Jackson Saga

not the only legal thriller in estates

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Michael Jackson's untimely exit from the global stage has sparked an outpouring of grief from around the world. But for the family of the late King of Pop, issues surrounding his estimated US$1 billion estate are posing a real legal thriller, with his mother Katherine Jackson already having challenged the will's executors and with creditors waiting in the wings.

Sadly, legal battles over estates are not restricted to superstars like Michael Jackson, or in Australia's case, former INXS lead singer Michael Hutchence.

Estate planning is all about making sure that the appropriate assets end up with the appropriate people at the appropriate time. It is much more than just about simply making a will; careful thought must be given to what you own and how you own it, and your wishes and intentions must be balanced against the needs of your surviving family members and dependants.

If careful thought is not given to your estate planning, the result will be traumatic for those family members left behind, with the only people benefitting from your lack of thought being the lawyers fighting over your will and your estate.

Michael Hutchence probably failed to give adequate thought to his estate planning before he passed away in 1997, with the result being years of protracted litigation over his estimated $20 million estate, and a result which probably would not even closely resemble his true wishes.

In the media recently, there has been much discussion around Michael Jackson's estate and it is apparent that he too may not have given sufficient thought to his estate planning. He had not reviewed or updated his will since 2002, and his estate is structured in such a way that it is crippled with debt.

While the ongoing royalties from the superstar's music should eventually see significant benefits flow through to his family, the next year or two will be very difficult and Michael Jackson's creditors will demand repayment of the monies owed to them in priority to any benefits flowing through to his three children and family.

The emotional cost and time delay for the surviving family of not properly considering estate planning is significant. Often an estate which is in dispute will be delayed by up to two years while the lawyers argue issues of capacity or adequate provision in the will through the courts. These delays and litigation are so often caused by inadequate estate planning on the part of the deceased.

High profile estates like those of Jackson and Hutchence bring the need for effective structuring of business and personal assets into sharp focus, particularly for high net worth individuals and business owners. Both these high profile estates involve family trusts and related entities where the issue is not so much about gifting or transferring assets, but the passing of control over those trusts and related entities to appropriate persons.

Fundamental changes to the taxation regime, the vast amounts of wealth accumulated within superannuation funds and the increasing tendency for both business and personal relationships to be relatively short term, as opposed to life long, have meant that traditional estate planning has been revolutionised.

A significant factor to note in the changing face of estate planning is the transfer of wealth from Australia's 'baby boomer' generation. Statistically, this segment of the population is by far the wealthiest and best educated in Australia's history, and consequently far more sophisticated estate planning strategies are being

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developed in order to minimise the ability for wealth to be attacked by creditors, former spouses, business associates and (in some instances) disgruntled beneficiaries.

While tax effective strategies incorporating complex will arrangements and testamentary trusts continue to be of relevance, recent developments in estate planning have been more focused on the protection of underlying wealth.

In particular, additional structures are now being utilised in conjunction with wills to ensure wealth passes efficiently to the intended recipients and that the transfer takes place at the intended time. Often the desire to ensure a suitable tax outcome needs to be balanced against a desire to ensure assets are protected from family disputes, spendthrift beneficiaries and creditors in deciding on an estate plan.

Asset protection strategies and the use of special purpose trusts are important issues to consider in estate planning, particularly where potential beneficiaries are in occupations, professional practice 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.

The difficulty in many estate planning exercises is that serious attempts to devise and implement a plan are often not made until some 'triggering event' stimulates action. Often the triggering event is itself an issue that may jeopardise the ability to implement appropriate strategies, for example financial or matrimonial misfortune or life threatening illness.

Given that the first wave of the baby boomer generation is now nearing 60, it is likely that the increased importance placed in recent years on appropriately structuring intergenerational wealth transfers will continue to intensify.

One option to consider in assisting clients with this transfer of wealth to the next generation is the use of testamentary trusts.

Testamentary trusts are simply trusts established pursuant to a will. In recent years numerous different types of testamentary trusts have included fixed, unit, discretionary (family), hybrid, resulting (constructive), bare, lineal descendent and superannuation proceeds trusts. The various types of trusts have a number of different features and specific uses, but fundamentally the legal structure of all testamentary trusts are very similar.

Essentially, the share of the estate intended for each beneficiary can be managed via a testamentary trust by the trustee appointed by the testator in their will (often the trustee and a beneficiary of the trust may be the same person although the advantages and disadvantages of this approach are dealt with in more detail below).

During each year the trustees of the trust may have complete discretionary power to choose which beneficiary takes what share of income for that year. They may also have the absolute discretion as to the distribution of capital, but often the distribution of capital can be limited to set amounts and for a limited range of direct descendants, or otherwise as instructed by a testator.

A will maker (or testator) sets out the terms of the trust in their will and can give the trustee complete discretion as to who should receive capital and income from the trust or alternatively the testator can restrict the trustee's discretion as much as they like.

A 'lineal descendant' trust is simply a specific type of testamentary trust whereby the testator may restrict the ability of the trustee so they may only distribute income or capital (or both) to the testator's children and grandchildren and so on, excluding any spouse of the children and/or grandchildren.

The main attraction to excluding spouses as potential beneficiaries is that in the event of a matrimonial (or de facto) relationship breakdown it is unlikely that a lineal descendant trust would be taken into account by the Family Court as anything other than a resource of the relevant

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marriage. Thus the assets of the testamentary trust are likely to be protected in this scenario.

Conversely, many people argue that the flexibilities normally associated with a trust structure are significantly diminished if a whole class of potential beneficiaries are excluded.

In recent times many people have adopted a 'hybrid' approach to testamentary trusts so that spouses can be potential income beneficiaries from year to year but that in relation to any capital distributions from the trust, these distributions may only be made to lineal descendants of the original will maker.

The main advantages of an appropriately drafted testamentary discretionary trust ('TDT') established by a will are as follows:

(a) the flexibility given to the trustees to allocate income and capital with reference to the facts at the time, rather than a testator's prediction (no matter how careful) of the future. It allows the trustee to make a greater distribution for a testator's child with a special need, such as (in particular) wastrel children, as well as those with a disability;

(b) if an estate was left to a child absolutely then it is their property and could be jeopardised by their financial position at the time of death or after. In addition, should that child suffer matrimonial or financial misfortune at some time in the future, the trust at least provides a facility whereby the inheritance can be kept separate. As indicated above, it is unlikely (particularly where spouses are not potential beneficiaries) that the assets of the TDT would be seen as anything more than a resource for the relevant beneficiary and not part of the assets of the matrimonial pool which are physically distributed between the parties to the marriage breakdown;

(c) the TDT can be drafted such that it complies with the requirements set out in section 102AG(2)(a)(i) *Income Tax Assessment Act 1936* ('ITAA 1936'), so that income each year allocated to minor children is not subject to the same tax rates as if it were a normal family discretionary trust established during a person's lifetime (where a small amount distributed to a child is tax free but then any further income is taxed at the highest rate);

(d) where income is derived under the section quoted above infant children are assessed at the normal, individual rates (the first $6,000 tax free and the balance at normal adult rates) which may be a significant saving in tax when you look at the gross income for a family unit. The Commissioner does have some discretion in these cases, but generally the discretion is exercised in favour of the TDTs as they are a 'traditional' form of trust; and

(e) even if, for any reason the trust does not come into effect through the operation of law, or it fails, then the will can include a fall-back provision whereby the capital vests in the intended beneficiary anyway, with provision for their children if necessary, or even revert to trusts established for other beneficiaries.

Ultimately TDTs are particularly useful structures in the following circumstances:

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

(b) to protect accumulated wealth from spendthrift beneficiaries;

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

(d) to protect inheritances from attack by the family law courts and trustee in bankruptcy.

There are a number of potential disadvantages to TDTs, including:

(a) once income is determined to be distributed to an infant and is then not applied in payment of the infant's needs there will be an accumulating debt owing to that infant by the TDT. Thus when it comes time to wind up the trust and for the beneficiaries to take the capital, they may find the capital substantially eroded by the necessity to pay these debts to the children or other beneficiaries, unless of course they are in some way forgiven. Alternatively, when the relevant child reaches the age of majority it may be that they seek repayment of the loan owing to them;

(b) the TDT structure requires a reasonable degree of control, similar to a normal family discretionary trust, including recourse to competent accountants and lawyers for trust administration advice. This all involves a cost;

(c) the taxation aspects of a TDT have not been ably and forcefully contested in a Court in the last decade. Notwithstanding this, the language of section 102AG(2)(a)(i) of the ITAA 1936 is clear and there are income tax rulings (both private and public rulings) given in favour of the establishment of TDTs; and

(d) where the beneficiary of a trust is also a trustee, they should for safety's sake always have at least one trustee with them when undertaking trust-related issues, so the beneficiary will need to be able to work with their co-trustee/s. Protection against creditors or former spouses is diminished when a beneficiary is the sole trustee of the trust, as that beneficiary has power as trustee to distribute the whole of the income and/or capital to themselves. Finding suitable co-trustees can be a difficult exercise, and can also cause increased expenses where a professional is appointed.

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Testamentary trusts are of course only one of many issues involved in a review and finalisation of a comprehensive estate plan. Superannuation death benefits, life insurance, loans, guarantees and related entities must all be considered before signing off on the estate plan.

To reiterate, estate planning is about making sure that the appropriate assets, being the assets a client actually own, pass to the appropriate people, being their family and dependants and not lawyers or creditors, at the appropriate time. This is to stop 18-year-old Johnny going and blowing his inheritance at the local Ferrari dealership.

There are many options available to assist with estate planning, including the use of testamentary trusts. Making sure these options are fully considered and utilised will give your clients every opportunity to avoid becoming the next big headline.

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