FEATURE

Trust assets and estate planning: how has the dust settled after Kennon v Spry?

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Abstract: In recent years, there have been numerous developments which have challenged the effectiveness of trust structures, causing a loss of faith in the ability of traditional family discretionary trusts to protect assets in the event of marriage breakdown. The High Court decision in *Kennon v Spry*, in particular, appears to alter longstanding principles relating to the asset protection advantages of trusts in this context. This article considers the consequences of that decision, discusses the treatment of trust assets in a relationship breakdown and the distinction between assets forming part of the pool of property or being treated as a financial resource, examines the application of these principles in recent decisions, and offers some practical recommendations. The authors conclude that, while this is an evolving area of law, recent case law indicates that, for the foreseeable future, well-structured trusts should continue to be an effective vehicle for asset protection and estate planning.

Introduction

Recent years have been a turbulent time for the controllers of trusts and their advisers.

Some of the developments challenging the effectiveness of trust structures that have taken place have included:

(1) amendments to the bankruptcy legislation to widen the situations in which trust assets might be exposed in the event of an individual associated with the trust becoming bankrupt;

(2) continuing attempts (which to date have been unsuccessful) by trustees in bankruptcy to argue that the power of appointment over trust assets is of itself an asset of a bankrupt person capable of being exercised by the trustee in bankruptcy;

(3) numerous changes to the application of the Div 7A tax regime to capture and tax arrangements where unpaid present entitlements have arisen following a distribution from a discretionary trust;

(4) the *Richstar*[1] , [2] *Colonial*[3] and *Clark*[4] and subsequent Taxation Office and government responses.

While all of the above issues have required (in some instances significant) additional planning, for a combination of reasons, family discretionary trusts are still often viewed as the structure of choice for many business owners and private investors. In recent times, however, many advisers and clients alike have, perhaps unnecessarily, lost faith in the ability of trusts to protect assets in the event of a marriage[5] breakdown.

Arguably, the most significant cause of this lack of confidence in trusts is the High Court decision of *Kennon v Spry*,[6] on the basis that it appears to alter the longstanding principles relating to the asset protection advantages of trusts in the context of a marriage breakdown.

This article considers:

(1) the consequences of the decision in *Kennon v Spry*;

(2) discussion about the treatment of trust assets in a relationship breakdown and the distinction between assets forming part of the pool of property or being treated as a financial resource;

(3) the application of these principles in recent decisions;

(4) some practical recommendations when dealing with trusts in the context of estate planning and structuring clients' affairs; and

(5) whether a trust can still be an effective tool to protect assets from exposure to relationship breakdowns.

For completeness, references to trusts in this article mean traditional family discretionary trusts. Some time will be devoted to exploring the impact of various trust structuring nuances.

Summary of the core principles: the Family Courts' powers to deal with trust assets

Asset protection principles relating to trusts

The asset protection typically understood to be afforded by trusts is derived from the longstanding view that a mere discretionary beneficiary of a trust does not have a proprietary interest in a trust's assets, and the main right of a discretionary beneficiary is limited to enforcing due administration by the trustee. Consequently, it is difficult to value this right when the beneficiary has no present entitlement to the trust's assets and may never have any entitlement to any part of the income or capital of the discretionary trust.

While this has been the accepted view for hundreds of years, recent decisions in Australia potentially undermine the level of asset protection afforded by trusts.

The high-profile decision of *Richstar* considered whether a beneficiary can have a proprietary interest in the assets of a trust where that beneficiary has "effective control" over the trust.

In *Richstar*, the court held that some of the defendants had "at least a contingent interest" in the trust property, which was sufficient for the property to be potentially available to the receivers. A contingent interest was found to arise where "the trustee is effectively the alter ego of the relevant beneficiary or otherwise subject to his or its effective control".

Although the court did not allow the full order sought by ASIC, the decision challenged the traditional view that a beneficiary of a discretionary trust has no more than a mere "expectancy" that of itself is not sufficient to constitute "property" which is available to creditors.

For completeness, it should be noted that *Richstar* was a decision about proprietary interests in a bankruptcy context. As the focus of this article is on the proprietary interest of a beneficiary of a trust in the context of the Family Law Courts, the *Richstar* decision is not discussed any further.

Similarly, although included in the title of this article, the facts of *Kennon v Spry* are not set out in full. For those interested in understanding in more detail the circumstances surrounding *Kennon v Spry*, the excellent papers written by Arlene Macdonald for the Tax Institute's 2010 Tax Intensive[7] and Ken Schurgott for the Tax Institute's 2011 Tax Intensive[8] are highly recommended.

Kennon v Spry

In 1968, the husband settled a discretionary trust named the ICF Spry Trust, of which he was both the trustee and settlor. The eligible beneficiaries consisted of the "standard" range of beneficiaries typically found in a discretionary trust, including the husband, any spouse of the husband, the husband's issue, his siblings, their spouses and their issue, and charitable beneficiaries.

In 1978, the husband and the wife married and they subsequently had four daughters.

In 1983, the husband varied the trust deed by excluding himself as a beneficiary and appointing the wife as trustee on his death or resignation. As a result, the husband ceased to be a potential beneficiary. It was understood that this variation was done predominately for land tax purposes.

In December 1998, at a time when the wife argued that the relationship was starting to strain, the husband executed a further deed of variation which excluded the wife as a capital beneficiary.

During the course of 2002, the husband established a discretionary trust for each of the four daughters of the marriage, of which he was the initial trustee and was later the joint trustee with a Mr Edwin Philip Kennon. As trustee of the ICF Spry Trust, the husband then distributed the capital and income of that trust equally between the four children's trusts.

Following the couple's separation and subsequent divorce, the wife sought orders from the court setting aside the distributions from the ICF Spry Trust to the children's trusts, arguing that the pool of assets for distribution should include the ICF Spry Trust's assets and the income distributed to the children's trusts.

The primary question before the court was whether the pool of assets for distribution on the property settlement should comprise the assets of the ICF Spry Trust. The wife argued that the pool should include the assets in the children's trusts, while the husband alleged that neither the ICF Spry Trust, nor any of the children's trusts, could be considered property or indeed even a financial resource of the parties to the marriage.

The trial judge made orders to set aside the 1998 and 2002 instruments and ordered that the assets of the ICF Spry Trust be included in the pool of assets for division between the parties.

On appeal (ultimately) to the High Court, the majority held (among other things) that the husband's legal ownership of the assets as sole trustee, combined with the wife's interest as a beneficiary of the trust, were a proper basis for the assets of the ICF Spry Trust to be treated as the property of the parties.

What Kennon v Spry means for trusts

Initially, *Kennon v Spry* raised concerns that the decision represented a significant widening of the courts' power to effectively disregard the existence of a trust when considering the division of assets on a property settlement.

Over time, the practical impact of the decision has arguably softened, not least of which due to the fact that the outcome of the decision appears to be strongly linked to the somewhat unique circumstances of the case. In particular, the arguably questionable conduct by the husband (such as mismanagement of trust assets, threatened destruction of trust assets, misleading representations to the courts, and attempted direct communication with the judges) may have contributed significantly to the outcome.

A number of cases since 2008 reinforce the conclusion that the impact of *Kennon v Spry* has not been as severe as initially feared. However, before exploring some of the cases in this regard, it is relevant to consider the underlying powers conferred on the courts in relation to trusts by the *Family Law Act 1975* (Cth).

Powers in the Family Law Act relating to trusts

The summary below is intended to give only a "high-level" introduction to the powers of the Family Court, to provide context when considering the decisions following *Kennon v Spry.* For a comprehensive summary of the court's powers relating to trusts, Arlene Macdonald's paper mentioned above is again suggested as recommended reading.

The meaning of "property" in the Family Law Act

The starting point of a property division is determining the nature of the assets and liabilities of the parties to the marriage, and to classify those assets and liabilities as either property of the parties or a financial resource or, potentially, neither. If a court determines as part of this process that a trust's assets fall under the definition of a financial resource (as opposed to being the property of the parties), then those assets cannot be divided between the parties under a court order.

Table 1 provides a diagrammatic summary of the options available to the court when dealing with assets of the marriage.

Table 1

Not property or a financial resource	Is a financial resource	Is property but only a portion represents property of the marriage	Is property and 100% should be treated as property of the marriage

The Family Law Act defines "property" as "property to which those parties are, or that party is, as the case may be, entitled, whether in possession or reversion".[9] If an asset is property of a party to a marriage, the Family Law Act confers a wide power on the court to vary the legal interests in the property and to make orders for a settlement of property in substitution for any interest in the property.[10]

The definition of property in the Family Law Act can be contrasted with the definition under the *Bankruptcy Act 1966* (Cth), which states that property is "real or personal property of every description … and includes any estate, interest or profit, whether present or future, vested or contingent, arising out of or incident to any such real or personal property".[11]

Due to the very broad definition of property in the Family Law Act, the Family Court therefore has a much wider ability to deal with trust property than the courts dealing with other regimes, for example, bankruptcy.

Thus, in *Kennon v Spry*, the court held that where:

(1) the husband was (at the relevant junctures) the sole trustee and appointor; and

(2) the trustee had absolute discretion to vary the terms of the trust deed and distribute income and capital to any one or more of the beneficiaries to the exclusion of any,

this was indicative that the husband was the sole controller of the trust.

The husband's control role (which meant that the husband had the discretionary power to transfer all assets of the trust to the wife), together with the wife's right of due administration as a beneficiary of the trust, was sufficient justification for the court to determine that the assets of the ICF Spry Trust should be treated as property of the parties.

One developing issue in this regard (which is outside the scope of this article but warrants mention) relates to the so-called "Jodee Rich"[12] amendments that, in certain situations, empower the Family Court to make decisions that simultaneously bind the parties to the marriage breakdown and various third parties, including creditors. This power arose from O'Ryan J's judgment in the matter of *Australian Securities and Investments Commission & Rich*:[13]

> "… I have no jurisdiction to make the orders sought by ASIC pursuant to s 90K … However, it is of concern to me that the consequence of my finding is that the Family Court has no jurisdiction to deal with an application by an unsecured or contingent creditor to set aside a financial agreement in circumstances where the interests of such a third party are or may be adversely affected by the terms of the agreement … It was therefore entered into to defeat the interests of third parties … In my view, consideration should be given to conferring jurisdiction on this Court to deal with an application by the third party whose interests may be adversely affected by the terms of a binding financial agreement to set aside the agreement. There are public policy reasons for why this should be so. Thus Part VIIIA should be reviewed, at least in terms of its effect on the legitimate interests of third parties, because the Family Law Act may be made … an instrument of harm to a third party."

Section 79 of the Family Law Act 1975

Section 79 of the *Family Law Act 1975* applies where the court finds that the trust assets are property of a party to the marriage, rather than a financial resource. Broadly, the four powers of the court in relation to assets held via a trust are as follows:

(1) bringing assets notionally into the matrimonial property pool;

(2) setting aside transactions which would have the effect of diminishing claims under the Family Law Act;

(3) declaring the purported trust arrangements to be a sham; and

(4) altering the ownership of a third party and making binding orders on third parties.[14]

Determining the "notional" pool of assets

As set out above, arguably the most important step in the making of a property settlement by the court is the process of determining the "pool" of assets available for distribution. Where there is clear evidence that one spouse is the true, unilateral controller of a trust holding assets accrued throughout the marriage of the parties, as well as a potential beneficiary, the court will treat the trust assets as the property of the parties. In these situations, the assets of the trust will be automatically added to the pool.

In *Beeson & Spence*,[15] it was held that, where trust assets are in fact used for the benefit of one (or both) of the parties of the marriage, the court can "look through" the formal legal ownership by the trustee when determining the pool of assets.

The rationale for these powers is that it would be contrary to public policy to allow a spouse with full control of assets to quarantine them via a trust from property settlement proceedings where the controlling spouse has the power to determine at any point to whom income and/or capital will be distributed, including to themselves.

Setting aside transactions

The court has power under s 106B of the *Family Law Act 1975* to set aside attempts to alter a trust relationship for the purpose of preventing the court from adding the assets of the trust to the property pool.

In *Kennon v Spry*, the court relied on this power to set aside the 1998 and 2002 instruments on the basis that the amendments were undertaken for the purpose of limiting the wife's access to the assets of the trust in any subsequent property settlement. At face value, the use of the power in s 106B by the court appeared to create a situation where the assets of a trust could be fully exposed, even where:

(1) neither party to the marriage solely controlled the trusteeship of a trust; or

(2) neither party to the marriage were beneficiaries of the trust.

While the husband in *Kennon v Spry* argued that it should be the four children's trusts (of which he was only a co-trustee, and neither he nor the wife were beneficiaries) that should be the subject of the court proceedings, by relying on s 106B, the court effectively ignored the establishment of those trusts and the purported removal of the wife as a potential beneficiary of the original trust.

Having effectively redefined the structure of the trusts, the decision in *Kennon v Spry* ultimately became a relatively "standard" application of how the Family Court determines the notional pool of assets and should be seen as an extension of the powers as previously understood in s 106B.

Sham trusts

The courts also have power to effectively ignore a trust structure where the trust arrangement is, in fact, a sham. A trust will be treated as a sham (and its purported existence ignored) where the parties intended to create rights and obligations different from those described in the documents. Before a document is held to be a sham, it must be shown that there was the intention to mislead third parties in respect of the relevant rights and obligations in dispute.[16]

The relatively recent decision of *Harris & Harris*[17] is an example of the court considering whether a trust arrangement was in fact a sham. In that case, the trust had been established at the instigation of the father of the husband prior to the husband's marriage.

“… the exercise of these powers must be supported by the underlying factual circumstances.”

The trustee of the trust was a company of which the husband and his sister and mother were directors. The husband's mother held 50% of the shares, and the husband and his sister each held 25% of the shares. At the time of the proceedings, the husband's mother was also the appointor of the trust. The husband was listed as a potential beneficiary of the trust, together with his other family members. The trust owned, among other assets, all of the shares in a company which ran a business initially operated by the husband and wife and after the separation operated only by the husband.

The wife argued that the control arrangements in place were a sham, and that the trading company (of which there was no dispute that the husband was the managing director) was an alter ego of the husband and, on this basis, the husband had sufficient control of the trust itself such that the assets of both the trust and trading company should be regarded as being included in the property pool.

Alternatively, the wife alleged that the husband's mother was "a puppet" of the husband, and he had indirect control of the trust through her.

The court applied the principles set out by French CJ in *Kennon v Spry* and found that, while the husband was a "beneficiary of the trust, he did not control the trustee directly or indirectly ..." and there was no basis to notionally include the assets of the trust (including its shares in the trading company) as part of the pool of assets.

In relation to whether the trust arrangements were effectively a sham, the court found that the wife did not advance sufficient evidence to support a finding that the husband's mother was the husband's "puppet", through which he exercised de facto control of the trustee company and of the trust.

The fact that the trust had been established by the father of the husband, and that virtually every change in the management and direction of the trust could be at least partially referrable to the ongoing estate and succession planning arrangements of the husband's parents, provided strong support to the conclusion that the trust was not a sham.

Altering third party ownership

Under the powers in ss 90AC and 90AE, the court effectively has power to make the following orders:

(1) direct a third party to do a thing in relation to the property of the marriage, or alter the rights, liabilities or property interests of a third party in relation to the marriage;[18]

(2) restrain a person from repossession of property of a party to the marriage or grant an injunction restraining a person from commencing legal proceedings against a party to the marriage;[19] and

(3) direct a third party to do a thing in relation to the property of the marriage or alter the rights, liabilities or property interests of a third party in relation to the marriage.[20]

The practical implications of this power were demonstrated in the enforcement action following *Kennon v Spry* in the matter of *Stephens & Stephens (Enforcement)*,[21] where it was held that:[22]

> "In our view, it follows that an order may be made that enables an entitlement of a party to the marriage who is an object of the trust, or ceased to be an object by reason of divorce, to be satisfied out of the assets of the trust. Put another way, an order may be made that enables a party to the marriage who is in control of the trust to satisfy his or her personal liability to the other party to the marriage who is an object of the trust from the assets of the trust."

Decisions following Kennon v Spry

There have been a number of reported decisions since *Kennon v Spry* which provide context to the exact scope of the court's powers under s 79 of the *Family Law Act 1975*.

While there is little doubt about the potentially wide scope of the court's powers under s 79, the exercise of these powers must be supported by the underlying factual circumstances. Set out below are summaries of a few of the most relevant cases involving trusts, which in each instance explore one or more of the key themes addressed in *Kennon v Spry*.

The cases explored are summarised under the following four headings, namely:

(1) the manner in which a trust is controlled;

(2) the purpose of the trust on establishment (including the range of potential beneficiaries);

(3) the source of trust assets; and

(4) trusts established as part of an estate plan.

Control of trusts

Beeson & Spence involved a trust established by the wife during the marriage. The wife argued that the trust was established with the purpose of benefitting the children of the relationship and should not be treated as property of the marriage.

On establishment of the trust, the wife's father and her solicitor were appointed as trustees and the wife was the appointor. At a time when the husband was going through financial difficulties, the deed was varied to exclude the wife and the husband as potential beneficiaries of the trust, as well as to resign the wife as appointor. A new appointor, being the wife's sister, was nominated in her place.

The husband argued that the trust was established for the benefit of the family and not just the children.

The court ignored the release of direct control by the wife (through her resignation as the appointor) and held that the wife still retained sufficient control of the trust to support a conclusion that the assets should be treated as property of the marriage, citing the following reasons:[23]

> "The Deed of Variation recognised the resignation of the wife as the appointor and brought about important and fundamental changes to the Trust

> by appointing a new appointor and by removing the wife and the husband as beneficiaries in their own right as parents of the specified beneficiaries. Until then, the wife could have continued to lawfully control the Trust by ensuring it was administered in a manner of her choosing, including administered for her sole benefit, both as to income and capital. The recitals to the Deed of Variation suggest the wife's resignation as appointor was preceded by a request from the trustees and that, in turn, was made referable to the trustee's concern at possible insolvency and the Trust fund being placed in jeopardy. Yet whatever the thinking behind it or wherever the motivation lay, the plain fact is that nothing, including a request from the trustees, obliged the wife to relinquish control of the Trust by relinquishing the power to appoint the trustees by whose discretion it is administered. To the contrary, it was within her singular and unquestionable power to remove the trustees and appoint another at any point. So while the recital suggests the relinquishment of the power of appointment was brought about by the trustees, it was obviously and necessarily done with the wife's co-operation and consent which she was at no time obliged to give. Then, having relinquished control and with the new appointor installed, the Deed was altered to remove the 'parents' as beneficiaries in their own right. The steps taken via the Deed of Variation must be seen as having been taken at the wife's direction."

In contrast, the recent case of *Morton & Morton*[24] saw the court decide that, as the husband was merely a potential beneficiary and did not in fact control the trust, the trust was not his "alter ego" on the basis that there was not sufficient control over the trust. Therefore, there was nothing to support a finding that the assets of the trust should be held to be the property of the husband.

In summary, the facts of the case were as follows:

(1) the couple were married approximately 10 years and had no children;

(2) at the time of the relationship breakdown, the husband was a beneficiary of a discretionary trust, the Morton Trust;

(3) the beneficiaries of the trust included the husband, the husband's brother, mother, any grandchildren or remote relatives and any company or trust in which the husband and his brother had an interest;

(4) the trustee of the Morton Trust was a trustee company, J Pty Ltd, of which the husband and his brother were equal shareholders and both were directors;

(5) J Pty Ltd, in turn, owned a "bucket company" on behalf of the trust, known as T Pty Ltd (to which unpaid present entitlements were owed). The husband's brother was the sole director of T Pty Ltd; and

(6) finally, the husband and his brother were the joint appointors of the Morton Trust.

The wife argued that, as the two brothers each had a 50% share of the Morton Trust and T Pty Ltd, a 50% interest should be treated as the husband's property in the property settlement. The wife claimed that the husband, in his capacity as director of J Pty Ltd, had sufficient control of the trust to support this conclusion.[25]

The husband argued that neither he nor his brother had control of J Pty Ltd as neither had a better right than the other in their standings as directors, shareholders or appointors.

The court accepted the husband's arguments and held that the trust assets should not form part of the property pool. It was the case, as accepted by the husband, that the trust's assets were his financial resource.

The decision largely rejected a number of the wife's arguments based on principles set out in *Kennon v Spry*, and highlights the importance of considering the most appropriate approach to take whenever structuring trust arrangements.

The decision in *Harris*[26] (summarised above) provides further guidance about the relevance of actual control and, in particular, held as follows:[27]

> "In the present case and on the basis of the material before us the husband appears to be no more than a beneficiary of a trust. He is not the appointor of the trust nor does he hold any position in the current trustee company.
>
> On the assumption that by the use of the word 'directly', the Chief Justice was referring to the strict legal position, it therefore cannot be said that the husband 'directly' controls the current trustee. Nor could it be said that he 'directly' controlled the previous trustee.
>
> On the assumption that the reference by the Chief Justice to 'indirect' control of a discretionary trust by a beneficiary was a reference to a 'puppet' situation, in the sense that the person with legal control of the trust is a puppet of the beneficiary, that could be the situation in the present case. In the sense, that is, of the mother (who is the appointor of the trust, and one of the three directors of the trustee company holding two shares in that company with each of the other two directors holding one share each) being the puppet of the husband. This, as was made clear by Counsel's oral submissions to us, has always been the wife's case.
>
> The difficulty, however, for the wife on this appeal is to be able to point to any evidence which would support a finding that the husband's mother is his puppet, and that it is through her, or perhaps otherwise, that he exercises de facto control of the trustee company and of the Trust."

Purpose of establishing the trust and range of beneficiaries

The decision of *Essex & Essex*[28] considered the husband's interest in two family trusts, the S Trust and the N Trust. The circumstances of the case were:

(1) in relation to the S trust, the husband was a default beneficiary, and the two children from the marriage were the capital beneficiaries;

(2) the husband was only a general beneficiary in the N Trust, on the basis that he was the brother of the primary beneficiary;

(3) the assets of the two trusts had largely been contributed by the husband's parents for the purpose of providing for the husband's mother's living expenses, and benefiting the husband and his brother and their bloodline;

(4) the husband had not received distributions from either trust; and

(5) the husband's brother was held by the court to be the controller of both trusts.

It was held in the trial court (and endorsed on appeal) that the assets of the N trust could not be considered to be property of the spouse parties, as it was unlikely that the husband would ever receive distributions from the trust and it was established for the primary benefit of the husband's brother's family.

In reaching his decision, the trial judge considered the control of the trusts:[29]

> "The facts in this matter are distinguishable from the majority of family law proceedings involving discretionary family trusts. Typically when discretionary trusts are involved in family law proceedings one of the parties is the appointor and, frequently, that party is also a director or major shareholder in the trustee company. In such scenarios, the requisite degree of control may be established relatively easily. This is a significant

distinguishing factor from the present case, where there is little evidence that the husband has or will have control of either of the trusts. Such evidence as exists … is not persuasive."

The trial judge initially held that the assets of the S trust were not a financial resource. However, this conclusion was overturned on appeal. The trust assets were held to be a financial resource of the husband, on the basis that:

(1) the trust deed terms evidenced a clear intention that the husband should benefit from the trust; and

(2) there was evidence that the husband was likely to receive distributions from the trust following finalising of the matter.

The Full Court stated:[30]

"… The S Trust deed evinces a clear intention that the capital of that trust be distributed on vesting, or at such earlier time as the trustee may determine, to the two children of the marriage, the grandchildren of the husband's mother. It also discloses a clear intent that the husband, as one of the three named income beneficiaries, is entitled to be considered to receive distributions of income until the vesting of the trust."

On appeal, the court confirmed the conclusion of the trial judge that the trust assets could not be property of the marriage, as the husband did not have control of the trusts, nor had he contributed the assets to the trusts.[31]

The primary questions asked of the Family Court in *Keach & Keach*[32] were whether:

(1) being a potential beneficiary of a trust meant its assets should be included in the pool of property; and

(2) the trust was a sham such that the husband was in fact the true owner of the assets of the trust.

The husband's father had established a separate trust for each of his four children. The husband's trust was referred to in the judgment as "the Junior Trust". On establishment, the beneficiaries and residuary beneficiaries named in the schedule of the Junior Trust were the husband and his three siblings. The father's trust ("the Senior Trust") was also later appointed as a discretionary beneficiary.

A corporate trustee was initially appointed for the four trusts, which at time of the marriage was Keach Nominees Pty Ltd. The father held five shares and the mother and the children (including the husband) held one share each. The father was the principal of the Junior Trust.

Keach Nominees Pty Ltd retired as trustee of the Junior Trust and was replaced by J Pty Ltd, in which the husband's brothers (but not the husband) were issued one ordinary share each.

The court considered the following:[33]

"… [the husband's father] established the Junior Trust, … was the sole source of the assets, at all times … gave any necessary legal instructions to the Trust's solicitors, the accounts of the Trust were managed by an accountant under the direction of the … father … who at all times … managed and controlled the Trust, any assistance [the father] received in that regard from the husband was always under [the father's] direction ... and he determined what assets the Trust would hold and acquire … attended the auction and bid for the M property … arranged the finances for the purchase by the Trust of the property … It is also noteworthy that not all allocations/distributions of the income of the Trust were made to the husband. The wife's senior counsel suggested that the evidence of this is incomplete, and it was not possible to determine the full extent of the allocations/distributions. However, I do not accept that submission. There is ample evidence to demonstrate the pattern of allocations/distributions and they certainly were not all to the husband. Indeed, it was the opposite. There were only four allocations/distributions of income to him over a period of 23 years. I also find that the wife was under no illusion as to the ownership of the property. I consider that she was aware that the Trust owned the property from the time of its purchase …"

Accordingly, the court held that the assets of the Junior Trust should not form part of the property pool and should be treated as a financial resource only.

Although from prior to the *Kennon v Spry* decision, the case of *Webster & Webster*[34] is relevant in this context as the husband sought to argue that the trusts in question were the "alter ego" of the wife, and should be included in the property pool.

The facts are as follows:

(1) the wife was originally a beneficiary of a family trust established by the wife's (late) father. On the wife's 40th birthday, according to a letter of wishes drafted by the father, the capital of the trust was to be distributed to the wife (and any of her children in such proportions as the trustees thought fit);

(2) at the same time as the distribution, two trusts were established, being the P Trust and the Q Trust, to receive the assets from the original trust;

(3) the wife was the appointor of both trusts;

(4) the wife, the wife's mother, the children and remoter issue of the wife and any spouse of the children and remoter issue were listed as income and capital beneficiaries of the P Trust;

(5) the beneficiaries of the Q Trust were the wife, her children and remoter issue and their spouses; and

(6) the wife was the sole director of the corporate trustee of both trusts.

During the proceedings, the wife offered an undertaking to the court and the husband (which the court accepted) to:[35]

"... not at any time in the future exercise, cause or permit to be exercised any position or power under the Deed dated 11 July 1996 establishing the trust known as the Q Trust which would have the effect of causing or permitting any distribution to be made to any potential beneficiary other than the said children."

The trial judge held that establishing a trust for the protection of the children had been one of the objectives to achieve the wishes of the wife's father. To this effect the trial judge held:[36]

"So while the husband's original intention appeared to accord with the wife's, by the case presented on his behalf he now seeks to shift from that by having his entitlement determined by treating the funds as owned by the wife absolutely. Of course it is the fact that the funds have been lent to ... entities, this has been done on an interest free basis and the wife, therefore, as the beneficial owner of the entities concerned has the use and benefit of the whole of the funds in her current operations. Provided that is recognised, I can see no cause to ignore the intention (initially at least shared by the husband) to benefit the children when the Trust was created and, in the light of the undertaking offered by the wife, no reason to set aside or ignore the rights and obligations created at that time by the Trust. Accordingly, it is proper, in my opinion, to view this fund not as an asset of the wife's but as a resource available to her, indeed a substantial one.

... Whether the assets of any trust are to be included in the assets available for distribution is a matter of fact to be determined taking into account various considerations. More often than not the assets of discretionary trusts are included in the net asset pool because the factual analysis suggests they ought to be. But there is no automatic assumption or presumption that they be treated this way as distinct from constituting a resource to the controlling party. Here in this case, the facts suggest that the trust was indeed specifically established for the children's benefit and protection, that was done consciously as part of the arrangements in re-settling the [original] Trust, it was a step which clearly had the support not only of the wife but also the husband at the time. That ought to be respected now."

The Full Court upheld the earlier judgment, stating that:[37]

"... given that it was the intention of both the husband and the wife that the children would have an interest in the property or income of the trust ... it was open to the trial Judge, in the somewhat unusual circumstances of this case, to conclude that the trust property should be taken into account in the proceedings as a financial resource of the wife and not as her property ... In so doing, the trial Judge ... was not excluding the assets held by the Trust from her consideration. We are thus not satisfied that the ground of not finding as a fact that the Q Trust was the alter ego of the wife and treating its assets as a resource rather than as assets immediately available to the wife has been established and it is not necessary for us to determine whether, in the circumstances of this case, the trial Judge erred in accepting the undertaking given by the wife."

The case of *Leader & Martin-Leader*[38] considered a scenario where neither party to the relationship had control of the trust assets. In this case, the wife was listed as a discretionary beneficiary of several trusts established by the wife's parents.

The wife was one of seven parties to a family agreement which catalogued that the wife and her siblings were within the definition of an eligible beneficiary for a number of trusts. Under the agreement, the siblings acknowledged that "although they qualified as beneficiaries" under particular trusts, they agreed to direct the trustee not to consider them (or any spouse or descendent) when exercising its discretion to distribute income or capital from the relevant trust fund.[39]

In light of this, the court held:[40]

"Similarly, whether the interest of the wife as a person within a class of beneficiaries is to be described as 'property' or a 'financial resource' is a matter which can only be determined after the full consideration of all of the relevant evidence which has been provided and appropriately tested ...

On the face of the documents produced and the evidence ... it appears that the ultimate control of the trusts and entities under consideration remains with the wife's parents.

Thus, the related factors of control by one party to the marriage and a potential beneficial interest of one party to the marriage which existed together in the matter of *Kennon v Spry* (supra) can be distinguished from this matter in which it is asserted that the wife does not have any control of any of the entities but is merely a potential beneficiary or a person falling within the class of beneficiaries. The Family Agreement between the parents and siblings is not construed to be binding upon the parents so far as their exercise of control of the trust is concerned. The Family Agreement could be construed as providing the wife with certain rights in relation to her siblings and possible other rights yet to be determined.

The decision of *Kennon v Spry* (supra) dealt specifically with consideration of issues relating to what was property of the husband and wife or parties to the marriage. The decision did not consider whether the entitlements of either of the parties could be described as a financial resource and thus relevant for the purposes of ss 75(2) and 79 of the *Family Law Act*.

In this case the wife's status as a potential beneficiary or a person who could be described as an 'eligible beneficiary' is a factor which may be relevant to determining the financial resources of the wife ..."

In *Edgehill & Edgehill*,[41] the wife's mother established a discretionary trust and appointed the wife as trustee and a class B beneficiary with the wife's children. The wife's two siblings were class A and C beneficiaries respectively.

Shortly after separation from the husband:

(1) the wife was removed as a trustee and beneficiary; and

(2) the wife's mother prepared a memorandum of wishes of which it was held part of its purposes were:[42]

"… that on her death the trustees of the trust may, if the trustee acts on her wishes, re-settle the family trust into three discretionary trusts for the benefit of each of her children, grandchildren and their lineal descendants."

The court held that the interest was a financial resource not property and, in particular, the trial judge made the following comments:[43]

"There are a whole range of possibilities attaching to the ultimate benefit which the wife may receive under this trust. The recent documentation relating to the trust outlining the intention and/or request of the wife's mother in respect of how the trust should be dealt with in the future all seem to me to require the consensus of considerable number of people and having regard to human nature there would have to be, in the absence of clear evidence to the contrary, a probability that there will be a distribution under the trust some time (probably within two or three years) of the demise of the wife's mother."

Source of trust assets

As part of the property settlement process, it is relevant to consider the contributions made by each of the parties to creating the relationship property. In this context, the courts normally place at least some weight on the source of assets owned via a trust.

In *Simmons & Simmons*,[44] the wife argued that the husband's interest in the trust should be included in the property pool. The relevant trust was a discretionary trust settled by the husband's father in 1979. All of the members of the husband's family were potential beneficiaries.

The court found that there was a sufficient nexus between the husband and the trust in that he had significantly invested in the trust by personally making loans to the trust. This, in the court's opinion, was sufficient to consider the assets of the trust to be included as the property of the parties to the marriage.

Similarly, in *Pittman & Pittman*,[45] a trust was established with the husband listed as a general and specified beneficiary, together with his father, his mother and siblings.

The husband's father (who was the appointor and guardian of the trust on its establishment) nominated the husband's mother, the husband and his brothers, as appointors and guardians after his death. Under two later deeds, the trust fund was irrevocably appointed in favour of the nominated beneficiaries in equal shares (which included the husband).

The court held as follows:[46]

"We consider that the PFT interest was property because whatever the original nature of that trust and the husband's interest in it, the various amending instruments have resulted in a situation where the husband has irrevocable entitlements not only to income, but also to a share of capital.

It is true that there is a possibility (perhaps best described as a theoretical possibility) that the husband's one quarter share of the capital might ultimately be diluted by the appointment of other beneficiaries. But he would still be entitled to some share in the capital. It is only the value of his share that might change (indeed it might increase on his mother's death).

The values of all items of property which are the subject of section 79 proceedings are likely to

> change between the time of such proceedings and the time when such items are eventually realised. Uncertainty of ultimate value cannot provide a reason for not categorising an item as property, and the submissions of Senior Counsel for the husband to the contrary must be rejected.
>
> We also reject the submissions of Senior Counsel for the husband which sought to rely on the absence of control in the husband over the trust. It is true that the husband cannot be said to have control of the trust, but that fact does not affect his irrevocable entitlements to a quarter of the income of the trust and to a share in the capital."

While both of these cases are examples where trust assets were treated as property of the marriage as opposed to merely a financial resource, they also demonstrate the requirement for there to be a significant level of control and nexus to support this conclusion.

Trusts established under an estate plan

Although the decision of *Ward v Ward*[47] was prior to *Kennon v Spry*, it is important because it was one of the first to consider the application of the court's powers to a modern testamentary discretionary trust (TDT) established under a will.

The parties had a 30-year marriage before their divorce, which produced two children. The court was required to adjudicate a numbers of issues, one of which was how to treat the husband's interest in a TDT.

The will of the husband's mother established a TDT and it was admitted that the dominant purpose in establishing the trust was to protect the husband's inheritance. The trustees of the TDT were the husband's two sisters. The range of beneficiaries included the husband and his two children, but not the wife.

An earlier draft of the mother's will had included the husband as a co-trustee and executor, but she had amended it shortly before her death to exclude the husband from these roles once she became aware of the husband's marriage difficulties.

At the time of the proceedings, by the court's acknowledgment, there was no evidence of any expectations or distributions under the TDT to any of the beneficiaries.

The court found the circumstances as being similar to the matter of *Bonnici & Bonnici*,[48] in which the Full Court had stated that "property does not fall into a protected category merely because it is an inheritance".[49]

The court acknowledged that it was probable that the husband would receive the whole entitlement of the TDT at some point. Despite this, it was held that the interest of the TDT could not be considered property of the husband. Accordingly, the court found that the interest was merely a financial resource of the husband and one that the wife had contributed very little to creating.

The recent decision of *Lovine & Connor*[50] considered the assets in two TDTs (which were administered as one TDT) established in the husband's father's will approximately nine years before the separation of the parties.

The court found the following facts:[51]

(1) the beneficiaries of the TDTs included the husband, his two sisters, and their respective children;

(2) the husband's sisters had each effectively received their one-third interest in the assets of the TDTs;

(3) the remaining assets of the TDTs represented the one-third share of the estate held for the husband, and it was the ultimate intention of the husband to distribute the TDT assets to himself and/or his children; and

(4) the husband was the only real controller of the TDTs and, while the will appointed the husband's sisters as joint trustees with him, they played no active role in the control of the TDT.

The husband argued that the assets of the TDTs should only be classified as a financial resource. However, the trial judge determined (and it was later upheld on appeal[52]) that, due to the husband's control over the assets and the real likelihood that he would ultimately receive the benefit of the assets, the assets of the TDTs should be treated as property of the marriage.[53]

Practical recommendations

It is clear from *Kennon v Spry* and subsequent decisions that the Family Court has extremely broad powers beyond ordinary trust law principles when dealing with trust assets in a property settlement.

As with any court decision, the outcome in relation to a particular trust will often depend on the exact facts and surrounding circumstances. However, arguably the recent decisions indicate that each of the following characteristics would tend to lead to a conclusion that trust assets should be considered to be property of the parties to the relationship:

(1) where both spouses are able to benefit, and historically have benefited fully from the income and capital of a trust;

(2) where a spouse is the controller of a trust, for example, as the sole trustee, appointor or through shareholding or directorship of a corporate trustee;

(3) where the property of a trust has been contributed by the parties to the relationship or through the efforts of a party to the relationship; or

(4) the property of the trust was acquired during the relationship.

In light of these broad principles, it is also possible to draw some practical conclusions from the recent court decisions, as outlined below. Many of these principles are particularly relevant when structuring trusts to facilitate the intergenerational transfer of wealth, both during a person's lifetime and under their estate plan.

Obviously, any trust structuring steps should be considered and implemented as part of a comprehensive review, and ideally not immediately prior to a relationship breaking down. As outlined above, *Kennon v Spry* is a clear example of the court's ability to use the powers in s 106B to unwind unilateral changes to a trust once there is evidence that a relationship is starting to strain.

"… any trust structuring steps should be considered and implemented as part of a comprehensive review …"

Trust structure audits

Arguably, the overriding principle to apply whenever considering the use of a trust is the appropriate structure of each aspect of the arrangement. The issues that are often relevant in this regard include:

(1) Who is the trustee of the trust? If the trustee ceases to act, do their powers pass to anyone else and, if so, who?

(2) Is the trustee an individual or a company?

(3) If the trustee is a company, who are the directors?

(4) Is there a default distribution of the income and capital of the trust to certain beneficiaries?

(5) Does the trust deed restrict the range of beneficiaries who can receive income or capital distributions?

(6) Does the trustee need consent/approval of any other person for distribution?

(7) Does the trustee effectively/practically control the trust in an unfettered way?

(8) Does the trustee exercise its powers independently or are they controlled or subject to approval by any other person/entity?

(9) Is the trustee a beneficiary of the trust?

(10) Can a beneficiary or a class of beneficiaries control the actions of the trustee?

(11) Can beneficiaries be removed or added, and if so by whom?

(12) Is there any risk that the trustee may be seen as simply the 'alter ego' of some other person?

(13) Does someone (eg an appointor, guardian, principal) have the power to unilaterally change the trustee?

(14) If there is an appointor, is the role automatically terminated on certain events (for example, death, bankruptcy)?

(15) If the appointor ceases to act, do their powers pass to anyone else and, if so, who?

(16) If there is more than one appointor, must they act jointly?

(17) Is the appointor a beneficiary of the trust?

(18) Will the trust own more than one asset class?

(19) For an existing trust, has there been a pattern of income or capital distributions to at risk individuals associated with the trust?

(20) For an existing trust, have there been variations to the deed following establishment that impact on the overall control of the trust?

TDTs

Asset protection strategies and the use of special purpose trusts are important issues to consider in estate planning, particularly where potential beneficiaries are in professional practice occupations or in business, or where there is a risk that a personal relationship of a beneficiary may degenerate in the future. Potential beneficiaries that fall into any of these "at-risk" categories will be exposed to losing assets, unless appropriate structures are put in place.

A TDT is simply a trust established pursuant to a will. Generally, TDTs are seen as particularly useful in the following circumstances:

(1) to ensure concessional tax treatment is available to distributions of capital and income to minor beneficiaries;

(2) to protect accumulated wealth from wastrel or spendthrift beneficiaries;

(3) to provide for infant children and disabled beneficiaries; and

(4) to help protect inheritances from attack by the Family Law Courts and trustees in bankruptcy.

Often, TDTs are structured to limit the range of beneficiaries to "lineal descendants", whereby the testator restricts the discretionary powers of the trustee so they may only distribute income or capital (or both) to the testator's children and grandchildren, excluding any spouse of the children and/or grandchildren.

A significant attraction of excluding spouses as potential beneficiaries is the perception that it is more difficult for an excluded spouse to argue before the Family Court that the assets of the TDT should be considered as anything other than a financial resource. Recent cases certainly appear to support this view.

When establishing TDTs as part of an estate plan, it is relevant to consider whether a separate TDT should be established for each child, or if all children should effectively share their inheritance jointly via a single TDT.

There are a myriad of issues that should be taken into account when deciding whether to use a single, multiple or "hybrid" TDT approach. As with many estate planning issues, there is no "correct" approach, as different factors will be relevant depending on the situation.

Broadly, a single TDT will most likely be preferable if:

(1) some or all of the children are minors. The primary focus in this situation should be on the surviving spouse and therefore it is not ideal to have wealth held across multiple TDTs where the surviving spouse will likely be in control for many years;

(2) the testator has the vision that the children should act as custodians of the wealth for future generations;

(3) the main objective of establishing the TDT is asset protection; and

(4) the nature of the assets (such as a real property) would render a split ownership structure overly complicated.

In contrast, a multiple TDT approach (ie a TDT established for the benefit of each child) may be more appropriate, despite probably offering less security on a relationship breakdown, if:

(1) there are different geographical locations of the children;

(2) the relationships between the children is poor. This consideration is important as jointly controlling wealth might further deepen existing rifts between family members;

(3) the risk profiles of each child's investment outlook differ significantly;

(4) the underlying nature of the trust assets make a single TDT impractical, for example, particular assets being earmarked for the sole control of a particular beneficiary; and

(5) there is a desire to implement different control mechanisms for each child (in this context one child may be the sole controller of their trust, whereas another child may require a co-trustee or be wholly excluded from being a trustee).

The hybrid approach combines elements of a single TDT as well as multiple TDTs. Generally, a hybrid approach distributes a set percentage of the estate (or certain assets) to a "head TDT" of which the control is shared between the various family members and any independent trustees. This head trust will include all lineal descendants as potential beneficiaries.

Sub-TDTs are then created for each child (and their respective spouses and lineal descendants) to which separate assets are gifted. The children will usually control their own sub-TDT and independently regulate succession of the sub-TDT.

Letters of wishes

Another factor that Family Courts have considered relevant, particularly in recent times, is the use of a letter of wishes, which is often prepared by a testator (in the case of a TDT) or significant contributor to a trust.

A letter of wishes is typically a non-binding document that gives guidance to the trustee as to how they should ideally exercise their discretionary powers to administer a trust's assets.

In both *Breakspear & Ackland*[54] and *Read & Chang*,[55] the courts ordered disclosure of the relevant letters of wishes. The predicament specifically considered by Brigg J in *Breakspear & Ackland* was that, on one hand, the disclosure of such confidential documents would cause them to lose favour with those establishing trusts, arguably resulting in less favourable and helpful information for trustees.

Conversely, a letter of wishes is often crucial to determining the manner in which the trustees are likely to exercise their powers. Withholding disclosure may reduce the practical extent to which trustees can be held accountable and courts could make informed decisions about how to factor a trust's assets into a property settlement.

In *Read & Chang*,[55] Cohen J acknowledged the decision in *White & Tulloch v White*[56] which found that the key criteria to determine if disclosure is appropriate is whether the evidence is, or may be, relevant to the just and equitable process under s 79 of the *Family Law Act 1975*. In particular, the likely relevance will depend upon the nature of the claims being put forward and the overall facts of a particular case[57] or, as the court held:[58]

> "Although trustees should primarily regard themselves as having a duty to withhold disclosure of a confidential memorandum of wishes ... the Trustees and Court ought determine whether countervailing circumstances, including the likely relevance of the wishes of the person at whose request the trust was created, warrants disclosure."

Arguably, if trustees are concerned about protecting the confidentiality of letters of wishes, in light of these cases, they should consider advancing no reasons at all for the decision to withhold the letter as, if they do advance such reasons, the court is entitled (upon application by a beneficiary) to enquire as to the reasonableness of the trustee's decision.[59]

Read & Chang[55] in particular demonstrates this point. In that case, the trustees admitted to being influenced by the memorandum of wishes in making past income distributions to the wife from the relevant trust. This admission gave credence to the husband's argument that the letter would better inform the court about future distributions, and the court therefore examined the relevant document before making its decision.

Range of beneficiaries

As noted above, when structuring trusts, careful consideration should always be given to the range of potential beneficiaries and, in particular, whether spouses should be included. Generally, it is difficult for the Family Court to draw a sufficient nexus between a trust and the parties to a relationship where the relevant spouse has never been a beneficiary of the trust.

In the case of *Essex & Essex*,[60] the mere *possibility* of receiving trust distributions was confirmed as being sufficient to support a finding that the trust was a financial resource. In particular, the court held:[61]

> "The husband was a named income beneficiary of the S Trust. The husband at no time sought to remove himself as a beneficiary, and the husband's brother's attempt to do so had no relevant purpose (other than to attempt to put the trust's assets beyond the reach of the Court) ... Significantly, as the sole director of the corporate trustee of the S Trust the husband's brother had control of that trust and was only obliged to consider the husband as one of the three income beneficiaries entitled to the income of the trust. However, the husband's brother conceded that, but for a disqualifying factor (the property proceedings) the husband should have the benefit of assets in the trusts. This in our view required the trial Judge to find that the S Trust was a financial resource of the husband."

Distributions

It is common for parents to use trust assets to assist children with making personal investments, for example, the purchase of a family home. Rather than simply distributing or gifting assets to the relevant child, significant asset protection can be achieved by having funds loaned by the trust, with appropriate security taken over the assets acquired by the child.

Similarly, trust assets can often be inadvertently drawn into the property pool where there are unpaid present entitlements or credit loan accounts owing to a party to the relationship breakdown. In cases where the trust owes a debt to a spouse, that amount will be included as an asset of the spouse without needing to consider the issues outlined above in relation to the trust.

Binding financial agreements

If increased certainty that trust assets will not be exposed in a property settlement is desired, consideration should be given to implementing a binding financial agreement (BFA). Commentary about how a BFA can be a useful tool to limit the application of the Family Court's powers in relation to trust assets is, however, outside the scope of this article.

Conclusion

Superficially, the outcome of *Kennon v Spry* appears to undermine the fundamental principle of trust law that a mere discretionary beneficiary of a trust does not have a property interest in the assets of the trust. Ultimately, however, the decision is an example of the court's utilisation of the broad powers under the Family Law Act in relatively unique circumstances.

While this is an evolving area of law, decisions following *Kennon v Spry* indicate that, for the foreseeable future, well-structured trusts should continue to be an effective vehicle for asset protection and estate planning.

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