DEEDS OF FAMILY ARRANGEMENT

INTRODUCTION

This paper doesn't have all the answers. There is no vanilla agreement you can roll out like your costs agreement and change some of the figures to suit the individuals. As with most legal issues, you will need to spend time on what are the issues and only once these are resolved roll out the vanilla agreements and vary them to suit your particular situation.

Encourage your client/s to come and see you early, and such meetings should include any interested parties, spouse, children and, if necessary, grandchildren, maybe even key employees where a family business which employs staff is involved.

This will be a lengthy and possibly heated meeting in which not much legal work will be done, but will be time and money well spent so both you and your client and all the relevant parties, know what the likely issues are so they can then make informed decisions on the legal options you present to them. Time could be shortened in this exercise by giving each of the participants questionnaires, collating their responses and drafting an appropriate agenda for the meeting.[1]

You will, of course, need to inform the business accountant prior to any final decisions being made, but at the initial stage you really want to just find out what the dynamics are and hear what people want.

Some experts suggest a Facilitator to assist with this process. Given lawyers are used to negotiating and the discussion needs to lead to a solution that can be made legally binding, I'm not convinced of the use of such a facilitator. You may achieve a mediated solution but if it can't be implemented legally this would be a waste of time.

If what the parties want to do can't be done they may as well find out before any more effort is spent on the option. It may work for the parties but if it

[1] See *Family Business Succession Guide* Sue Prestney.

can't be sustained legally someone may challenge it and defeat the whole point of the exercise.

Once you have worked out a viable option, ie something that all parties can live with, *then* call in the accountant to critique the tax aspects and maybe change some things, but not the other way round. There are too many cases where an accountant has advised on the best option for the growth of the business or for tax minimisation, but one that will not stand up to a legal challenge, and, in the case of a small business, such legal wrangles can be financially crippling.

If the parties end up in a deadlock and try and get a Court to sort it out, the Court may well just wind-up the company if the principal parties just can't work together[2].

AGREEING AHEAD OF TIME HOW ASSETS WILL BE DEALT WITH

How do I advise my client to prevent his son's wife getting hold of my business when I die if they split up?

Which of my three children will take over and keep the farm going?

I want to stop and take a break with my wife, how do I cash in my input and still keep the business for my children?

Or then there's what I like to call the "porcupine", one with lots of pointy bits:

I have a business, one of my daughter's works in it with her son and another daughter's husband, and her son, my grandson. I also have 4 other daughters, one of whom has a disability, the business runs out of 2 states and has a staff of 50 whose loyalties are split between the my working daughter and son in law? How do I organise this into a Deed of Family Arrangement?

There are two ways of addressing such questions, either make arrangements to dispose of assets prior to death, or else make provision for such disposal after death and put those arrangements in a Will. In the case where a husband and wife are both principals in a family business you will naturally need two wills.

[2] Jankar v Dellmain & Ors [2009] NSWSC 766 (4 September 2009)

If the Executor/Trustee is to take charge of some business undertakings, you need to ensure that the will contains sufficiently broad powers of investment, management and sale, including the power to postpone sale.[3]

Your Trustee doesn't want to be in the position of Equity Trustees in *Partridge v Equity Trustees & Executors Agency Co Ltd*[4] where the Trustees found themselves with a very large bill for failing to carry out their duties properly and for having delayed. Their failure to manage a debt owed to the estate, allowing a loan to remain unpaid for 5 years with a reasonable interest payable on the monies then relying on section 15 of the *Trustee Act* 1928 but was castigated by the court for his inaction which:

> "involves the exercise of an active discretion, not the mere passive attitude of leaving matters alone, and no relief is afforded where (as here) loss has arisen from carelessness or supineness": *Re Greenwood; Greenwood v. Firth*[4]; *Godefroi* on *Trusts*, 5th ed. (1927), p. 258."

The Court found that although the defendant had not acted fraudulently but neither had it acted "reasonably". Unfortunately the debtor went into liquidation and the Estate lost some £2, 150.

In a situation where there is an *inter vivos* Family Trust ensure that the Trustee has power to delay getting in the assets to preserve the Family Trust intact, including the reasons for the power to delay, ie "to preserve the family business for the benefit of specific beneficiaries".

In drafting a Discretionary Trust also ensure the Trustee/s has the power to accumulate income, distribute income and capital and to appropriate assets to beneficiaries in specie (always keeping in mind any encumbrances against any property transferred).[5] Depending on the construction of the Will, debts against any property to be transferred may be borne by the Estate, alternatively the beneficiary will take the property with the encumbrance.[6]

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[3] Section 40 Power to raise Charges on the Property of the deceased *Administration & Probate Act* 1958

[4] http://www.austlii.edu.au/au/cases/cth/HCA/1947/42.html and Elder's Trustee & Executor Co Ltd v Higgins [1963] HCA 48; (1963) 113 CLR 426 (1 November 1963); Reid v Hubbard [2003] VSC 387 (3 October 2003)

[5] Section 14 *Administration & Probate Act* 1958 and *In the Estate of Leys* [2000] VSC 164. http://www.austlii.edu.au/au/cases/vic/VSC/2000/164.html

[6] *In the Will of Fisher* [1948] VLR 8

You may also want to consider whether an *inter vivos* transfer of some assets may ease the transition.

Once you have given the Trustee/s these broad powers, it is as well to ensure that the Will contains indemnity clauses to protect the Trustee/s from any losses which may rise out of their investment decisions or out of their management of the Trust. In Victoria the current law is the "prudent person" rule regarding the management of trustee investments[7].

This requires Trustee/s to have management plans in place, reviewing those plans annually and keeping records of how this management is carried out.

Naturally the Discretionary Trust must still vest within 80 years[8], or 21 years of a life in being.[9]

DISTRIBUTION OF AN ESTATE TIED UP IN AN ONGOING ENTERPRISE

1. You have a restaurant managed by a company with two directors and shareholders conservatively valued at $1M. The restaurant has an excellent internationally known chef who is insured with key man insurance. Both directors are in the bloom of health but one suddenly dies. The remaining director is left to deal with his co-director's distraught spouse who is totally reliant on the company's income.

If properly advised at the time of setting up the company, the Partners would have considered taking out insurance to fund a "buy/sell" arrangement where the death of one of the Partners triggers the "buy/sell" agreement.

At the present time, the Tax Office considers that the payment of the proceeds of an insurance policy to fund a buy/sell agreement is not ordinary income received by the other business owner to fund the "buy/sell" agreement when the proceeds of the insurance are used to pay the deceased estate for the business interest of the deceased.[10] Note that this needs to be a specific policy for the "buy/sell" agreement. Wrapping it up in a combined policy which

[7] Section 44 *Trustee Act* 1958.
[8] Section 5 of *Perpetuities and Accumulations Act* 1968.
[9] Section 15 of *Perpetuities and Accumulations Act* 1968.
[10] ATO ID 2003/1189 and Product Ruling PR 2010/18.

includes cover for trauma and personal disablement could lose its tax effectiveness.

Another important aspect of insurance is taxation. Lump sum payouts of an insurance policy are generally considered capital and not subject to income tax.[11] Thus, in estate planning it is important to keep in mind who is the beneficiary of the insurance policy. If the beneficiary of the policy is the deceased, his/her estate, or their spouse, to whom they have transferred their benefit for "no consideration"[12] it will not be subject to normal income tax imposts, payment of the premium on the policy will not affect this[13]. If the beneficiary is the company, which has paid the premiums the lump sum payout estate of the deceased, should avoid these imposts.

2. The sole business owner dies. Insurance will take care of current debts but if the deceased signed a Personal Guarantee that could be called upon. Contracts entered into by the deceased are usually binding on his/her Executor who could find themselves in litigation with insufficient liquid funds.

DISTRIBUTION OF THE ESTATE CONTRARY TO THE DECEASED'S WISHES

If the deceased failed to sign a Deed of Family Arrangement and the Will is singularly unhelpful, the fallback position is for the beneficiaries to agree between themselves after the testator's death and drafting a Deed to reflect that agreement.

If all the beneficiaries are adult, have full mental capacity and agree, a will may be altered after the testator's death by a *deed of family arrangement*.[14] The deed can include an agreement between parties with an interest in an inheritance - this can include beneficiaries, executors, trustees and even creditors of the estate.

It is used either where all parties are agreed that they would like to alter the terms of the will, for whatever reason, or where there is a disagreement over a

[11] Section 118-300 *ITAA 1997.*
[12] Determination TD94/31
[13] Determination TD94/34
[14] Section 46 *Trustee Act* 1958.

will and the disputing parties are able to reach a compromise without going to court. Examples of such Deeds of Family arrangement are:

1. an agreement between the parties and land is not affected

2. an agreement between the parties and land is affected but not conveyed or vested. (Reference to a future conveyance or vesting may be included in the agreement).

3. an agreement between the parties and land is conveyed or vested (including to a third party). [15]

If the beneficiaries can't agree amongst themselves, application can be made to the Supreme Court to authorise a proposed rectification of the Will.[16]

So the disaster the facing the remaining partner in the restaurant could have been prevented, but the situation may still be able to be saved if they can continue to trade till the legals are resolved.

Instead of mortgaging or charging[17] the business with half the value of the dead partner's interest, maybe crippling the business, if the parties can agree on a compromise the dead Partner's failure to organise his/her affairs in anticipation of such an event may save the business and the relationship between the remaining parties and the deceased's spouse and family.

The Legal Practitioners Liability Commission's website has Bulletins which have some useful information dealing with the issue of Stamp Duty and a relatively recent ruling by the State Revenue Office.

WHERE THERE'S A WILL THERE'S A WAY

One hopes that even if the Partner was not insured by the Company, he/she did at least execute a Will and you are not dealing with intestacy.

Protection of Family Assets

[15] Section 41 *Administration & Probate Act* 1958.
[16] Section 31 *Wills Act* 1997.
[17] Section 44(1)(a) *Administration & Probate Act* 1958.

Sometimes a big inheritance can precipitate the end of a marriage as the non-family partner sees a pot of gold and tries to take away half of it to start a new life, or it could be that the widow of a family member needs help, but the family wish to avoid her passing the inheritance on to a new husband. Perhaps as an alternative to a Life Tenancy, a deed of family arrangement, in the right circumstances, can transfer the assets into a trust which can LEND money to the widow, interest free but repayable on demand. The widow is then supported by the family money as long as she needs to be, but will have to repay it on death from the sale of her asset, possibly her home.

Another serious issue is beneficiaries who are under a disability and in receipt of benefits. The same procedure can often be used to provide for family members who are on benefits, which they would otherwise lose. The same could apply to a family member in financial difficulties, or even bankrupt, whose inheritance would otherwise be lost to creditors or their Trustees in Bankruptcy. Where a beneficiary is a potential bankrupt, a Protective Trust[18] could be set up.

The Statement in a Will that "my trustees shall hold the annuity on protective trusts for the benefit of (name of beneficiary) for life" is sufficient to create a Protective Trust. However, these Trusts need to be drawn with care to ensure that the beneficiary will lose the benefit in the event of their bankruptcy, and the gift over passes to another. For an interesting case about a Family Provision application by a bankrupt I recommend *Herszlikowicz v Czarny*.[19]

FAMILY AGREEMENT FOR ELDER CARE?

A Family Agreement to cover care of an ageing relative.

Some of the reasons the parties might want to do this:

- An aversion of the parties to 'institutional ' care of nursing homes and hostels;
- Maybe a wish to be an individual and have individual facilities;
- Maybe a wish to preserve assets for later generations;
- A reluctance to realise assets such as the family home to pay premiums and bonds for assisted care;
- Organising one's affairs so that access to social security is maximised.

[18] Secton 39 *Trustee Act 1958*.
[19] Herszlikowicz v Czarny [2005] VSC 354 (8 September 2005)

The house is too big, the relative not yet that frail, not wanting to give up their independence. Maybe co-ownership possession of a particular property, a 'granny-flat' type of agreement, a care and residence agreement, or a contract to make a will to leave their property to the carer which will be conditional upon carer services being provided.

According to Senior Rights Victoria, the number of Australians over the age of 85 increased by 170.6% and the number of centenarians increased by 185% whilst the total population grew 30.9%. A recent survey stated that less than 1% of Victorians over 65 who live with relatives have a formal arrangement in place.

"Elder Abuse" is a growing problem. Such abuse is primarily conducted by adult children against their parents in exploitative arrangements for the exchange of assets for care and accommodation. In formalising such proposed arrangements it is your role to ensure that ny such arrangements are "free and voluntary"[20]

In a case of *Schmutz*[21] Justice Bryson of the Supreme Court of New South Wales had this to say about the importance of intention to make a binding agreement:

> "Although Courts have frequently concluded that agreements and arrangements among family members are not intended to be binding and hence do not give rise to contractual or other legal obligations, the key to the question whether they give rise to contractual obligations is the intention of the parties … when arrangements are made among family members, the nature of the arrangements, the value of the property affected by them or the extent and nature of the participation required and the period over which it is required may indicate an intention to create obligations."

As mentioned, unless there is discussion between *all* the interested parties, these arrangements can go sour. I was recently advising on a case where, there was no Deed of Family Arrangement and there are other issues in the family, but where the father was living near his son and became too ill to care for himself, he mortgaged his property to fund renovations to his son's house

[20] *Badman v Drake [2008] NSWSC* 1366 para 84.
[21] Ruta Ona Schmutz and Ricardo Schmutz v Vytantas Aras and Galina Aras [1996] NSWSC 340 (7 August 1996)

to provide accommodation for himself with the son and his family. The mortgage reduced the father's estate by half.

The father had made a Will many years previously leaving his whole estate to his son, totally excluding his daughter who had cared for him for the ten years prior to his moving closer to his son.

Sadly, no sooner had the renovations been completed but the father had a heart-attack and died. The son now has the benefit of a $200,000 renovation and his sister is cut out of the Will. Should she make a Part IV claim against that Estate, of which her enriched brother is the Executor is sole beneficiary, the father's Estate she can claim against is half what it should be.

Some issues to consider

From a review of a number of cases it is clear that some recurring problems in human relationships and risks may be, or ought to be accepted as possibilities such as:

- Marriage breakdown;
- Relationship breakdown;
- Discord and conflict among siblings;
- Serious illness or serious disability;
- Vague recollection of original arrangements or agreement;

Of course, there is an offset to the capital contribution involved. In similar cases the care of the father needs to be valued in some way to make a fair assessment of the care given. Perhaps an hourly or daily rate, which would reduce the value of the contribution to the building up of the son's property, could be incorporated into the Agreement. There are many ways of putting a value on the work of a carer.

Whatever the formula, it is possible in circumstances which require it and where there is agreement, to find ways to calculate contributions in financial terms by carers to avoid later dispute, which may occur when unexpected events and/or premature termination of the arrangement take place.

As with the Deed of Family Arrangement regarding pre- and post death Estate matters, if at all possible all interested parties should be present at an initial

meeting. In particular if there is some disconnect between children of the parent giving up their assets. It should be made clear to the elder party that the time and cost of initial discussions is well spent if it saves the grief and expense of costly litigation post-death, and the consequent rift in family relations.

MUTUAL WILLS

Mutual Wills are another possible solution to resolving issues within the family although these have experienced mixed success. In *Osborne v Osborne* [22], the Plaintiff was claiming a Deed of Family arrangement had been entered into by his parents when they executed Mutual Wills in which they were to leave their property to their two sons. No Deed of Family Arrangement had been entered into, although there may have been oral representations made to the sons.

Harper J found that there was no reason the defendant could not revoke his Mutual Will and execute a different Will, as he did. In order for the plaintiff's case to succeed there would have had to be one further step, a Deed of Family arrangement for the parties not to change their Wills. His Honour cited :

> In re Dale [1994] Ch. 31 where Morritt, J. held, uncontroversially, that the application of the doctrine of mutual or corresponding wills requires the parties to have entered into a legally binding contract to make and not to revoke mutual wills. His Lordship also held, equally uncontroversially, that the doctrine requires that the first testator to die has performed (as in the case of Winifred Osborne) her part of the agreement; and that the aim of the principle underlying the doctrine is to prevent fraud on him or her. More controversially, his Lordship went on to hold that the doctrine is not confined to cases in which the surviving testator has benefited under the will of the other testator, but in appropriate circumstances may extend also to cases where the two testators have left all their property to beneficiaries other than themselves. It is possible, his Lordship held, that even in such cases, a fraud might (in certain circumstances) be perpetrated on the first testator were the survivor permitted to depart from the bargain, and make a new and materially different will.

[22] Osborne v Osborne [2000] VSC 95 (23 March 2000)

The father, who had executed a new Will, had re-married so the Mutual Will executed by the father would have been revoked upon his marriage.

TAXATION AND STAMP DUTIES?

Generally where an asset "passes" to a beneficiary in the estate the relevant rules are set out in s128-20 of the *Income Tax Assessment Act* 1997, in s128-20(1) an asset "passes" when the beneficiary "becomes the owner of the asset":

- Under the will, or that will as varied by the court order; or
- By operation of an intestacy law, or such law as varied by a court order; or
- Because it is appropriated to the beneficiary by the personal representative in satisfaction of a pecuniary legacy or some other interest or share in the estate; or
- Under a deed of arrangement if:
    - The beneficiary entered into the deed to settle a claim to participate in the distribution of the estate, and;
    - Any consideration given by the beneficiary for the asset consisted only of the variation or waiver of a claim to one or more other assets that formed part of the estate.

Section 128-20(1)(c) confirms that a distribution of assets in specie to a beneficiary is within s128-15 even where the will did not make a specific gift of the assets to the beneficiary.

Section 128(1)(d) allows parties to reach an out of court settlement regarding the distribution of assets of a deceased estate and retain eligibility for the CGT exemption but must follow certain formalities, namely:

- There must be a deed of arrangement; and
- The only consideration given by a beneficiary is the waiver of a claim to the estate.

TR2006/14 confirms the flexibility of personal representatives and genuine potential beneficiaries in dealing with rights and assets of the estate.

Similarly, a pre-death agreement between Partners in a business, such as a conditional "buy/sell" agreement should provide for the following:

- A call option for the surviving business owner giving them the right to require the personal representative of the deceased estate to sell to them the business interests of the deceased; and
- A put option that gives the personal representative of the deceased business owner the right to require the surviving business owner/s to purchase the deceased's interest in the business.

There is no clear guidance from the ATO although in ATO ID 2003/1190 the ATO has said that where the intention in the contract is clear that the parties intend that the contract operates only at the death of a business owner, the contract is treated as commencing at the date of death. See also PR 2010/18 and PBR 30018. The wording in the contract needs to be clear that the parties are *not bound* at the time of signing the contract but at the date of death of one of the parties[23].

OTHER ISSUES TO BE AWARE OF?

Managing Conflict of Interest by ensuring that even where members of a family may be completely harmonious at the time of making the Deed, are individually advised of the impact of what they are signing. Six different lawyers getting involved sounds excessive, but the likelihood of the Deed being challenged is lessened.

CONCLUSION

Family businesses often strike difficulties resolving succession. Very often there is reluctance on the part of the creator of the business to acknowledge their own mortality and by the time they get to the point when they don't want to run the business or, in the words of the well worn cliché "the horse has bolted", ie the person they thought may take over from them is no longer willing or available to take over.

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[23] See *Death & Taxes, Tax Effective Estate Planning 5th Edition,* Miranda Stewart and Michael Flynn.

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