



**THE TAX INSTITUTE**

THE MARK OF EXPERTISE

# NSW 8<sup>TH</sup> ANNUAL TAX FORUM

## CUTTING EDGE ESTATE PLANNING TECHNIQUES

**Adrian Abbott**  
Senior Consultant - Tax  
Advisory  
Crowe Horwath

NSW Division  
21-22 May 2015  
*Sofitel Sydney Wentworth*

Adrian Abbott Crowe Horwath 2015

Disclaimer: The material and opinions in this paper are those of the author and not those of The Tax Institute. The Tax Institute did not review the contents of this paper and does not have any view as to its accuracy. The material and opinions in the paper should not be used or treated as professional advice and readers should rely on their own enquiries in making any decisions concerning their own interests.

Adrian Abbott Crowe Horwath 2015

Disclaimer: The material and opinions in this paper are those of the author and not those of The Tax Institute. The Tax Institute did not review the contents of this paper and does not have any view as to its accuracy. The material and opinions in the paper should not be used or treated as professional advice and readers should rely on their own enquiries in making any decisions concerning their own interests.

## CONTENTS

<b>1</b>	<b>Estate Planning Concept</b>	<b>3</b>
<b>2</b>	<b>The Family Constitution</b>	<b>5</b>
2.1	What is a Family Constitution	5
2.2	Objectives and Purposes	5
2.3	Parties	5
2.4	The Process	5
2.5	Issues to Be Covered	6
2.6	How to Make Them Work	8
2.7	Where Family Constitutions Are Relevant	8
2.8	Controversy	10
2.9	Binding Agreement	10
<b>3</b>	<b>Overall Strategies for Preparing a Family Constitution</b>	<b>11</b>
3.1	The General Approach	11
3.2	Central Company Structure	11
3.3	Double Trusts for Children	12
3.4	Family Law Issues and Lineal Issue Trusts	14
3.5	Shareholders and Directors of Central Company	15
3.5.1	The Number of Shares Available to be Transferred	15
3.5.2	Right of Appointment as a Director	15
3.5.3	Voting by Directors	16
3.5.4	Provisions Where Child Dies	17
3.5.5	Communication	18
3.5.6	Income Entitlements	18

<b>4</b>	<b>Case Studies of Establishing a Family Constitution</b>	<b>19</b>
4.1	<i>Case Study 1 – Bill and Colleen</i>	19
4.2	<i>Case Study 2 – Geoff and Mary</i> .....	23
4.3	<i>Case Study 3 – Alex and Pat</i> .....	26

# 1

# Estate Planning Concepts

The concept of estate planning is not confined solely to the drafting of a Will and an enduring power of attorney.

A properly constructed estate plan is one which includes the transfer of *ownership and control* of the family group asset holdings without adverse tax, commercial (including asset protection) and family dispute consequences. As tax practitioners we understand the importance of the ownership and structuring of business and investment entities. We also understand that an estate plan that fails to consider tax issues and asset protection matters may have lost the opportunity to gain the benefits that are potentially available.

The traditional focus in estate planning for addressing tax and asset protection is to look at creating effective legal structures. This focus inevitably leads to a consideration of the establishment and use of trusts (whether set up *inter vivos* or testamentary).

The considerations that are taken into account by a tax practitioner in an estate plan generally include:

- a. Revenue issues such as stamp duty, capital gains tax and income tax;
- b. Family law issues;
- c. Ownership of assets;
- d. Asset protection planning;
- e. Claims made by family members in contradiction to the plan;
- f. Provision for members of the family that may be unable to look after their own affairs.

However, there are significant issues other than tax and asset protection in a properly constructed estate plan that must be considered.

Legal structuring (whether a restructuring as part of an estate plan or as a result of testamentary provisions) by itself may not ultimately achieve the objectives of effectively transferring the management and control of family business assets to the Next Generation. In the estate planning process the drafting of the Will is obviously the central point, as it is the only way that an individual can determine who will own the assets after death.

However, the terms of a Will only deal with the immediate ownership of assets. A Will determines ownership of individual assets but does not address control and management of family assets. What the Will cannot enforce is how decisions are made and implemented in respect of the assets in the future. This is one important function of so-called family constitutions.

Today in the profession we are looking at additional strategies in the estate planning process. In particular, where family owned businesses are involved an important supplement to legal structuring is

Adrian Abbott Crowe Horwath 2015

Disclaimer: The material and opinions in this paper are those of the author and not those of The Tax Institute. The Tax Institute did not review the contents of this paper and does not have any view as to its accuracy. The material and opinions in the paper should not be used or treated as professional advice and readers should rely on their own enquiries in making any decisions concerning their own interests.

the use of a deed of family agreement (a DOFA) or simply a family constitution. This paper will refer to such documents as family constitutions.

It is the view of the authors that tax practitioners when dealing with estate planning for client family groups should include as part of that plan the possible adoption by the family of such an agreement. This is particularly important in family groups with business assets or substantial investment assets.

This presentation will examine the adoption of a family constitution in the estate planning context.

Implementing a family constitution can in certain circumstances serve two purposes.

- a. The first purpose is to produce a legally binding document that defines the rights and entitlements of each family member in the estate plan.
- b. The second, equally important, purpose is to provide, through the process of implementing the family constitution, a forum for robust and full discussions within the family group. If handled properly, this can lead to authentic communication between the generations in the family and result in much greater understanding by the family members of the issues confronting the family and how the legal structures are to be implemented to deal effectively with these issues.

This presentation will also examine the issues around family constitutions, their effectiveness and the terms that can be considered in such agreements. We will also examine the practical use of a family constitution as applied in client matters that the authors have jointly participated as professional advisers.

## 2

# The Family Constitution

## 1.1 What is a Family Constitution

The family constitution is a written statement or agreement that serves as a record of the family's objectives and aspirations for the current and future generations. Essentially it is a document which deals with control of assets which survives the death of the current owners.

## 1.2 Objectives and Purpose

What the family constitution attempts to do is bind the various aspects of the legal structures in the family group in a cohesive way and with an overlying set of family principles and governance protocols. The objectives of the family constitution are to keep the different interests of the family members (current and future) and the family group entities working together efficiently and successfully. The family constitution forms a framework that engages with the family members and the business and investment entities that constitute the family group structure.

A core priority in any family dynamic is to decide how to balance issues of control over the management of wealth with the ability or rights to enjoy the successes and benefits that arise from the family assets.

Quite simply the purpose of a family constitution is to avoid the failure of the family businesses because of internal conflicts rather than external events or pressures. In particular, the purpose of the family constitution is to provide procedures and mechanisms to cope with the changing dynamics of the members of the family and to address the problems that can arise in a family such as death, the divorce of a family member, or a substantial claim brought by a creditor against the family or the business.

An objective of the family constitution is to anticipate issues that may be faced and to provide a plan to deal with such issues. If the family governance forum has not successfully anticipated a particular issue, it can still be a key advantage to have the processes in place to facilitate swift and proper consideration of a problem in order to circumvent whatever unexpected problems arise.

The family constitution, in part, is no more than a shareholders' agreement in respect of the family group structure. However, the family constitution should go further than what a shareholder's agreement provides. The latter will often focus, not inappropriately, on the formal legal rights and responsibilities that arise in relation to the interests in the business and the operation of the business. The family constitution should obviously cover those legal rights and responsibilities and include much broader concepts of family dynamics.

A general 'objectives' clause that can be adopted in a family constitution is as follows

*For the purposes of enhancing the general wellbeing of the family members and to avoid misunderstandings amongst the family members they have undertaken an extensive review*

Adrian Abbott Crowe Horwath 2015

Disclaimer: The material and opinions in this paper are those of the author and not those of The Tax Institute. The Tax Institute did not review the contents of this paper and does not have any view as to its accuracy. The material and opinions in the paper should not be used or treated as professional advice and readers should rely on their own enquiries in making any decisions concerning their own interests.

*and as a consequence have developed this agreement.*

*The parties agree to use their best endeavours to comply with the substance of this Deed and, in particular, to avoid conflict and change except where the consequences are thoroughly considered including obtaining financial, legal and general commercial advice from independent qualified persons.*

*The parties acknowledge that they wish to record that they will deal with each other in good faith, co-operation and without malice. The parties further agree not to resort to confrontation and will endeavour to act in a manner principally arrived at resolving disputes or misunderstandings on an amicable and fair basis putting the interests of the family group foremost. In applying these concepts the family members agree to apply the principles as set out in the Family Charter.*

### 1.3 Parties

All interested parties play a vital and interlocking role in ensuring the smooth governance of the family's affairs and interests. This will strengthen the prospects of the family avoiding the kind of devastating disruption and damage that disputes or unforeseen catastrophic events can create for the family wealth.

A family constitution is, in essence, a multi-party agreement. This means that it must be agreed by everyone involved in the process and not presented as a *fait accompli* by the current head of the family or the business founders. The constitution will only be useful to the family if everyone commits to the process and to acceptance of the end result.

### 1.4 The Process

The importance of a family agreement often is reflected not so much in its implementation but the process by which it is formed. Namely, the opportunity for all family members to participate in the determination of the terms of a family agreement can overcome many of the misperceptions that arise amongst family members in respect of their expectations concerning the estate plan. However, it is important to recognize the danger that this process can also bring to light underlying family tensions that might otherwise have remained dormant.

In some cases, the attempt by a family group to undertake a family agreement simply leads to a further breakdown in relationships. That obviously is the worst outcome. Accordingly, an initial attempt at a family agreement in some situations may better be approached by attempting to set out the "social" aspects of the family agreement. Once those motherhood-type statements are resolved the chances of getting common agreement on the legal details covered by the family agreement are generally improved.

The constitution is the outcome of a process which is as important as the document itself. Obviously

Adrian Abbott Crowe Horwath 2015

Disclaimer: The material and opinions in this paper are those of the author and not those of The Tax Institute. The Tax Institute did not review the contents of this paper and does not have any view as to its accuracy. The material and opinions in the paper should not be used or treated as professional advice and readers should rely on their own enquiries in making any decisions concerning their own interests.



most of us as lawyers and accountants are not well trained for guiding such a process and we may need to recommend the involvement of someone capable of driving the process. This process of agreement can be emotional and take time. The agreement should be developed by in depth family discussion.

The family constitution should not be drafted by outsiders and imposed upon the family. It is the reverse. The family could agree a set of principles and seek to have those embodied in document, then drafted by the advisers.

## 1.5 The Issues to be Covered

The most valuable part is for the family to discuss and reach a consensus and action on so many issues, including:

- a. Deciding on principles important to the family including governance, education, communication, social values and objectives.
- b. It should consider the goals and ambitions of each of the family members and deal with issues such as investments connected with environmental, ethical or religious matters significant to the family members' beliefs and concerns.
- c. Identify the family members to be included within the family constitution.
- d. Identify the business or businesses the family wish to protect
- e. Decide on a management structure whether it be family or outsiders and to remunerate and provide incentives for the management group.
- f. Income distribution policies for entities within the group
- g. Financial returns within the family to recognize both equity participation and active roles played by family members in respect of the family business and investments held by the family group.
- h. Succession planning issues.
- i. Decide on financial risk parameters (such as debt/equity ratios, limits on purchases or sales) and the processes for agreement outside such parameters.
- j. Identifying the importance of family Lineal Issue and the retention of ownership of certain assets that are critical to the family.
- k. Role of spouses who are not part of the lineal issue.

- l. Representation in the decision-making process.
- m. The importance of protecting dependents in the family in the event of the death of a parent
- n. Ensuring that the document is binding on the parties.
- o. Dispute resolution procedures.
- p. Pre-emptive rights and the exit of family members.
- q. Key decision-making issues that require say, unanimous vote.
- r. Involvement of external advisers in different aspects of the family group;
- s. Principles to apply in the event of such matters as death of family members, marriage breakdown of family members or the risk that a family member becoming financially irresponsible.
- t. Participation in charitable activities.

Most importantly, the document should be an aspirational document and not simply a set of rules.

## 1.6 How to Make Them Work

To ensure the success of a family constitution it must be

- a. fair to all parties;
- b. financially sound;
- c. achievable within the background of the family attitude and social upbringing;
- d. agreed by all members of the family and all entities in the group;
- e. address the involvement of spouses including whether they are party to the agreement or simply kept informed of the nature and purpose of the agreement;
- f. driven by someone and ensure that it remains relevant;
- g. legally enforceable;
- h. in the form of a Deed;
- i. address Family Law issues;

Adrian Abbott Crowe Horwath 2015

Disclaimer: The material and opinions in this paper are those of the author and not those of The Tax Institute. The Tax Institute did not review the contents of this paper and does not have any view as to its accuracy. The material and opinions in the paper should not be used or treated as professional advice and readers should rely on their own enquiries in making any decisions concerning their own interests.

- j. ensure that distribution of income is efficient;
- k. part of a regular review by the family.

## 1.7 Where Family Constitutions are Relevant

Obviously a family constitution is not relevant to all estate planning matters. In reality it is limited to clients where assets held in the family group are to survive into future generations. That is, the family constitution is not relevant for all family groups but only where significant business assets and significant investment assets are to survive into the Next Generation. A prime example is primary production family groups.

In the case where a family constitution is relevant then it becomes even more significant an issue where the following apply

- a. Certain members of the family are employed in the enterprise carried on by the family group and require control of business assets (as compared to equity entitlement);
- b. Members of the family have different executive roles and different expertise;
- c. Some members of the family have limited commercial expertise;
- d. There are conflicting social objectives within the family;
- e. Asset protection (both commercial and family law) are prominent issues.

## 1.8 Controversy

It is the family that, with appropriate advice and recommendations, must decide on the essence of the family constitution and the areas that it should cover. Inevitably, some of the issues that a family will need to consider will be difficult topics; this reinforces the importance of the family thinking about the right forum for these kinds of issues to be considered, at the appropriate time.

Discussions over testamentary and succession plans between family members and/or with the family business (where non-family members may also have significant interests) can be hard to start and difficult to manage once started.

## 1.9 Binding Agreement

The question often arises as to whether 'agreements' of the nature of family constitutions are legally

Adrian Abbott Crowe Horwath 2015

Disclaimer: The material and opinions in this paper are those of the author and not those of The Tax Institute. The Tax Institute did not review the contents of this paper and does not have any view as to its accuracy. The material and opinions in the paper should not be used or treated as professional advice and readers should rely on their own enquiries in making any decisions concerning their own interests.

enforceable. At this stage, this issue remains unresolved as there is no judicial authority that we are aware directly on point.

Historically, the law of contract has discriminated between agreements of a commercial nature and agreements of a domestic nature. However, it is essential that the parties to the family agreement not only have the intention for the agreement to be legally binding but also that this aspect is clearly expressed in the agreement. In the absence of this intention, the purported agreement may not be enforceable. Intention to create legal relations is presumed in commercial agreements, but not in domestic agreements.

In many cases it is desirable that the individual family members:

- a. obtain independent legal advice regarding the nature and effect of the agreement; and
- b. act in reliance of a reasonable assumption that a valid contractual relationship exists.

Accordingly, a clause should be included in the family agreement indicating that the parties intend for the agreement to be legally binding and that all parties have obtained independent legal advice in relation to the operation and effect of the agreements. Clauses that could be included are as follows

*The parties agree to use their best endeavours to comply with the substance of this Deed and, in particular, to avoid conflict and change except where the consequences are thoroughly considered including obtaining financial, legal and general commercial advice from independent qualified persons.*

*The parties acknowledge that they have either obtained or consented they do not require to obtain legal and financial advice prior to entering into this deed and that they wish to record they will deal with each other in good faith, co-operation and without malice. The parties further agree not to resort to confrontation and will endeavour to act in a manner principally arrived at resolving disputes or misunderstandings on an amicable and fair basis putting the interests of the family group foremost.*

### 3

# Overall Strategies for Preparing a Family Constitution

## 1.10 The General Approach

The general approach that can be taken can be summarised as follows (the following is not intended to be an exhaustive check list):

- a. The key to starting the preparation of a family constitution is to identify a individual to drive the process. There must be a chairman to ensure that all participants (family members and advisors) are focused and responsive. Ideally it is the head of the family that takes this role however it could be an advisor trained in such a role.
- b. The commitment of all family members to the process is essential and, accordingly, an important early step is commence a program of communication within the family group.
- c. Preparation of a group structure diagram setting out the current structure and future structures as a consequence of the death of various family members. The diagram must cover the three important issues in the legal structure, namely
  - Decision making powers including current directors of corporate entities; voting rights of shareholders; powers of appointments within trusts in the group.
  - Income entitlements and directions of flow within the group;
  - Asset ownership and, in particular, loan balances within the group.

A “picture is worth a thousand words” is very true for clients to understand as to what exists and how the ownership and control of the family assets will look with the death of different family members.

- d. Identify or create a single entity within the group to effect a control mechanism that can apply to all entities in the group either immediately or as a consequence of estate planning put into place.
- e. Establish an agenda and timetable to complete the process – the time taken will in most cases far exceed what is generally thought to be achievable from the outset.

## 3.1 Central Company Structure

Leaving the above aside, a major part of the family constitution (and a reason for its likely success) is to

Adrian Abbott Crowe Horwath 2015

Disclaimer: The material and opinions in this paper are those of the author and not those of The Tax Institute. The Tax Institute did not review the contents of this paper and does not have any view as to its accuracy. The material and opinions in the paper should not be used or treated as professional advice and readers should rely on their own enquiries in making any decisions concerning their own interests.

create within the agreement a central controlling entity in the group structure. This will likely be a company and the estate planner should restructure the group as part of the estate plan so that the company concerned is:

- a. the trustee, and possibly also the appointor, for any testamentary trust;
- b. the holding company in any corporate structure;
- c. the trustee (or appointor) of any existing family trusts; and
- d. the trustee of trusts established for the children where those trusts have share of income or capital from the main business entity.

Wherever possible, the family constitution should be drafted, in part at least, as a shareholders' agreement relating to that core or central company. Namely, the agreement will determine the directors and shareholders and set out the decisions that can be made with different levels of agreement among the family group.

The restructuring process to create a central company arrangement obviously requires the expertise of the tax practitioner. It is this role that has in our view the essence of any estate planning. To restructure so that one company effectively controls the group will provide the basis for the implementation of both a successful estate plan and a functional family constitution.

The aim is to have a structure where on the death of the parents all assets would be under the control of the central company in its various capacities. As a result, the family constitution could be drafted with a concentration on the role of the family members (not only in respect of the current generation but also future generations) in the manner in which the central company will exercise its management role in the family group. Accordingly, in essence, the family agreement part of the family constitution could then be implemented adopting a shareholders' agreement type approach in respect of the central company.

## 1.11 Double Trusts for Children

Consideration should be given to creating a double trust arrangement for the adult children in the family group. This double trust arrangement will be appropriate in circumstances where the aims of the family group include

- a. ensuring the ownership and control of the family business remained in the family Lineal Issue;
- b. providing the family members with a flow of income from the business;
- c. providing a legal structure for the family to, in part, reinvest the income flow from the business;
- d. ensuring, as far as possible, the protection of assets of the children in the event of a matrimonial dispute.

In these situations the two trusts for each of the adult children will play separate roles. Trust 1 would be the entity that has income and capital entitlements in respect of the main business entity whereas Trust 2 would be solely involved with individual investments generated by that adult child.

The selection of trustees and appointors of the trusts in this case is critical. In the case of Trust 1 the trustee/appointor should be the selected central company as discussed earlier in the paper. As a consequence, the only controllers of Trust 1 will be the family members (the adult child and that person's siblings). That control can then be managed through the terms of the family constitution.

The trustee/appointors of Trust 2 would be the adult child and possibly that person's spouse. Trust 2's assets will be investments accumulated by the family of that adult child – the conduct of such a trust need not be a topic in the family constitution.

The Trust 1 trusts in the group would become the beneficiaries of the income and capital of the main business. That income and capital would then be applied at the discretion of the directors of the central company – where say the parents had died then the directors would be each of the Next Generation children. Whilst all of the children were living then the distribution policy applying to the respective trusts would be equal unless the directors as a group could justify an exercise of a discretion in an uneven manner.

## 3.2 Family Law Issues and Lineal Issue Trusts

Many clients look to trusts as a possible answer in protecting family assets in the event of matrimonial disputes involving their children. Clients in this situation request that the estate plan is structured so that the plan has the effect of prohibiting the spouse of one of the children from gaining access to assets accumulated through the efforts of the parents of the child. Trusts designed to protect family assets in this way are sometimes referred to as “lineal issue trusts”. This is important where the ownership and control of business assets are involved.

Where guarding family assets against the effect of matrimonial disputes is a concern, the estate planner needs to have some understanding of the issues that can arise in respect of trusts in a family law dispute. There are of course significant powers available to the Family Court to treat trust property as the property of the parties (or one of them) and so make orders that take account of such property. See, in particular, the High Court decision in [Kenyon v Spry \[2008\] HCA 56](#).

From a family law perspective, where a spouse is the real controller/appointor of a trust then the assets of the trust are usually treated as property of the parties to the marriage and added to their pool of property to be divided in the event of a financial settlement relating to a matrimonial dispute. This is especially likely where the assets of the trust accrued during the marriage from the efforts of one or both spouses.

On the other hand, where a party to the marriage was not a settlor, trustee, appointor nor beneficiary of

a trust then the assets of the trust concerned may not normally be included in the pool of property. (In the Marriage of Kelly (No. 2) (1981) 7 Fam LR 762).

Accordingly, the double trust arrangement as discussed in point 3.3 above is important. The Trust 1 type structures referred to earlier will be under the control of the directors of the central company (namely, the relevant adult child and that person's siblings). The aim then is to ensure that Trust 1 type entities are seen by the Family Court as falling within In the Marriage of Kelly (No. 2).

This issue is obviously also relevant to any testamentary trusts established under the estate plan. It would appear that the cases so far lend support to the view that the source of the property in a testamentary trust will not necessarily protect the property from being included in the pool of matrimonial assets during a matrimonial dispute involving an adult child. See, for example, Coventry v Coventry & Smith [2004] FamCA 249, Essex v Essex [2009] FamCAFC 236 and Lovine & Connor and Anor [2014] FamCAFC. Those cases may be compared with the trust in MacDowell & Williams and ors [2014] FamCA 479.

The question remains open, however, whether the Trust 1 type entity or a single testamentary trust controlled equally by several adult children will protect the property of the trust from a matrimonial dispute involving one of the adult children. There is no case that we are aware of that provides a definitive answer to this question. It is, however, strongly arguable that property in a trust should not be included in the pool of matrimonial assets where the trust is under joint control. Note, however, the case of Simmons v Simmons [2008] Fam CA 1088 which resulted in the inclusion of the husband's interest in such a trust (namely, a multiple family trust). However, the facts in that case were unusual and, in particular, the husband had made financial contributions to the trust concerned.

### 3.3 Shareholders and Directors of Central Company

It is not uncommon in an estate plan to overlook the structure of the corporate entities in the family group. These entities could be companies acting in their own right as investment vehicles or trading vehicles. Alternatively, the entities could be acting as corporate trustees of family trusts and the testamentary trust. The constitution of all such companies should be reviewed and considered as part of the estate plan.

However, as discussed above the primary issue should be the central company selected in the overall plan and the essence of the family constitution. As part of the estate plan (either pre-death of the principal individuals in the family group or as part of their provisions in their Wills) all shares in companies in the group (trustee companies and companies acting in their own capacity) should be shifted to the central company selected. That then leaves dealing with the shares in the central company. These should be organised with the following consideration to be taken into account:



### 1.11.1 The Number of Shares Available to be Transferred

It is common in a will to see the following in Wills:

*I give my shares in A Pty Ltd to my children equally as tenants in common.*

This can have the undesirable result that the ownership of the shares concerned in the share register of the company will only be recognized for corporate law purposes as a joint tenancy ownership (see section 169 of the Corporations Act). A major problem that arises in this situation is that the first shareholder mentioned on the share register will be the only one of the joint shareholders that is entitled to receive notices of meetings of shareholders (section 249J of the Corporations Act) or entitled to vote at a meeting of shareholders (see section 250F of the Corporations Act).

Accordingly, if there are say 3 adult children then the shares in the company should be split in to a number of shares which can be divided evenly by 3. Then in the Will it would be preferable to gift a specific number or proportion of shares to each of the adult children individually. This ensures that each child has their own share allocation and will have an entitlement to vote in the proportions intended.

### 1.11.2 Right of Appointment as a Director

Consideration should be given to the rights of shareholders to appoint directors. For example, if there are 3 equal shareholders then each one individually will not have sufficient votes as a shareholder to appoint a director. It may be intended that each child has that right and therefore such a provision should be included in the constitution of the company.

*Notwithstanding anything contained in the Constitution of Central Co, on the death of Parent or Parent is not Able to Act the following shall apply:*

- (a) *Child 1, Child 2, Child 3 shall each be entitled to appoint one director to the Board of Central Co.*
- (b) *The total number of Directors shall initially be three and no additional directors shall be appointed to increase the number of Directors to more than three or no Director shall be removed to reduce the number of Directors to less than three unless the Directors Unanimously Agree.*

### 1.11.3 Voting by Directors

The family constitution should cover who are the members of the board of directors of Central Co and how they are appointed. The quorum and requirement for decisions to be made should then be specified. Note that these items would probably vary depending on particular circumstances. For example, whilst say the parents are alive it may be decided to have major decisions resolved by the parents alone despite the children also being on the Board. In the event of the death of one of the

Adrian Abbott Crowe Horwath 2015

Disclaimer: The material and opinions in this paper are those of the author and not those of The Tax Institute. The Tax Institute did not review the contents of this paper and does not have any view as to its accuracy. The material and opinions in the paper should not be used or treated as professional advice and readers should rely on their own enquiries in making any decisions concerning their own interests.

parents then a different formula could apply. This could then vary again where both parents have died.

Finally, the formula could vary once more where the parents are not living as well as one of the children where that child leaves surviving children under say 25 years. These matters need to be considered carefully and each family will more than likely have different approaches. Where the parents are not living and the children are in a dead-lock over a major decision then the agreement could provide a mechanism to break such dead-locks. One method is to provide for the appointment of an arbitrator (a trusted friend or advisor to the family for example) to resolve the issue.

The important issue is to ensure a mechanism for the appointment of directors over the years which excludes non lineal issue members. This will then ensure that the decision making process is left in the hands of the family. In addition, the family constitution could provide for the requirement of a unanimous decision of the directors in respect of certain major decisions dealing with the main business entity in the group (Trading Co). For example, such matters could include:

*The parties acknowledge that after the death of Parent, any of the following decisions must be made by the Directors by Unanimous Agreement*

- (a) *the sale of some or all of its shares in Trading Co; or*
- (b) *the issue of shares in Trading Co to new shareholders (not being employees); or*
- (c) *the sale by Trading Co of the business conducted by that company; or*
- (d) *the application by Trading Coe for, or the provision to Trading Co of, financial accommodation of any nature which would result in Trading Co's unrelated borrowings being in excess of 100% of EBITDA or, together with guarantees and other forms of securities in Trading Co, exceeds 100% of EBITDA; or*
- (e) *the acquisition or disposal of any asset by Trading Co with a value of the assets exceeding 50% of EBITDA; or*
- (f) *an alteration to the dividend policy of Trading Co other than as currently fixed at 50% of net after tax profits.*

In the case of corporate trustees the matters could also include issues relating to the trust such as setting the vesting date, making capital distributions, making loans and the like.

#### 1.11.4 Provisions where Child Dies

Where a structure is set in place with an entity (such as Central Co as we have suggested) having the control of the group then thought needs to be given to the process of decision making for income and capital entitlements of minor children of a deceased child in the group.

How can that child (or at least the child's surviving spouse) be satisfied that his siblings will continue to exercise their discretion in an appropriate manner? Can there be situations where the surviving siblings

'turn the tap off' in respect of income distributions to the children of the deceased family member.

These questions can be a central issue among the family. In our experience, where interviews are conducted with the respective couples (the children and their partners) there is often much discussion on this point. The following clause can be included in the family constitution as a solution to the issue (note that the reference to a Distribution Notice was an instruction in writing that each of the children were recommended to make and attach to their estate documents).

*The Directors must ensure that the relevant Related Trust of the Deceased Director distributes to the members of the family of the Deceased Director the amounts specified in a Distribution Notice in respect of that Related Trust;*

*Where no Distribution Notice in respect of the relevant Related Trust exists the Directors, unless otherwise unanimously agreed, must ensure that the relevant Related Trust of the Deceased Director distributes to the members of the family of the Deceased Director on a regular basis amounts to meet the living expenses, maintenance, education and advancement in life of such family members in keeping with the generally accepted standards as applies to the Directors and their respective families; and*

*The balance of any income (inclusive of taxable capital gains and applicable tax discounts) of the relevant Related Trust is to be accumulated and reinvested by the Directors for the long term well-being of the children and more remote descendants of the Deceased Director.*

The family constitution should consider the decision making process of the central company in the event that say one of the adult children subsequently dies leaving minor children. Namely, there may need to be special provisions so that the surviving children of one of the adult children are protected. Suggested clauses could include

*If a Trigger Event (death of a child leaving issue) has occurred then the Directors shall appoint a child of the Deceased Director as a Director provided that such child to be appointed has attained the age of 25 years and provided that the said child signs a deed under which the child agrees to be bound by the terms and conditions of this Family Constitution.*

*If there is no Issue of a Deceased Director that has attained the age of 25 years or if having attained the age of 25 years refuses to sign a deed under which the child agrees to be bound by the terms and conditions of this Family Constitution and the then the position remains vacant until an Issue meets those requirements.*

### 3.3.1 Communication

The success of any structure will depend on the support of the family. In most cases, the parents are strong in driving for the implementation of a plan and undertake the role of ensuring appropriate communication within the family. This can be achieved through a series of family meetings – with in most cases the spouses of the children included. In addition, each couple should meet with the advisors

Adrian Abbott Crowe Horwath 2015

Disclaimer: The material and opinions in this paper are those of the author and not those of The Tax Institute. The Tax Institute did not review the contents of this paper and does not have any view as to its accuracy. The material and opinions in the paper should not be used or treated as professional advice and readers should rely on their own enquiries in making any decisions concerning their own interests.

(accounting and law) to discuss the proposed plan and the latest drafts of the family constitution. These individual meetings are also useful in taking instructions for their Wills, Enduring Powers of Attorney and Binding Death Benefit Nominations as no estate plan is complete unless all family members have valid estate plan documents.

### 3.3.2 Income Entitlements

A further important provision in the family constitution is a statement of income or dividend distribution policy. Again that policy could vary depending on the position within the family – namely, whether one of the parents is living or whether say one of the children is deceased leaving surviving children. In all the variations between the two situations described there could be different policies that apply. In particular, the discretionary powers may become restricted following the death of different members in the family.

An example clause is as follows:

*Unless otherwise Unanimously Agreed by the Directors, after the death of [Parent] or a Deceased Director [a child leaving surviving issue] whichever occurs first:*

- a. *The Directors must distribute 60% of the after tax profits of the previous year of income of Holding Co (“**Holding Co Dividend Amount**”).*
- b. *The Holding Co Dividend Amount subject to clause A, is to be distributed annually to the shareholders.*

## 4

# Case Studies of Establishing a Family Constitution

## 1.12 Case Study - Bill and Colleen

### 1.12.1 Background Facts

1. The parents, Bill and Colleen, are aged 72 and 71 respectively. They each have one ordinary share in a family manufacturing company that has been operated by Bill for some forty years.
2. The company makes widgets and has a net profit after tax of \$500k per annum, after all family wages.
3. Bill has not worked in the business for probably two years and wishes to retire permanently, to devote more of his time to his grandchildren.
4. Colleen has had nothing to do with the business and has looked after their six children ("Next Gen").
5. Bill has not received salary for years, but receives with Colleen fully franked dividends from the company, which amounts to \$120k per annum. Bill has little super. They live a relatively meagre lifestyle.
6. They now want to transfer the business to four of their Next Gen who work in the business.
7. Bill seeks advice and is told that his shares, pre CGT, are worth approximately \$2 million. Bill does his sums. If he received \$2 million from the Next Gen and invested it at 6% that would give them the \$120k that they needed to live.
8. Of the four Next Gen working in the business, the eldest is the Managing Director (MD) and earns \$110k per annum plus a car. The second of the Next Gen is the CFO and receives the same \$110k plus a car. The third Next Gen is the Sales Director and receives \$100k plus a car. The fourth Next Gen works part-time and is in an administration role, mostly following up receivables, on a salary of \$60k plus car.
9. Bill would like to know how the business was going as the MD does not share that information with him, or the rest of the family.
10. The MD is not happy with his salary and the Sales Director wants bonuses if the sales targets

are met. They all want the administration Next Gen not to receive a car.

11. A family dispute looms.
12. Bill has set the salaries and the terms and conditions of employment, since the Next Gen had begun working in the business, which is now more than ten years ago.
13. Bill does not know the proper arm's length remuneration for the positions occupied by the Next Gen in the business. He sets the salaries based on his perception of their need.
14. The two Next Gen that do not work in the business receive nothing from the business. Colleen wants them to get something.
15. Bill and Colleen have been to see their accountant, who suggests that they sell their pre CGT shares to the four Next Gen working in the business at a consideration of \$2 million. With the proceeds they would invest in secure bank term deposits and live from the interest.
16. Bill and Colleen then decide that they would change their wills and leave the house to the two Next Gen not in the business and give to the four Next Gen in the business, whatever remains of the \$2 million at the time of their death.
17. That was fine when the interest rate was 6% not 2% as it is now, but of course it was always available for Bill and Colleen to use up the principal.
18. It was not so simple for the four Next Gen. They had to approach the bank and to borrow the \$2 million personally. The company had no real estate, but would still be required to give guarantees to the Bank. The question not raised at the time, was whether there was financial accommodation by the company to the Next Gen. Did Div. 7A come into play?
19. The other issue that caused some worry, was that the four Next Gen were required to give mortgages on their homes and guarantees to the bank. Unfortunately their homes were of different values and the spouses of two of the Next Gen were not prepared to sign the mortgages. So, the bank's security fell on only two of the Next Gen.
20. Not contemplated at the time, was the fact that Bill and Colleen's shares that are pre-CGT will become post-CGT to the four Next Gen, albeit they will have a cost base of \$2 million.
21. The Next Gen are now at their accountants, trying to work out whether they can increase their remuneration, or receive fully franked dividends, so that they have sufficient monies to pay the bank interest on their loans, together with the repayment of principal. They are all a little worried about cash flows.

### 1.12.2 Suggested Approach

1. A Deed of Family Arrangement or Family Constitution be set up where the desired outcome of both the parents and the Next Gen could be fulfilled, without the sale of the pre-CGT ordinary shares.
2. The Deed of Family Arrangement could provide the answers to the issues raised by the family as follows
  - Bill and Colleen could keep their ordinary shares by issuing of a discretionary dividend share to a newly established trust, the beneficiaries of which are the six Next Gen and their issue, the distribution of income is possible to all the Next Gen.
  - Bill and Colleen keep their ordinary shares and continue to receive a \$120k fully franked dividend in keeping with their present lifestyle that would avoid the four Next Gen borrowing from the bank and being financially squeezed.
  - A dividend policy could be put in place, so as to satisfy the parent's needs, by way of a fully franked dividend and 50% of the after tax profits to flow through the trust to the six Next Gen. The dividends to the six could be equal, as this represents the family equity in the company and not reward for services.
  - The job function and remuneration of the four Next Gen could be addressed, by an independent arm's length determination of the Next Gen remuneration.
  - The issues of management and control could be addressed and a functioning Board of Directors be established.
  - A proper reporting monthly financial statement could be sent to all family members, with financial disciplines such as budgets and comparables, highlighting capital requirements and working capital needs.
  - An experienced business outsider and independent person could be appointed to the Board and maybe that person will act as Chairperson.

### 1.12.3 The Implementation Process

Then followed six months of family discussion on how to protect Bill and Colleen, how to secure the ongoing business, properly remunerate the four Next Gen and more distributions to all members of the family of surplus after tax profits of the business.

Adrian Abbott Crowe Horwath 2015

Disclaimer: The material and opinions in this paper are those of the author and not those of The Tax Institute. The Tax Institute did not review the contents of this paper and does not have any view as to its accuracy. The material and opinions in the paper should not be used or treated as professional advice and readers should rely on their own enquiries in making any decisions concerning their own interests.

The family decided that it was enough that Bill and Colleen would transfer their shares to a will trust on their deaths.

A Deed of Family Arrangement (DOFA) was drawn up which covered: –

- The ongoing ownership by Bill and Colleen of the ordinary shares in the company on which fully franked dividends are to be paid.
- Five members of the Board were appointed, an independent Chairperson, the MD, the CFO, part-time administration person and one of the Next Generation that is not involved in the business. In this particular case, the non-involved Next Gen was an Architect and reasonably commercial. Board decisions were based on a majority.
- One of the key decisions of the Board was to set the business plan for the twelve months, including a budget.
- A will trust was set up in the parents' wills, all part of the Deed of Family Arrangement.
- The DOFA was intended to be binding. The ordinary shares will be transferred to the will trust on the deaths of Bill and Colleen. That will trust will hold the shares and distributed income to the Next Gen.
- A dividend access share was issued in the company so dividends could be paid to the Next Gen, before the death of Bill and Colleen. That dividend followed the Deed of Family Arrangement provisions which provided \$120,000 for the franked dividends to Bill and Colleen on their ordinary shares and then a dividend up to 50% of the after-tax profit to the Next Gen on that dividend access share. It should be noted that the ATO are looking closely at dividend access shares from the point of view of a dividend strip. It would be difficult to see how this dividend of current year income to the Next Gen can, in the circumstances contemplated, be seen as a dividend strip.
- An independent expert did set the remuneration of the four Next Gen who are working in the business. A proper employment agreement was entered into covering the role, responsibility and the employment conditions together with setting out remuneration and milestones to be achieved.
- On the death of a Next Gen leaving a spouse and children, the distribution from the dividend access trust will go to the surviving spouse and children.
- Bill and Colleen and the six Next Gen had a vote on major decisions that affected the company. Six out of the eight was the majority needed to carry the following decisions:-
  - Conduct the business materially different to the business plan and budget.

Adrian Abbott Crowe Horwath 2015

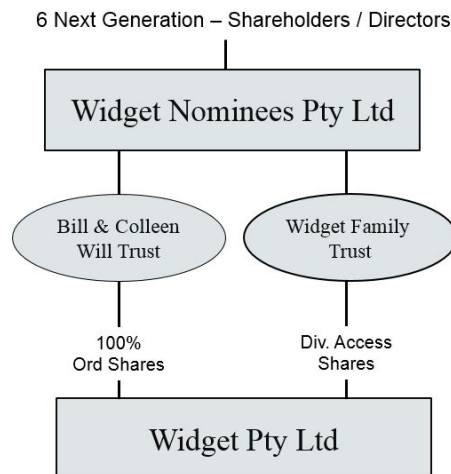
Disclaimer: The material and opinions in this paper are those of the author and not those of The Tax Institute. The Tax Institute did not review the contents of this paper and does not have any view as to its accuracy. The material and opinions in the paper should not be used or treated as professional advice and readers should rely on their own enquiries in making any decisions concerning their own interests.



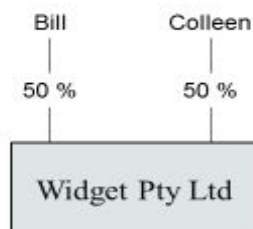
- o Changing remuneration package for the four Next Gen.
  - o Changing dividend policy of the company.
  - o Change in share capital.
  - o Purchase or sale of assets of more than \$500k.
  - o Enter into a loan of more than \$750k.
  - o Changing distributions from the dividend access share trust.
  - o Sale of a Next Gens interest in the dividend access share trust.
- Not of great concern to the family was the family law issues, but there is considerable advantage for the four Next Gen to have dividend distribution via the dividend access share trust, rather than have direct ownership of the company shares.

See power point on the structure pre DOFA and following the death of Bill and Colleen.

## Post DOFA & Deaths of Bill & Colleen



## Bill & Colleen Pre DOFA



Adrian Abbott Crowe Horwath 2015

Disclaimer: The material and opinions in this paper are those of the author and not those of The Tax Institute. The Tax Institute did not review the contents of this paper and does not have any view as to its accuracy. The material and opinions in the paper should not be used or treated as professional advice and readers should rely on their own enquiries in making any decisions concerning their own interests.

## 1.13 Case Study– Geoff and Mary

### 1.13.1 Background Facts

1. Geoff and Mary, who are in their 70s, own through a discretionary trust 50% of the shares in a company owning a large neighbourhood shopping centre. The value of the shopping centre is about \$30 million.
2. The other 50% is owned by Steve, a close personal friend, who has developed and managed the shopping centre for 35 years. Geoff has not been close to the management of the centre and simply relied on a monthly cheque arriving in the bank account. Geoff and Steve are mates, but are now getting on in years. They are thinking about the future. There is no written shareholders' agreement. All day-to-day management decisions have been made by Steve and the major decisions by a handshake between Geoff and Steve.
3. Geoff wishes to sell his 50% interest to Steve. However, Steve does not wish to borrow money to pay out Geoff.
4. Geoff now realises that his family is locked into a long term investment and he should structure his family, so as to protect his wife and children. He cannot do that in his will.
5. There is a further problem, Geoff's wife Mary is not commercial and their two Next Gen are very

Adrian Abbott Crowe Horwath 2015

Disclaimer: The material and opinions in this paper are those of the author and not those of The Tax Institute. The Tax Institute did not review the contents of this paper and does not have any view as to its accuracy. The material and opinions in the paper should not be used or treated as professional advice and readers should rely on their own enquiries in making any decisions concerning their own interests.

different in nature and commercial understanding. One lives an alternative lifestyle in Queensland and is not commercial, while the other is commercial and has business acumen. Both have a stable family life with adult children.

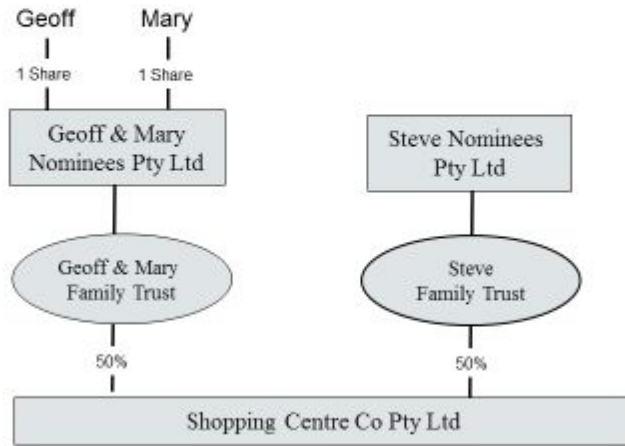
6. Mary is worried that if she dies before Geoff, then he may remarry and part of her Next Gen's inheritance might be lost.
7. Both Next Gen would like to receive income now rather than wait for their parents to die, before benefiting from their assets.

### 1.13.2 Suggested Approach

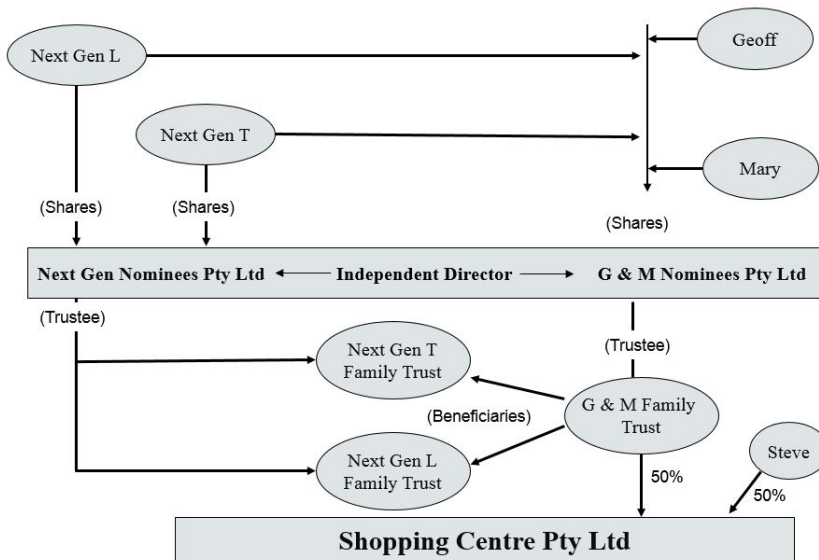
1. After advice, Geoff, Mary and their Next Gen decide to enter into a Family Constitution to achieve their aims, which are:
  - a. To have control of the family trust, to be in the hands of the four of them, with provision that there be appointed an independent director. That person is known to the family and has commercial acumen. That way, decision making requires three to agree.
  - b. The major decisions to be made by the trustee of the family trust will be:
    - Who is to be appointed as a director of the company owning the shopping centre, to bring about commercial decision making. This includes protecting the interests of all shareholders and making decisions with Steve and his family.
    - What distribution of income will be made by the family trust. In the Family Constitution there is an income distribution policy, which would require unanimous consent to alter that policy.
    - To provide an avenue where one Next Gen wishes to exit the family trust.
  - c. A new family trust be established for each of the two Next Gen. The trustee of the trusts should be a company controlled by the two Next Gen, with provision for an independent director.

See power point on the structure pre and post Family Constitution.

# Geoff & Mary Pre DOFA



# Geoff & Mary – Post DOFA



## 1.14 Case Study – Alex and Pat

### 1.14.1 Background Facts

1. Alex and Pat own ordinary shares in a holding company, which in turn owns all of the shares in a large operating business.
2. Over the years, income distributions have been made on dividend access shares to a family trust. Distributions have been made to members of the family and to a corporate beneficiary, which has used the funds to establish a significant property investment company.
3. Alex and Pat have four adult Next Gen, who in one way or the other, work in the operating business or in the property company.
4. It has been decided that the operating business should remain in the family past the deaths of Alex and Pat and that the Next Gen be given defined roles and rewards now so that the operating business and property group can grow significantly into the future.
5. The Next Gen want to spread the ownership and control so it is widely held by them and left to make their own decisions on the investment of income distributed to them. They want to have a build-up of assets in the property entity.

### 1.14.2 Suggested Approach

1. After much discussion by the family, they decided to enter into a binding Family Constitution which set out the structure that would give them asset protection and yet allowed them to make decisions on their own investments. It was decided that the structure going forward would be a limited partnership, where each of the Next Gen had a family trust that was the limited partner.
2. The general partner, who controls the limited partnership, was a company in which Alex and Pat and the four Next Gen were shareholders and directors.
3. Under the Family Constitution there was a requirement for an independent director, who had expertise in the area of the operating business.
4. The relationship between each of the Next Gen and the ongoing management and control of the limited partnership and the operating business, were all covered in the Family Constitution. This included:
  - a. The ability to nominate a director to the general partner.
  - b. Decide on the board for the operating business.

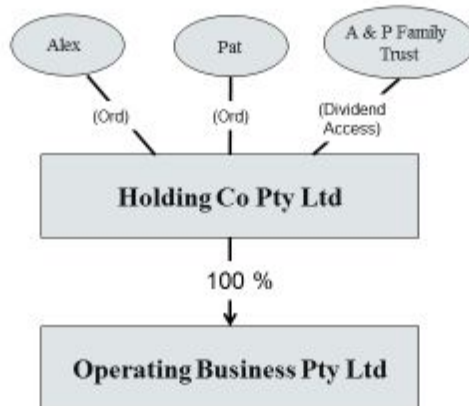
Adrian Abbott Crowe Horwath 2015

Disclaimer: The material and opinions in this paper are those of the author and not those of The Tax Institute. The Tax Institute did not review the contents of this paper and does not have any view as to its accuracy. The material and opinions in the paper should not be used or treated as professional advice and readers should rely on their own enquiries in making any decisions concerning their own interests.

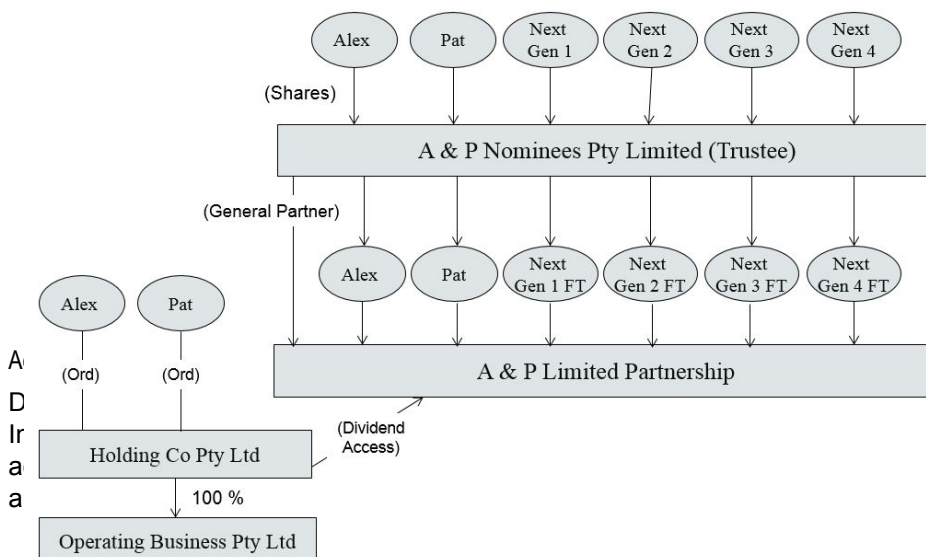
- c. Ensure independent directors were appointed both to the general partner and the operating business.
  - d. Decided on dividend policy and re-investment policy.
  - e. Investment decisions referred to the board and limited in amount unless unanimous consent.
  - f. Deal with income distributions from both the operating business and the limited partnership.
  - g. Provide for an income flow to the family of a deceased Next Gen.
  - h. Dispute resolution provisions.
  - i. Pre-emptive rights on exit by a Next Gen.
5. The Family Constitution also covered the establishment of the will trust for Alex and Pat for the transfer of the ordinary shares in the holding company and their interests in the limited partnership.

See power point on the structure pre and post Family Constitution.

### Alex & Pat Pre DOFA



### Alex & Pat – Post DOFA



those of The Tax  
ave any view as to its  
professional advice  
| their own interests.