ACCOUNTANTS v TRUST LAWYERS:

SOME RECENT CASES IN THE LAW OF TRUSTS

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Introduction

Some recent decisions in regard to the law of trusts highlight once again the differing perspectives on trusts between accountants and financial advisors on the one hand, and trust lawyers on the other. These decisions all involve typical discretionary trusts set up for the benefit of families. Such discretionary trusts remain popular in Australia, although their *raison d'etre* has changed with time. No longer associated with attempts to minimise death duties, they are still frequently perceived to have benefits in regard to income tax. Certainly, wherever there is some business enterprise or farming venture conducted amongst several members of a family, the discretionary trust does provide a very flexible means for arranging the distribution of income.

Many of the tax structures that now find their way to Courts were set up decades ago, and changing tax regimes may have largely deprived them of any significant advantage as against other structures. Nevertheless it can be complex to dismantle such arrangements, and it can carry its own financial penalties. Thus, it is not unusual to see such structures continuing even when they are no longer convenient.

The nature of the discretionary trust, which gives almost the complete control of the trust to the trustee and/or the appointor on the one hand, and on the other, almost no power to govern the operation of the trust to the beneficiaries, creates its own special legal issues where there is dispute between those trustees and beneficiaries. These issues usually arise when there has

been a breakdown in the relationship between those in control of the trust on the one hand, and certain or all of the beneficiaries on the other.[1]

When relationships between the trustee of a discretionary trust, and the beneficiaries break down, and there is an attack on the trustee's position, perhaps coupled with an application for his removal, there is also an incentive to examine carefully the previous administration of the trust, to seek signs of administrative incompetence, or malfeasance, as a potential ground for removal.

Apart from conflicts between the trustee and beneficiaries, the death of controllers of the trust can also give rise to conflicts. This is especially so where the estate of the deceased controller is enmeshed with the affairs of the trust. This can give rise to difficult but important questions about what assets now form part of the estate of the deceased, and which assets are still properly within the trust.

Some recent cases involving conflicts of the sort just described highlight some important issues regarding the administration of trusts. In each of these cases the issue arose because accountants had sought to effect distributions from the trust by so called "book entries" without any distribution *in specie*. These transactions were attacked by parties claiming that they were ineffective as distributions of income or capital of the trust. So far, the accountants have been vindicated, but a pending Special Leave Application to the High Court in the second of the two matters could see that situation change.

While the distribution by so called book entries have been supported thus far, the litigation demonstrates some of the risks in dealing with trusts from a purely accounting perspective, without being sufficiently cognisant of the law of trusts.

The *Clark v Inglis* Case

Upon the death of Dr William Inglis, a dispute arose as to whether a beneficiary loan account, in the records of the discretionary trust that Dr Inglis had set up, was enforceable at the demand of his executors, or was void and hence no sum was due.

The matter at first instance, named *Wood v Inglis* [2009] NSWSC 601, was determined by Brereton J in the New South Wales Supreme Court. The evidence revealed that the trust

[1] I dealt briefly with these issues in a paper presented for the Law Society of New South Wales last November. *"A Beneficiary's Entitlement To Obtain Information And Have An Executor Or Trustee Removed"*

accounts for the family discretionary trust of Dr Inglis for the eight odd years before his death had been prepared on the basis that the share portfolio held by the trust was revalued each year to market, and any net positive movement in the value of investments was treated as income, and distributed to Dr Inglis by being credited to his beneficiary loan account. No actual payments were made to Dr Inglis. At the date of his death as a result of the credits to his beneficiary loan account, the accounts of the trustee company showed it indebted to his estate in the sum of $1.3 million.

At the hearing at first instance, there was controversy as to whether or not the increases in the market value of the share portfolio were income, and hence distributable as such by the trustee in circumstances where they had not been realised by a sale of the assets. Expert accounting evidence was called. His Honour concluded that the trustee was entitled to treat the increases in net value of the investments as income on account, and moreover even if they had been unrealised capital gains, they were capable of being distributed as capital under the provision in the trust deed permitting the trustee to advance capital in its discretion.

As the case was conducted before Brereton J, the focus was on the proper characterisation of the increases in market value of the share portfolio, and whether that fell within the description of income under the deed. Further, there was substantial controversy as to whether the accounting treatment was something that had been undertaken by the accountant properly instructed by the trustee, or whether it had been merely done by the accountant on the assumption that this was how the trust had, in the past, operated. In regard to this issue Brereton J found that the late Dr Inglis had been actively involved in the administration of the trust, had viewed the accounts each year and accepted them, and that as the controlling mind of the corporate trustee, His Honour inferred that Dr Inglis had approved of the distributions of income recorded in those accounts.

Importantly, Brereton J found that Dr Inglis had made his last will on the footing that the substantial loan account in the trust was an asset of his estate (ie that the trust owed him the sum of the loan account which was in effect repayable on call).

One further issue, although having only a subsidiary significance in the litigation at this stage, was whether the trustee did in fact make the relevant distributions to Dr Inglis. Keeping in mind that no money was distributed, but that he was merely credited in the books of the trust with an amount equal to the distribution, as a sum for which the trustee was now indebted to Dr Inglis, His Honour nevertheless concluded that these distributions had been made. There

were resolutions of the company in its capacity as trustee resolving to distribute the relevant amounts. Further, His Honour noted that there was a default distribution of income to Dr Inglis, if the trustee's discretion had not otherwise been exercised, and His Honour concluded that this would have resulted in the same practical outcome had the resolutions not been effective.

Although the issue is hinted at before Brereton J, it was not suggested in the boldest terms that distributions could not be made by accounting entries in the books of the trustee recording an acknowledgement of debt to the beneficiaries. The issue was implicitly dealt with, in regard to the question as to whether the increases in value of the assets was income in the absence of realisation, but that was not a matter directly relevant to the issue of distribution under trust law, and that is an issue which arises in a number of other legal contexts including tax and company law.

The decision of Justice Brereton upholding the validity of the loan accounts was appealed to the New South Wales Court of Appeal (*Clark v Inglis* (2010) 79 ATR 447). Before a Bench consisting of Allsop P, McColl and Macfarlan JJA, the issues underwent a subtle change of emphasis. Allsop P noted that if the distributions in the books of the trust were effective, then the distributed income fell within the assessable income of the beneficiaries in consequence of provisions of the *Income Tax Assessment Act* 1936 (Cth), and that the tax returns of the beneficiaries, and the trust, did not appear to be consistent with the claim that there had been such a distribution.

Importantly, Allsop P characterised what had happened as - "the making of the distribution and the lending back of the distribution" at [30]. This clearly implied that the relevant entries in the accounts showing a loan associated with a distribution ought be understood as having reflected a notional distribution on the one hand, and a loan of the amount of that distribution by the beneficiary back to the trustee, leaving the trustee indebted to the beneficiary by the amount of the income distributed.

Before the Court of Appeal the principal argument of the applicants was that regardless of accounting principles, income tax law, or company law concerning the availability of profit for the declaration and distribution of dividends, unrealised capital gain per say, is not property whether under the trust deed or at law. The increased value of the investments may constitute a profit, but that did not equate to income and was not distributable. This argument was rejected by the Court which concluded that both under the trust deed, and the law generally, unrealised

increases in value of investments were capable of being treated as income. The Court granted leave to appeal, but dismissed the appeal and upheld the decision of Brereton J.

In *Wilson v Chapman* [2012] QSC 395, a decision of Justice Daubney of the Supreme Court of Queensland, the focus of that case was again on whether the increases in value of investments constituted or could constitute income or capital gain. His Honour however noted that in *Clark v Inglis* the trust deed had merely required the trustee to "apply" the income and that this was done by crediting beneficiaries' accounts, although no money in fact was realised. In *Wilson v Chapman* the trust deed required the trustees to "pay, transfer and hand over" the income and profits, and this His Honour concluded, could not be done in regard to unrealised increases in valuing book entries.

Fischer v Nemeske Pty Limited

Issues touched upon only tangentially in the *Inglis* litigation became the central question in the litigation involving the family trust of the late Mr Nemes. At the death of Mr Nemes in September 2011 the accounts kept by Nemeske Pty Limited as trustee of the Nemes Family Trust showed a debt owed by the trust to the late Mr Nemes of $3.9 million. Once again the issue turned upon whether that money ought be paid by the trustee to the Nemes estate for the benefit of the residuary beneficiaries of that estate, or whether the debt was void, thus enlarging the corpus of the trust to the advantage of the beneficiaries of the trust.

The origin of the debt lay in decisions of the trustee in 1994. The trustee had created an asset revaluation reserve following a revaluation of the assets by a further $3.9 million. The assets were shares in private companies which in turn held assets, largely land, in both Australia and the United States.

Some months after creating the asset revaluation reserve the trustee resolved to make – "a final distribution" out of the asset revaluation reserve, the entire reserve to be paid or credited to two of the beneficiaries, Mr and Mrs Nemes as joint tenants. Beneficiaries accounts at 30 September 1994 after the resolution showed a capital distribution of $3.9 million, and liabilities recorded – "loans-secured B.G and M Nemes $3.9 million".

In addition to these entries in the accounts of the trustee a charge was executed by the trustee and registered, securing a debt by the trustee to Mr and Mrs Nemes of the $3.9 million dollars. The existence of that deed of charge added a number of additional issues to the litigation, and was significant in light of a limitation defence raised by the trustee. However, both at first

instance and in the Court of Appeal, the primary issue was whether the relevant oral resolution and accounting entries gave rise to a debt, and this paper will focus on that aspect of the litigation.

The trustee raised an interesting and novel argument. A distribution by a trustee, it was said, either of income or of capital, required an actual transfer of property from the trust to the beneficiaries. While the issue was in part governed by the terms of the deed, the deed in this case, gave the trustee power to "advance" or "raise" any part of the capital or income, and to "pay" or "apply" the same as the trustee thought fit for any of the beneficiaries. Even such broad words as these, so it was argued, coupled with the general law of trusts, required that the trustee transfer ownership of some property of the trust, and that the resolutions of the trustee and entries in the accounts were, until such distribution took place, nothing more than an indication of an intention, albeit unacted upon by the trustee.

The trustee further argued that there appeared to have been confusion in the mind of those responsible for the drafting of the resolution and the creation of the accounts. In company law, a declaration by the Board of a company of a dividend typically gives rise upon that declaration, to a debt by the company to the shareholder for the requisite dividend. From the time of the declaration, the declared dividend is a liability of the company until extinguished by payment. Subject to the constitution of the company and the terms of the declaration, the dividend is from its declaration a debt enforceable by the shareholder in the event that the company fails to make the payment. By contrast the trustee argued, trust law knows no analogous doctrine whereby a mere resolution or determination by a trustee of an intention to make a distribution of income or capital, gives rise immediately to a debt enforceable at the behest of the beneficiary for the quantum of the intended distribution. The determination by the trustee reflects merely a statement of intention, and gives the beneficiary no enforceable right to sue for the distribution the trustee has resolved to make.

Applying arguments of the sort just set out, the trustee contended that the resolution made by its directors some 20 years earlier, and the entries in the accounts, were wholly ineffectual to make a distribution or advance capital to Mr and Mrs Nemes. If there had been no effectual distribution of capital, then there was nothing to support any debt by the trustee company to the beneficiaries, and there was in consequence no enforceable loan owed by the trustee to the beneficiaries, and nothing secured by the registered charge.

The matter was dealt with at first instance by Justice Stevenson in the Supreme Court of New South Wales. There were a number of other issues not relevant to this paper concerning the proper construction of provisions of the trust deed, and further factual issues generated by the incomplete records of the trustee company. Only one of those issues is of present interest, namely, that the very words of the resolution whereby the trustee purported to distribute the "asset revaluation reserve" was clearly not capable of literal application. The asset revaluation reserve was just an accounting entity and could not, in any sense, be distributed. However, Stevenson J concluded that properly construed, the resolution clearly intended to distribute money to the value of the asset revaluation reserve, namely $3.9 million.

Having resolved the issue just described, His Honour came to the critical question, namely, given that no money was in fact paid out, whether the creation of the capital distribution entry in the beneficiaries' accounts, and creation of a non-current liability in the balance sheet styled "loans-secured EG & M Nemes" was a manner in which the trustee was able to make a distribution, and gave rise to an enforceable debt at the behest of the beneficiaries.

His Honour concluded that it was not necessary that the trustee actually distribute cash or other property, and that a distribution could be made by the creation of an indebtedness by the appropriate resolution and accounting entries. Stevenson J found support in the *Wood v Inglis* and *Clark v Inglis* cases in which at least implicitly it had been assumed that it was possible for a trustee to make a distribution by crediting the beneficiaries' loan accounts. His Honour therefore concluded that an effective distribution had been made by the resolution, coupled with the crediting of the loan accounts, and that the trustee had thereby become indebted to Mr and Mrs Nemes for the amount of the distribution.

From the decision of Stevenson J, the trustee who had failed to defeat the enforceability of the debt on any of its arguments, appealed to the Court of Appeal (*Fischer v Nemeske Pty Limited* [2015] NSWCA 6). The decision of the Court (Beazley P, Barrett and Ward JJA) was given by Justice Barrett.

In the Court of Appeal the trustee now emphasised the terms of the trust deed, and that it was an impossibility under the law of trusts that a distribution could be effected without a transfer of property. The trust deed's authorisation to "advance" or "raise" the capital of the trust, and to "pay" or "apply" the same could, it was argued, only occur through a change of legal title in property of the trust. It was argued that if the *Inglis* decision was to be taken as authority for the proposition that a trustee could make a capital distribution of property by crediting loan

accounts, then it had been wrongly decided. However, it was noted that in *Inglis* this argument, about the necessity for a transfer of ownership of trust property to effect a distribution of income or capital, had not been directly raised or argued.

Before the Court of Appeal the executors contended that it was legitimate to view the resolution of the trustee and the accounting entries as reflective of a distribution by the trustee to Mr and Mrs Nemes, and a loan of those distributed moneys back to the trustee, thus giving rise to the loan liability. The books of the company reflected the final position of the parties in that situation, namely the assets continued to be held by the trustee, not having been liquidated and paid out in cash. Notionally the company had advanced to Mr and Mrs Nemes the distributed sum, but had borrowed it back, thereby creating its indebtedness to the beneficiaries. It ought not to be an objection that the parties had not physically handed the money back and forth for each step of the process.

The leading decision in the Court of Appeal by Barrett JA noted that some of the language used in the resolution of the trustee appeared borrowed from the company law context, but that it was important not to simply dismiss the legal efficacy of what had occurred as a misguided attempt to apply company law concepts, but to determine whether the words drawn from a company law context would nevertheless have meaning in regard to a trust.

Barrett JA referred to the decision of the Western Australian Court of Appeal in *Chianti Pty Limited v Leume Pty Limited* (2007) 35 WAR 488, in which the Court of Appeal concluded that the crediting to the beneficiaries' accounts of distributions gave rise to debt actionable by the beneficiaries. However in *Chianti* the trust deed empowered the trustees to pay, apply or set aside the income, and specifically provided that it might be effectually done by placing the amount to the credit of the relevant beneficiary in the books of the trust. No such words appeared in the Nemes Family Trust Deed. Barrett JA relied for a broader proposition on *Re: Baron Vestey's Settlement; Lloyds Bank Limited v O'Neara* [1951] Ch 209, which held that income could be applied for beneficiaries by the trustees resolving that the income belonged to certain beneficiaries in certain proportions.

Barrett JA noted that in *Chianti*, Buss JA had read the decision of North P of the New Zealand Court of Appeal in *Commissioner of Inland Revenue v Ward* [1970] NZLR 1 at 15, as authority for the proposition that a resolution deliberately arrived at and recorded, is itself sufficient to effect an immediate vesting of a specific part of the trust income in favour of the relevant

beneficiary. Barrett JA applied that principle in regard to the Nemes Family Trust's resolution to advance capital. His Honour concluded:

> "There is nothing anomalous about the concept that a trust fund is held, to an extent defined in money terms, for one beneficiary to the exclusion of others even though the assets in the trustees' hands do not include money of the relevant amount" (per Barrett JA at [63]).

As found by Barrett JA in *Nemeske,* and as discussed by Buss JA in *Chianti*, the ultimate legal effect of the trustee's determination was not the creation of a debt owed by the trustees to the beneficiary in a fashion analogous to a corporate declaration of a dividend. In the *Chianti* case Buss JA concluded that the entitlement of the beneficiary to demand the money from the trustee where there had been a determination that it should be distributed in the beneficiary's favour was as an action for money had and received. It was not necessary to bring an equitable action in circumstances where no further conduct was required of the trustee to render the moneys payable other than simply payment itself or where the trustee had acknowledged that the money was owed (*Chianti* at [59] and [67]). Barrett JA applied similar reasoning (at [61]).

On the approach taken by Barrett JA and Buss JA, it was not essential to conclude that there had been a notional distribution of the advance of capital, followed by a loan by the beneficiary back to the trustee of that distributed sum. However, while the legal analysis was subtly different, the practical consequences were identical, namely that by resolution to distribute, coupled with a written acknowledgment in the accounts of a distribution to the beneficiary, and a recording of a loan, there was sufficient acknowledgment by the trustee to give rise to an indebtedness pursuant to an action for moneys had and received.

Have the Accountants Been Entirely Successful

Thus far, the decisions just discussed suggest that the creation by accountants of book entry loan accounts has generally been successful to achieve distributions of income or capital from trusts to beneficiaries, although it has called for some complex legal analysis to establish a precise basis upon which the effectiveness of these transactions can be understood.

However the controversy is far from over. The decision in *Fischer v Nemeske* was delivered on 11 February 2015. Since that time the appellants have filed an application to set aside the judgment on the grounds that it was decided on a basis not argued before the Court of Appeal.

They have also filed an application for Special Leave to Appeal to the High Court. Both those applications are pending at this date.

What is to be Learned from these Cases

These cases have occurred in circumstances where, following the death of a key family member, a dispute has arisen as to the enforceability of a beneficiary loan account, and hence the question has been posed as to whether the debt owed by the family trust is indeed an asset in the estate of the family member. Many of the disputes one sees in this area might have been avoided if the solicitors retained to draft the wills had been instructed to review the underlying transactions said to ground assets such as loans owed to testators, and ensure the trust is indebted to the beneficiary on the original loan.

It is convenient for trustees in some circumstances to be able to make advances of income or capital without necessarily having the liquid funds to pay those advances. *Inglis v Clark* and *Fischer v Nemeske* suggest that this can be done by way of beneficiary loan accounts without the need for the trustee to transfer any portion of its property. Accountants record the net effect of such transactions without expecting the parties to physically go through the processes associated with each step of the transaction.

Inglis v Clark and *Fischer v Nemeske* have however pointed out that the process is fraught with legal danger. In both cases very detailed analysis was required to vindicate the transactions. The success of the transaction depended in part upon the precise terms of the trust deeds. The provision in the deed in the *Chianti* case that a distribution could be effected by crediting the loan account of the beneficiary was unusual.

Many trust deeds that might on close analysis be deficient as support for such book entry distributions, may be capable of cure if there is a party with the power to amend the deed in broad terms.

The powers of trustees to create book entry distributions are intimately tied up with the way in which the deeds are drafted. Many existing deeds are drafted in language superficially broad but on close analysis often quite limiting. The cases discussed engaged in detailed analysis of the meaning of such terms as "raise", "apply" and "pay".

It might be that a client intending to make a will, and intending to include as an asset of their estate substantial loans from family entities including trustee companies, would require detailed

work in order to ascertain whether the loans were indeed properly made and within the powers of the trustees. However, during the life of a testator some of these issues may be resolvable by procuring appropriate acknowledgments, ratifications, or amendments to the trust deed or the like. Obviously it is impossible to give a firm answer at such a general level, but much can be done for those aware of the issue at the time that wills are drafted.

The price of not being alert to these issues at the time of will drafting is to perhaps impose upon executors and beneficiaries complex and uncertain litigation.

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