply must be separated and totally financially divorced from each other, trust splitting will not achieve this.

Practicalities

29. Separate trustees for separate trust assets, within one trust, is extremely uncommon. Until it becomes more common place, I suspect an unintended consequence of the trust split would be administrative and bureaucratic confusion. How would government agencies, landlords, suppliers and not least to say, banks, deal with separate trustees for the same trust? Surely all would initially try to obtain the consent/signature of all trustees for all transactions, which would defeat the purpose of splitting the trust!

30. For this reason it is unlikely that trust splitting will explode into popularity.

31. However I would encourage financial advisors not to dismiss the strategy entirely as its succession planning potential is worth thoroughly investigating.

When will trust splitting be advantageous?

32. Trust splitting will be useful whenever there is a single discretionary trust which holds a variety of assets which the trustees and beneficiaries would like to divide between themselves without causing a tax event. Commonly this will be when the control of a family business and other investment assets passes from the original prime movers to the next generation.

33. The disadvantages of trust splitting ought to be carefully considered prior to splitting the family trust.

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