

Weekly Tax Bulletin, No 34, 10 August 2012

Assets of a family trust not necessarily at risk on a matrimonial breakdown

- by Matthew Burgess, Partner and James Ford, Graduate, McCullough Robertson

Trusts are structures regularly used for asset protection purposes or as vehicles to protect children from divorce when relationships break down. However, family trusts must be used carefully to avoid potential problems. A recent case is illustrative here.

The decision of the Family Court in *Morton v Morton* [2012] FamCA 30 has highlighted the importance of carefully considering the most appropriate structure for trust arrangements to achieve the objectives of the parties, particularly in the context of a relationship breakdown.

As explored in more detail below, the particular decision here largely rejected arguments based on the High Court decision in *Kennon v Spry* (2008) 238 CLR 366, which, at the time, caused many advisers to believe that family trusts provided little (and perhaps no) protection on a relationship breakdown.

It might be recalled that in *Kennon v Spry*, when the marriage was in difficulty, Dr Spry varied the discretionary trust to exclude himself and his wife as capital beneficiaries. He later divided the income and capital between 4 trusts he had set up for their 4 daughters. The High Court ultimately held the matrimonial property was to be divided on the assumption that it included all of the trust property.

Background to the *Morton* case

The case involved a property settlement in the divorce between Mr and Mrs Morton (pseudonym), a couple from Sydney who had been married for approximately 10 years. There were no children of the marriage.

At the time of the divorce, the husband was a beneficiary of a discretionary trust, the Morton Trust (Trust). The beneficiaries of the Trust included the Husband (H) and his brother (HB), their mother, any grandchildren or remoter relatives and any companies or trusts in which H or HB had an interest.

The trustee company, J Pty Ltd (Trustee) had 2 ordinary shares, one owned by each of the brothers. The brothers were both the directors of the Trustee, and the joint appointors of the Trust.

The Trust had a "bucket company", T Pty Ltd (Bucket Co), which was owned 100% by Trustee on behalf of the Trust. There were unpaid present entitlements (UPEs) owing to Bucket Co. HB was the sole director of Bucket Co.

The wife claimed that, between them, H and HB each effectively had a 50% share in the assets of the Trust and Bucket Co. As such, H's interest in the Trust and Bucket Co (half of its assets) should be treated as his property, and therefore added to his pool of assets for division under the property settlement.

Issues

The wife argued that H, as a director of Trustee, had "control" of the Trust and, consequently, Bucket Co. However, H argued that, as HB was appointed and acted in the same capacity as a director, neither H nor HB had control of the Trustee, and their rights were equal (ie neither brother had effective control).

The fact that the brothers were joint appointors and had the power to remove and appoint a trustee was also considered.

The Family Court held that there was a bona fide trust arrangement. While (as most families would hope) there was a "warm and loving relationship" between the brothers and there had been inter-mixing of funds - not only their own personal funds, but funds from various entities from which the Trust received distributions - there was insufficient evidence to convince the judge that H had sufficient control over the Trust and Bucket Co to simply treat those assets as his.

It was held that the interest in the Trust and the UPEs in Bucket Co should be excluded from the husband's asset pool. The interest in the Trust was treated as a "financial resource". However, this was not a contentious issue, as H had previously conceded that the interest in the Trust should be treated as such.

Implications of the decision

In considering the relevance of *Kennon v Spry*, the Court was satisfied on the evidence that the Trust did not hold the assets as an "alter ego" of H. As such, the judge found that the assets of the Trust were not to be treated as H's assets - ultimately, he was merely a potential beneficiary and did not in fact control the Trust.

Had it not been for the husband's brother, who was appointed as co-director of Trustee and co-appointor for the Trust, the outcome of this case may have been different.

The decision demonstrates that when establishing trusts and related entities, thought should be given to:

- relinquishing some control at a shareholder level of any trustee company;
- appointing multiple directors of any trustee company; and
- appointing more than one appointor and requiring that they act jointly.