Your Discretionary Trust Deed is a Time Bomb

With Grant Abbott – LY Legal & LBO

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Consider the recent case of *Owies v JJE Nominees Pty Ltd* (2022). The Owies Family Trust, established in 1970, named a couple's three children as primary beneficiaries. Yet for years the trustee distributed all trust income to the parents and one favored child, excluding the other two children.

When those overlooked children finally challenged the distributions, the Victorian Court of Appeal found the trustee had breached its fiduciary duty by failing to give "real and genuine consideration" to **all** beneficiaries. Despite the deed purporting to give the trustee "absolute and uncontrolled" discretion, the Court removed the trustee for overstepping its bounds.

This outcome sent shockwaves through the accounting and legal community – and serves as a stark warning. Had the accountants and advisors involved reviewed the trust deed and beneficiaries more carefully before issuing yearly distribution statements, this costly litigation and family rupture might have been averted.

The Lesson: Outdated Deeds Create Dangerous Risks

Legal Disputes

Outdated deeds can implode into costly legal battles between family members, as seen in the Owies case.

Tax Nightmares

Old deeds often lack provisions to handle modern tax laws, potentially triggering unexpected tax liabilities.

Unintended Transfers

Without proper review, wealth may flow to unintended recipients or be exposed to unnecessary claims.

Many Australian family trusts formed decades ago have never been properly reviewed or upgraded. Accountants often prepare year-end distribution resolutions by rote, without scrutinising whether the deed's provisions still align with the client's intentions or current law.

Outdated Definition of Trust Income

Pre-2010 Definitions

Many older trust deeds lack flexible income definitions and still use archaic concepts of income.

FCT v Bamford Impact

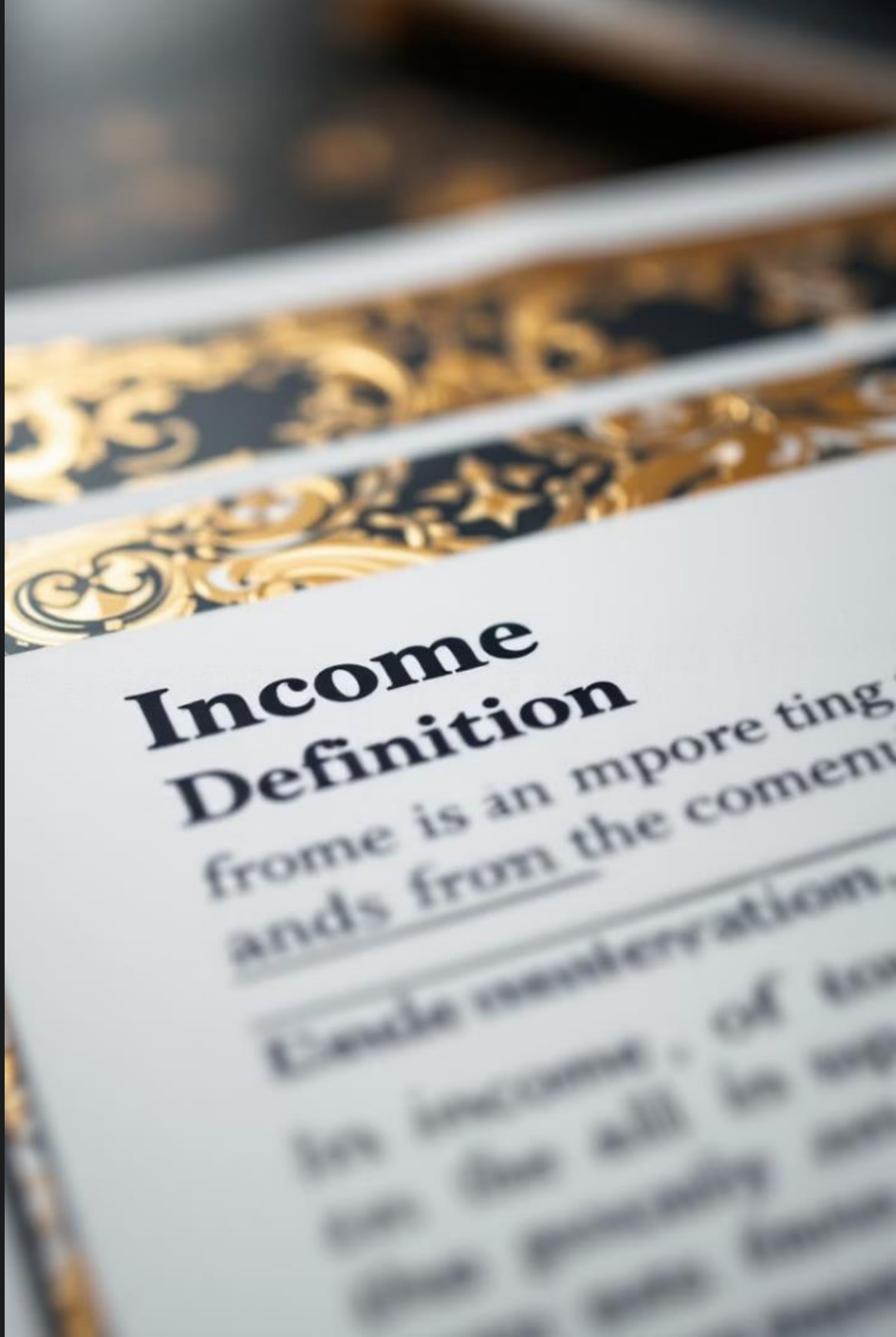
The High Court confirmed that a trust deed can define trust income, which determines how tax liabilities are allocated to beneficiaries.

Tax Consequences

If the deed's income definition is too restrictive or absent, the trustee may be taxed at 47% on undistributed amounts or certain capital gains.

Financial Risk

A trust deed that defines income as only "receipts of a revenue nature" could exclude capital gains from distributable income, resulting in unexpected tax bills.



No Streaming Powers for Capital Gains and Franked Dividends

Legislative Changes

After 2011 changes, trusts can only effectively stream capital gains and franked distributions if the deed permits it

Deed Limitations

Without streaming clauses, attempts to allocate specific income types to particular beneficiaries may be invalid

Lost Benefits

Tax credits or discounts could be lost or allocated contrary to plan

Modern Solution

Updated deeds include clauses to separately identify categories of income and allocate them accordingly

The High Court's decision in *Thomas v FCT* (2018) underscored that streaming franking credits requires adherence to the trust deed and tax law – franking credits must follow the beneficiary who receives the dividend income, unless the deed's terms allow separate treatment.

Imminent Vesting Date and Perpetuity Issues

Trust Establishment

Many trusts settled in the 1970s or 1980s specified an 80-year vesting period

Approaching Deadline

These trusts are now silently nearing their vesting date – when the trust must end and distribute assets

CGT Consequences

On vesting, beneficiaries' interests become fixed, potentially triggering a large CGT event as assets are deemed disposed at market value

Invalid Extensions

Any attempt to extend after the vesting date is usually void, and continuing the trust could cause CGT event E1

The ATO has illustrated a case where a trustee discovered the vesting date had passed and tried to extend it retroactively – the extension was invalid, and the continuation of the trust on new terms caused CGT event E1 (creation of a new trust).

Rigid or Limited Trustee Powers

No Power to Amend

Some old deeds have no variation mechanism or overly narrow amendment clauses, making even minor needed changes impossible without a Supreme Court order.

Deceased Consenters

Deeds requiring consent from a named person (e.g., an appointor) to any variation face problems if that person is deceased or incapacitated.

Invalid Variations

If a trustee attempts a variation not permitted by the deed, it will be invalid – the original terms prevail, and actions taken under the "amended" deed may be void.

Restricted Powers

Limitations on investing in certain assets, making loans, or allowing the trustee to be a beneficiary can impede effective administration and succession planning.

A sobering example was seen by LY Legal: a trust deed's amendment power applied only to clauses "hereinbefore" the power. The trustee had unknowingly been amending provisions that appeared after the power clause, thinking the changes were valid. In reality, those changes exceeded the power and were ineffective.

Missing or Unintended Beneficiaries in the Deed

Evolving Family Structures

Families change over time

Static Beneficiary Lists

Old deeds may not include new family members

Invalid Distributions

Distributions to non-beneficiaries are ineffective

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Tax Penalties

Income is taxed at the top marginal rate

LY Legal has seen cases where an accountant distributed trust income to a spouse or family company, only to later discover the deed never included them as permissible beneficiaries – rendering the distribution invalid and exposing the trustee to ATO assessments at the top marginal rate.

The ATO has warned that reading the deed is critical in making distributions, and trustees must ensure each beneficiary is within the deed's scope.

Exposure to "Foreign Person" Surcharges

Foreign Trust Classification

If any potential beneficiary is a foreign person, the entire trust can be deemed "foreign"

Significant Surcharges

8% extra duty on purchase and 2%-4% annual land tax surcharge

Exclusion Clauses Required

Deeds must expressly and irrevocably exclude foreign persons as beneficiaries

Many older deeds include very broad beneficiary classes (e.g., "any descendant of Adam and Eve" or categories that could include non-residents by marriage or remote lineage). That breadth unwittingly turns the trust into a foreign trust in the eyes of revenue offices.

In New South Wales, a discretionary trust will be deemed foreign unless the deed expressly and irrevocably excludes any foreign persons as beneficiaries. Victoria and other states have similar rules.

No Succession Plan for Trustee or Appointor Control

The Appointor Role

The appointor (also called principal or guardian in some deeds) is often the person with power to hire and fire the trustee – effectively the "controller" of the trust.

If the appointor dies without a successor named, the power might pass to their legal personal representative by default or as a matter of law... or it might simply lapse, leaving a power vacuum.

Succession Uncertainty

Without a clear succession mechanism in the deed, even simple changes become cumbersome – requiring probate, multiple court applications, or risking competing appointments.

This uncertainty can lead to ugly disputes, as family members jockey to install themselves as trustee to control assets.

Modern Solution

A modern deed builds in cascading appointor succession: e.g., on death of the parent, the role of appointor passes automatically to a specified successor or as directed in a Memo of Wishes.

It may also allow an appointor to nominate their successor by deed or will.

Mercanti v Mercanti (2016) is an example where a father's attempt to pass control via appointor powers led to protracted litigation among family members; the court dissected the deed's wording to determine if the variation of appointor was valid.

Risk of Family Disputes and Litigation

Sibling Conflicts

When one child controls the trust and excludes others, those "left-out" beneficiaries may accuse the trustee of breach of duty for failing to consider them or acting in bad faith.

Court Scrutiny

Courts are increasingly willing to scrutinise how trustees of family trusts exercise their discretionary powers, as seen in the Owies case where trustees were removed.

Preventative Measures

Modern trusts use mechanisms like bloodline-only beneficiary clauses, independent trustees, mandatory consultation provisions, or alternate dispute resolution clauses to mitigate these risks.

Asset Protection Gaps

Bankruptcy Risks

If a beneficiary becomes bankrupt, some old trust deeds might automatically vest that beneficiary's share of trust income or capital in them, undermining the trust's protection.

Family Court Exposure

If a trust is not clearly delineated as a truly separate entity, the Family Court might treat it as property of the relationship, especially if the controlling spouse can appoint themselves funds freely.

Family Protection Trust Solution

A Family Protection Trust model counters these risks by strictly limiting who can benefit (only bloodline descendants, no in-laws) and preventing distributions that would end up outside the family bloodline.

Notional Estate Claims

Without protections against family provision claims, assets left in a standard discretionary trust might still be attacked after the settlor's death under certain notional estate laws.

Tax Law Landmines – Section 100A and More

100A

Reimbursement Agreements

Anti-avoidance provision targeting trust distributions where income is appointed to a low-tax beneficiary but the economic benefit goes to someone else

6E

Division 6E

Income streaming provisions that require specific deed powers to implement effectively

7A

Division 7A

Provisions affecting loans from trusts to company beneficiaries that require specific administrative powers

The ATO in 2022 released guidance on 100A, scrutinising arrangements where trust income is appointed to a low-tax beneficiary but the economic benefit is provided to someone else. While 100A is about taxpayer behavior, the trust deed can either mitigate or exacerbate risk.

Some modern deeds include clauses to expressly allow or ratify certain beneficiary loan arrangements or to define default entitlements in a way that avoids 100A application. An old deed with rigid or overly broad distribution powers might inadvertently facilitate a 100A risky arrangement without anyone realizing.

Upgrade to a Modern Trust Deed

The foundational step is a comprehensive deed update or replacement. Using an expertly drafted modern discretionary trust deed can immediately address many of the issues identified.

A modern deed will have: a flexible income definition aligned with tax law; streaming powers for all income types; an extended perpetuity period; wide trustee powers including robust variation powers; clearly defined beneficiary classes including future descendants and excluding unwanted persons; and built-in succession of control provisions.

Importantly, the upgrade should be done by qualified legal professionals to ensure the changes themselves are valid and don't trigger a resettlement.

Family Protection Trust: The Gold Standard

Bloodline Protection

No individually named beneficiaries in the deed – instead, classes like "lineal descendants of Family Protection Appointors are used. This excludes non-blood individuals (spouses of descendants, step-children, etc.) from benefitting unless expressly allowed.

Succession Planning

Appoints a Family Protection Appointor – usually the patriarch or matriarch – who has power to direct the trust. Upon their death or incapacity, the role passes to the next in line according to a predetermined succession plan.

Asset Protection

Prohibits distributions outside the bloodline – meaning a child's spouse cannot receive assets, which both protects against divorce claims and ensures that in-law families don't siphon off wealth.

For families deeply concerned about asset protection and lineage control, the Family Protection Trust (FPT) is an optimal solution. An FPT is essentially a discretionary trust with special provisions to ensure the trust's benefits stay within the bloodline and under the guidance of successive family leaders.

CGT Implications of Trust Deed Changes

Valid Power

Changes made under a valid power in the deed

Preserve Continuity

Maintain the trust's essential nature

No CGT Event

No resettlement occurs for tax purposes

Whenever the topic of changing trust deeds comes up, advisors must consider capital gains tax (CGT) and stamp duty. A major fear is that a significant variation could be treated as a resettlement – causing a CGT disposal of all assets.

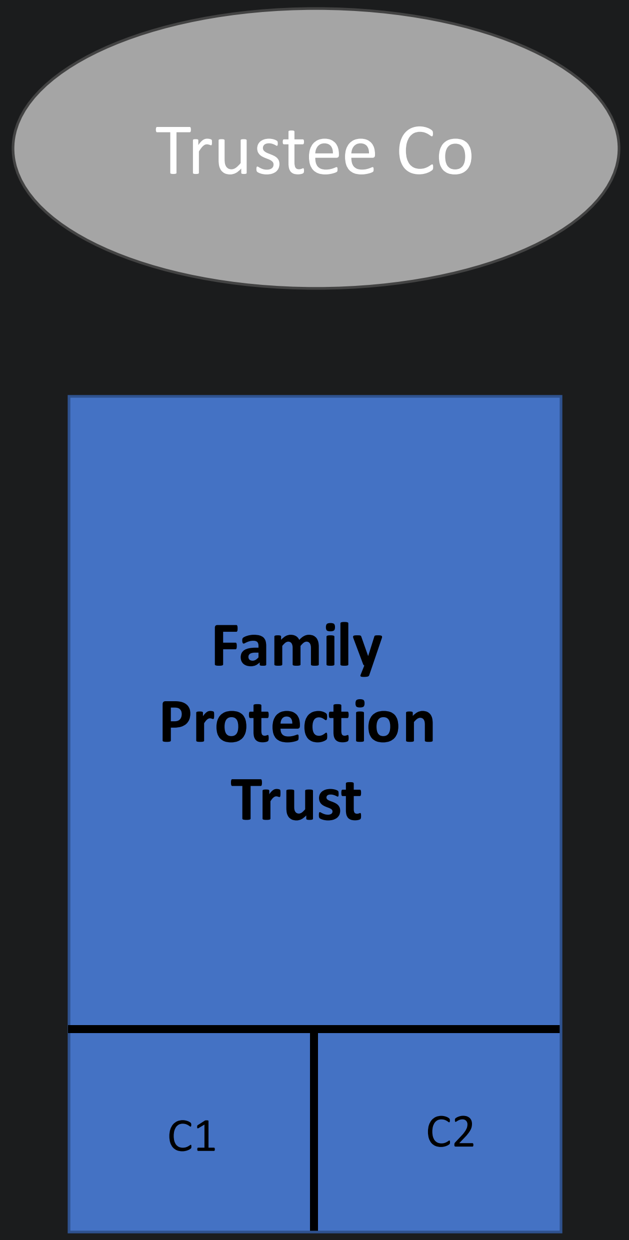
Tax Determination TD 2012/21 addresses when CGT event E1 or E2 happens on amending a trust. The ATO's view is that if changes are made in accordance with a valid power in the deed, and the changes do not fundamentally alter the trust's essential nature, then no CGT event occurs.

For example, TD 2012/21 gives an example of adding a definition of income, inserting streaming powers, and extending a vesting date on a decades-old trust – and concludes that doing so under the deed's amendment power does not give rise to a CGT event.

Sub-Trusts to Ring-Fence Wealth

Succession of FPA

- FPA
- FPA 2
- FPA 3



Bloodline Beneficiaries

Trust Splitting Considerations

ATO Guidance

Tax Determination TD 2019/14 specifically looks at "trust splitting" arrangements. The ATO concluded that a trust split can trigger CGT event E1 because it may result in a new trust being created over the assets under the new trustee's control.

In the TD's Example 1, a family trust was split so that certain shares were transferred to a new trustee company for the benefit of certain members exclusively, while the original trustee kept other assets for other members. The ATO viewed this as creating a new trust over the carved-out assets.

Safe Approaches

However, the TD also provides an Example 2 where a deed was amended to appoint separate trustees for separate parts of the fund for succession reasons, but with provisions to keep the trust as a single fund for other purposes. In that scenario, the ATO accepted it did not amount to a new trust – thus no CGT event.

Simply upgrading a deed to a modern form, or even implementing an internal sub-trust scheme, will not usually cause a CGT issue if done properly. But formally splitting a trust into two independent trusts could be seen as creating a new trust.

The main message to advisors is: involve legal and tax experts when contemplating substantial changes. With guidance, one can structure changes to avoid CGT events.

Professional Risk for Accountants

Legal Territory Risk

Interpreting trust provisions or making changes to deeds constitutes legal work that carries risk. Accountants may face liability if they overstep into legal territory or fail to flag issues.

Distribution Errors

Issuing distribution statements without checking the deed can lead to client disputes, tax problems, and potential liability for professional negligence if the oversight contributed to a loss.

DIY Dangers

Undertaking a trust deed upgrade using an off-the-shelf template without legal guidance is dangerous. If done incorrectly, the variation could be invalid or cause a resettlement.

Insurance Gaps

Preparing legal documents is outside the scope of typical accounting professional indemnity insurance, leaving accountants personally exposed if problems arise.

The safer approach is for accountants and financial advisors to partner with LY Legal when dealing with trust deed upgrades or complex variations.

The Smith Family Case Study: Traditional DT vs. Family Protection Trust

Scenario 1: Traditional Trust

John and Jane Smith have a traditional discretionary trust from 1990 with themselves as trustees and primary beneficiaries, and their two adult children listed as general beneficiaries.

When John passes away, Jane becomes sole trustee. One child, Alice, is very involved in the family business (owned by the trust) and expects to control it; the other child, Bob, is estranged.

Jane, influenced by Bob or a new partner, might favour one over the other. Alice has no automatic right to anything and grows frustrated. Eventually, suspecting unfairness, Alice considers legal action.

The trust deed's lack of clear succession means that if Jane becomes infirm, a power vacuum emerges. The family business is paralyzed and headed for court.

Scenario 2: Family Protection Trust

John and Jane instead upgraded to a Family Protection Trust structure. The deed was modernised so that only bloodline descendants can benefit; John is the Leading Member and Jane the next in line.

The deed also, at John's passing, automatically appoints Alice and Bob as joint trustees and immediately creates two sub-trust accounts – one for each family line.

When John dies, there is far less uncertainty: Jane takes over temporarily but she knows both kids will be involved per the deed's terms. She cannot simply allocate everything to one side because the deed's framework guides separate treatment.

Alice and Bob each effectively inherit controlled use of half the trust without the assets leaving the trust (preserving asset protection). The trust assets are insulated from divorce claims, and there's no fight over who controls the trust.

TRUSTIFY

Feature	Standard Deed Upgrade with other Legal Firms	TRUSTIFY(LY LEGAL)
Comprehensive Trust Deed Review	Basic	Comprehensive Plus
Income Definition Update	Yes	Yes
Trustee Powers Enhancement	Limited	Yes
Beneficiary Identification	Limited	Yes
Foreign Person Exclusion Clause	Sometimes	Yes
Trust Vesting Date Review	Sometimes	Yes
Clerical Error Corrections	No	Yes
Trustee Succession Planning	No	Yes
Educational Videos for Trustees	No	Yes
Specialist Family Protection Trust (FPT) Option	No	Yes
Turnaround Time	2-3 weeks	5 business days
Pricing	\$500-\$600	\$595 (Standard) / \$795 (FPT)

Call to Action: Review and Upgrade Now

Regular Reviews

A discretionary trust deed should ideally be reviewed annually or at least every few years, especially whenever there are significant tax law or family changes.

Professional Support

Contact specialists for a Trust Deed Review and Upgrade service. Book a Discovery Session to explore the best solutions for your client's situation.

Documentation

Always keep documentation of advice to review or vary a trust deed, and ensure the client signs off on engaging legal experts for the task.

Cost-Benefit

The cost of prevention (updating a deed) is negligible compared to the cost of cure (untangling a trust dispute or tax mess).

Your client's discretionary trust deed should be a cornerstone of their wealth plan – not a landmine waiting to blow up their legacy. By recognizing the warning signs and acting now to modernize and fortify these structures, you will protect your client's interests, uphold your professional duty, and possibly save everyone a fortune in future legal fees and taxes.