

## NEWSLETTER

### Legal Up-Date

October 2004

#### WHAT IS THE EXTENT OF A DIRECTOR'S LIABILITY IN A TRADING TRUST?

People who are directors of a corporate trustee of a trading trust should be particularly wary of s.197 of the Corporations Act 2001. That section provides:

*“A person who is a director of a corporation when it incurs a liability while acting, or purporting to act, as trustee, is liable to discharge the whole or a part of the liability if the corporation:*

- (a) has not, and cannot, discharge the liability or that part of it; and*
- (b) is not entitled to be fully indemnified against the liability out of trust assets.”*

The section creates some ambiguity about the position of directors of corporate trustees. The second limb of the section “*is not entitled to be fully indemnified against the liability out of trust assets*” is clearly contrary to a very important principle in the concept of trusts, namely that trustees are entitled to be indemnified out of the trust fund of which they are trustees. The section also appears to be contrary to the principle of the separate legal personality of a company law.

The interpretation of the section was a central issue in a decision by the Full Court of the Supreme Court of South Australia in Hanel & Anor v O'Neill handed down in December 2003.

In that case, the corporate trustee of a unit trust incurred a debt while acting as trustee. The debt was not discharged and the creditor brought proceedings against the sole director of the corporate trustee, alleging personal liability of the sole director. A central issue in the proceedings was whether s.197 quoted above, imposed personal liability on a director of a corporate trustee where there were insufficient funds in the trust to discharge that liability.

The issue was decided against the director at first instance. The director then appealed to the Full Court of the Supreme Court of South Australia. On appeal, Justices Mulligan and Gray determined that a director of a corporate trustee is liable to “*discharge the liability of a trust where [the trustee] is not entitled to be fully indemnified out of the assets of the trust*”. On the basis of this decision, directors of corporate trustees could be held personally liable where there is a shortfall in trust assets to meet a trust debt.

On the other hand, Justice DeBelle took the view that the fact that the trust does not have sufficient assets to indemnify the corporate trustee does not make the director of the corporate trustee liable for the debts of the trust. In his view, the pivotal question was whether the trust deed was drafted in such a way as to allow the trustee to be indemnified, regardless of whether there were sufficient assets in the trust or not.

The way that s.197 has been drafted certainly creates confusion for directors of corporate trustees. We do not believe either of these interpretations is correct. However, it appears from the decision that the problem lies in the wording of the section which compels interpretations which are peculiar and unfavourable to corporate trustees. Of course, this problem may be somewhat reduced by the careful drafting of trust deeds. At the end of the day, the only proper solution may have to be provided by the Federal Parliament by amending section 197 to clarify the position at law.

#### SPONSOR AND DIRECT EMPLOYER

A company wishing to sponsor an employee for a subclass 457 (temporary long stay business visa) must show, amongst other factors, either:

- (1) that it will introduce new or improved technology or business skills through the employment of the visa applicant; or
- (2) that it has a satisfactory training record of, or a demonstrated commitment towards training Australian citizens or permanent residents in its business operations.

Often the company which proposes to be the direct employer of the visa applicant may not be able to show that it fulfils either of the above criteria. However, another company in the same group may be able to show a satisfactory training record but may not have a need for the services of the visa applicant.

In some circumstances there is a solution to this problem. Pursuant to Regulation 1.20D(2)(b)(iv) of the Migration Regulations 1994 (“Migration Regulations”), the Minister must approve an application for sponsorship if the Minister is satisfied that the sponsoring company (under the Corporations Law) is related to the company which will be the direct employer of the visa applicant. Under the Corporations Law, a company is related to another company

if one company is either a holding company (or its subsidiary) or a subsidiary of the other.

Whether one company is a subsidiary of another company is determined by section 46 of the Corporations Act. Essentially, a company is a subsidiary of another company if the other company:

- (i) controls the composition of the first company's board of directors;
- (ii) is a majority shareholder of the first company; or
- (iii) is otherwise in a position to influence the votes in the first company.

According to section 50 of the Corporations Act, a company is also a subsidiary of another company if it is a subsidiary of a subsidiary of the other company. For example, if A is the holding company of B and C then, although B and C are not subsidiaries of each other (since they are both subsidiaries of A), both B and C are related companies of each other and therefore fall within section 50(c) of the Corporations Act.

Accordingly, if there are several companies in a group which are all subsidiaries of one holding company, it is possible that one company in the group could act as the sponsor of the visa applicant, while the company which actually requires the services of the visa applicant will be responsible for the payment of his wages and provision of a workplace and, will be the direct employer of the applicant.

## TAXATION TREATMENT OF TRUSTS

In the July 2004 edition of Legal Up-Date, we examined the taxation treatment of partnerships. In this edition, we look at the taxation treatment of trusts.

A number of taxation advantages attach to trusts and hence they are often used as a structure for conducting businesses. Of course, the types of advantages and disadvantages will depend on the exact nature of the trust in question, such as a unit trust, discretionary trust or a hybrid trust.

Generally, all trust structures allow for greater flexibility in tax planning compared to other business structures. This is because generally, the trust itself is not taxed. Any tax that is payable depends on how the income of the trust is distributed. For example if the income of the trust is distributed to a company, then the company will pay tax on that income at the company rate of tax, subject of course to any tax deductions allowed to the company. If it is distributed to an individual, then the person in question will pay tax at his or her marginal tax rate, also subject to tax deductions allowable to him or her. If, however, income is not distributed in a financial year, then tax will be payable by the trust itself on the undistributed income at the top marginal rate.

A second taxation advantage that is available to trusts is the 50% CGT discount on disposal of a CGT asset if the capital gain can be streamed to a natural person. The 50% CGT discount may be claimed by beneficiaries who are entitled to the discount (natural persons), provided that the benefit of the discount has been distributed to the beneficiary concerned.

Discretionary trusts are a recommended form of business structure for many businesses, particularly family businesses. This structure is especially attractive to family businesses as it allows income and assets to be split or streamed among individual members of the family. A discretionary trust is also able to accommodate changes in the circumstances of its beneficiaries. For example, if the tax position is not favourable for a particular beneficiary in any financial year, then the trustee may in its discretion decide to distribute little or no income to that beneficiary in that year. If, on the other hand, a particular beneficiary enjoys a favourable tax position in any financial year, greater income may be distributed to that beneficiary, resulting in a lesser amount of tax being paid on the total distribution of income by the trust.

As with any structure, there are also disadvantages to trusts. One of the main disadvantages is that losses including tax losses of a trust are trapped within the structure and cannot be distributed to beneficiaries.

Further, all income earned by a trust must be distributed to its beneficiaries. The income that is not distributed by the end of the relevant financial year will be taxed at the highest marginal rate of 48%. Therefore, income should not be accumulated in a trust.

If you have any questions about what is the most appropriate structure to adopt for your business, we would be happy to discuss your particular situation with you.

## INTRODUCING KERSTIN GLOMB:



Kerstin has been a German Law Consultant to the firm since 2000, advising predominantly in relation to inheritance and estate matters. After qualifying as a lawyer in Germany, Kerstin was initially appointed as a provisional judge of the Berlin District Court (Landgericht), and subsequently as a permanent judge at various local courts (Amtsgerichte) in Berlin. Kerstin

served as a judge in the Probate division of the Amtsgericht Berlin-Mitte for over four years. In that capacity, she primarily heard matters concerning German succession law and the succession law of the former East Germany as well as international succession law cases.

Kerstin holds a Diploma of Law from the Legal Practitioners Admission Board. In October 2003, she was admitted as a solicitor in New South Wales.

**Languages:** • German • English

## YOUR FEEDBACK

If you have any comments about this newsletter, suggestions for improvement or would like to see any particular areas of law which interests you covered, please drop us a line at:

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