TRUSTEE CAPACITY AND WHAT IF THEY LOSE IT?

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"With an ageing SMSF population what factors do we as advisers need to consider to determine whether our clients have capacity to act as a trustee?"

Learning Outcomes:

This webinar is designed to help you as the trustee's advisors to:

1. Understand the importance of trustee capacity in the context of an SMSF
2. Understand the different types of capacity and why legal capacity is a legal issue not a medical issue.
3. Learn the basic legal test for the legal capacity of a trustee
4. Learn the things that need to be considered when assessing a trustee's capacity
5. Learn the process for assessing the legal capacity of a trustee and the types of questions to ask
6. Learn how to stress test an SMSF to discover what needs to be done to protect the fund against trustee incapacity

1. Why is trustee capacity an important issue in the context of SMSFs?

a. Self-managed retirement savings

You wouldn't trust your retirement savings with someone who lacks capacity. An SMSF, as its name suggests, is self-managed. The trustees (or directors of corporate trustee) are generally the members themselves and if they lose capacity, they will need someone else with the necessary capacity to manage their SMSF.

b. Ability to maintain complying status of an SMSF

SMSF is more than just a portfolio of investments and a bank account. This tax friendly environment is provided to only those funds that can comply with the relevant superannuation laws. Although many trustees are supported by their professional advisors, trustees are ultimately responsible for the management of the funds in compliance with the laws. A trustee without capacity wouldn't be able to fulfil the role. Losing the complying status can have detrimental tax consequences.

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2. Understand the different types of capacity (The Three Types of Incapacity)

Often we use the term capacity to mean only mental capacity, which is one of the three different types of capacity.

Broadly the three kinds of incapacity are legal, mental and physical. They can overlap.

- Legal capacity is the ability to exercise all an independent adult's legal rights. It is therefore not available to someone under 18 years of age except in specific exceptional circumstances[1].

- There is no uniform definition of mental capacity. Generally it is the capacity to understand the nature of the transaction in concern. Accordingly, its definition depends on the type of transaction that is involved and the type of decisions that needs to be made. Mental capacity is a pre-condition to legal capacity. If you don't have mental capacity then you don't have legal capacity.

- Physical capacity is self explanatory – physical capacity to do something. It is also a pre-condition to legal capacity though to a lesser extent. In the context of managing an SMSF, physical abilities of hearing, speaking and signing are generally considered important in order to effectively communicate and formally make the trustee decisions. For example, if you can't physically sign your SMSF documents they may not be valid.

If someone is in a coma they have neither the physical nor the mental capacity necessary for legal capacity.

A person who suffers from a degree of physical incapacity but no mental incapacity can overcome the limitations imposed by their physical incapacity in other ways. For example, if they cannot speak, they can write their communications. If they cannot see, they can have documents read to them. Provided they retain the mental capacity necessary then they can still have legal capacity.

It is mental incapacity that often results in the lack of legal capacity.

Trustee capacity stems from legal capacity.

[1] A minor who is married may make a Will in at least NSW and VIC.

3. Learn the basic legal test for the legal capacity of a trustee

The tests for mental incapacity

There are different legal definitions of mental capacity depending on whether the context is the commission of a crime, the making of a Will or other acts or omissions.

Crime

- In the commission of many crimes it is necessary for the accused to be able to form a criminal intent (called 'mens rea'). This issue is beyond the scope of this paper.

Making a Will

- It was established in 1572 that to make a Will you had to be of 'sound mind'[2].

- The test for establishing soundness of mind was established in 1870 in *Banks v Goodfellow*.

'… "testamentary capacity" encompasses the following concepts:

a. that the testator is aware, and appreciates the significance, of the act in the law which he or she is about to embark upon;
b. that the testator is aware, at least in general terms, of the nature, and extent, and value, of the estate over which he or she has a disposing power;
c. that the testator is aware of those [who] may reasonably be thought to have a claim upon his or her testamentary bounty, and the basis for, and nature of, the claims of such persons;
d. that the testator has the ability to evaluate, and to discriminate between, the respective strengths of the claims of such persons.'

Other Matters

- Unless stated to the contrary in specific legislation[3] the mental capacity required by the law depends on the particular legal transaction which is being considered. The test is the capacity to understand the nature of that transaction (ie its broad application) when it is explained[4].

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[2] Marquess of Winchester's Case

[3] See for example the *Guardianship and Administration Act 1993 (SA)* which contains a particular definition of mental incapacity which must be met before the Guardianship Board can consider making orders or decisions under the Act.

[4] *Gibbons v Wright* [1954]

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4. Learn the things that need to be considered when assessing a trustee's capacity

a) The test of capacity is a legal test not a medical test.

It is not the role of the person's doctor to determine whether the person has capacity. If there is any doubt about it then the matter is decided by a Court.

Medical opinion is useful evidence but for the opinion to be effective the doctor needs to understand the legal test and provide opinion on the person's ability to meet the test criteria.

The role of the client's accountant is to be aware of the potential and if it is considered significant to then discuss with the client and their family with a view to seeking legal advice, and if necessary, medical opinion.

b) Incapacity is not 'all or nothing'

The different legal tests for capacity mean that a person may have the capacity to make some decisions, such as deciding whether to make small purchases like groceries, but may lack capacity to make other decisions, such as deciding whether to enter into more complicated financial arrangements.

A finding of incapacity in one area does not automatically mean that capacity is lacking in another area. The NSW Supreme Court has found that a person who has been found incapable of managing their financial affairs may still be capable of making a Will.

c) The presumption of sanity

With all transactions except a Will it is presumed that you have mental capacity[5]. In relation to a Will, there is no presumption of mental capacity; the onus of proving capacity always falls on the person propounding the Will. However it quickly shifts to the person challenging the Will once it is shown that the Will was duly executed and is rational on its face.

In the context of a trustee or trustee/director of an SMSF it is only where a doubt about mental capacity remains after examining all relevant and available information, that the presumption of sanity should be applied.

[5] *Szozda v Szozda* [2010]

Because it is presumed that the trustee has mental capacity, the onus of establishing mental *incapacity* lies on the person who alleges the incapacity. Clear evidence is necessary. Inferences, suppositions and tale-telling are not enough.

This makes the issue of the mental capacity of a super fund trustee particularly difficult if the trustee denies they lack the requisite mental capacity. If that happens the person alleging the incapacity must present medical and behavioural evidence to prove that the trustee is not able to meet the required standard of behaviour of a trustee.

Clearly if a person is unable to look after their own affairs they could not be said to be able to look after the affairs of an SMSF or act as a trustee or a director of a corporate trustee of an SMSF. If they have appointed an Enduring Power of Attorney that attorney can do all such acts and things required of a trustee of an SMSF.

If a trustee's mental capability has moved to the point of mental incapacity then remedial steps need to be taken to protect the SMSF and its assets. On the other hand, if the trustee's dementia still falls short of full-time mental incapacity they should, at a time of appropriate lucidity, sign an Enduring Power of Attorney so that the attorney can fulfill the required duties once the member's dementia progresses to full-time mental incapacity.

d) The Importance of Context

A person may not be mentally capable in relation to one type of legal transaction but that does not mean they lack capacity totally or with respect to another legal transaction.

The following are examples of cases showing different types of capacity. They tend to focus on Wills due to the large amount of litigation in the area of Will disputes and challenges, but the principles are equally applicable to trustees of an SMSF and the cases illustrate the issues:

- a person who is incapable of managing their financial affairs may still be capable of making a Will or an enduring power of attorney,
- a person who is incapable of managing their financial affairs may have mental capacity to make a simple contract;
- a person with insufficient capacity to make a Will may nonetheless have enough capacity to revoke a Will;
- a person with insufficient capacity to make a Will may nonetheless have enough to make a codicil to a current Will;
- a litigant may not have mental capacity to act in person but have enough mental capacity to instruct a solicitor;

- greater mental capacity may be needed to make a power of attorney compared to that required for a Will;
- a person suffering with schizophrenia and paranoia *can* have testamentary capacity although his or her estate *is* managed or may *not* have testamentary capacity even though his or her estate is *not* managed;
- a person may not have enough mental capacity to make a Will but have mental capacity to marry.

e) The Importance of Time

Just because a person lacks mental capacity at one point of time does not mean that mental capacity was or will be lacking at another time[6]. Ideally an assessment of mental capacity should be made at the time of the particular dealing in relation to which mental capacity is needed. For example a Victorian Court has remarked[7]:

> "As in many cases of this kind, [the testator's testamentary] capacity fluctuated over time; there was no day on which he ceased to have capacity forevermore."
>
> A NSW Court followed this line[8] by saying: "Stress, emotion and other external factors can impact upon a person's level of cognition at a particular time."

You can see the need to concentrate on the particular situation before you so that there can be no doubt that the person had the required level of cognition at the appropriate time.

f) The Importance of Complexity

It is probably not surprising that mental capacity may depend on the complexity of the transaction. Based on the principles above it is trite to say that the more complex the transaction being contemplated the higher the risk that a person suffering some level of mental capacity may not be competent in respect of the transaction.

But mental capacity is a legal concept and is not to be undermined by the subjective attitudes of others. The Courts have said that people are entitled to do strange things and to be

[6] *Guthrie v Spence* [2009]
[7] *Re Kensall* [2016]
[8] *Gray v Taylor; The Estate of the late Stanislaw Zajac* [2017]

"whimsical, capricious, vindictive, wrong in belief or their acts beyond explanation without that of itself proving lack of capacity."

Although, on the other hand, "a value judgment so extreme as to defy credulity" may be clear indication of incapacity.

g) Consider the Circumstances of the Transaction

You can only make an assessment by considering all the relevant circumstances of the particular transaction. In *Scott v Scott*[9] the Court had to consider whether the grantor had capacity to grant the power of attorney being challenged and noted that in reaching its decision it was necessary to consider:

- the identities of the parties to the disputed transaction;
- their relationship;
- the terms of the document;
- the nature of the business that might be undertaken pursuant to the transaction;
- the extent to which the parties might be affected in his or her person or property by the transaction;
- the circumstances in which the instrument came to be prepared for execution;
- the particular purpose for which the instrument may ostensibly have been prepared; and
- the circumstances in which it was executed.

h) The Danger Signals

In becoming alert to the prospect that the client has mental capacity issues the danger signals include

- current or recent hospitalisation
- a significant medical condition
- inability to grasp simple concepts
- material forgetfulness
- unusual repetition
- lack of focus or ability to concentrate
- failure to recognize people
- diagnosis of dementia
- increased confusion

[9] [2012]

- personality or behaviour changes
- apathy and withdrawal or depression
- loss of ability to do everyday tasks

5. Learn the process for assessing the legal capacity of a trustee and the types of questions to ask

The Assessment Process

The NSW government's guide to dealing with incapacity suggests that when it comes to the issue of assessment you begin by applying the six capacity assessment principles.

1. *Always presume a person has capacity*
   The most basic principle is to presume that a person has the capacity to make all decisions for themself.

2. *Capacity is decision specific*
   Apply the presumption of capacity for **every** decision the person makes. This is because a person may be able to make some, but not all, decisions for themself.

3. *Don't assume a person lacks capacity based on appearances*
   Do not assume a person lacks capacity because of their age, appearance, disability, behaviour or any other condition or characteristic.

4. *Assess a person's decision-making ability – not the decision they make*
   A person cannot be assessed as lacking capacity simply because they make a decision you think is unwise, reckless or wrong.

5. *Respect a person's privacy*
   Respect a person's right to privacy when you are assessing their capacity. This may mean doing the assessment with them alone with no-one else present. It might also mean restricting access to the results of the assessment to only those persons who need to know.

6. *Substitute decision-making is a last resort*
   If you decide that the person doesn't have capacity to make the necessary decisions you need to discuss this with their closest family. Moving to have a person formally assessed for mental capacity is a big step that needs careful handling and may need further legal and medical advice.

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Below are some specific questions you may ask as part of the assessment process to determine if the person you are assessing has capacity to make property and financial decisions as a trustee of their SMSF. Remember that the trustee may not know the specific details about the compliance aspects of superannuation generally or their fund in particular. In addition, often one of the married couple leaves the super fund administration to the other member and therefore may be unaware of many of the fund's details. Asking them questions about the fund may therefore provide a false positive and it may be better to ask questions more generally about them and their financial situation. You should assure the person that the answers are confidential.

Before getting to the specifics it is worth noting a few general rules:

- ask open-ended questions ("what is …?" or "when did …?" or "how will …?") - for example: "How many children do you have?"
- do not ask leading questions ie. a question that suggests the answer - for example: "You have three children, correct?"
- though you may need to spend a little time on the exercise, don't beat around the bush; frame your questions to quickly identify any areas of concern for which a person may need support or help
- ensure it is the person being assessed who answers the questions – this may require that you see them alone but be aware of their need to have someone with them for mental health, cultural or language reasons.

Examples of questions:

- what bank accounts do you/the fund have?
- how much money do you/the fund have in the bank at the moment?
- what property do you/the fund own?
- how much do you think the property is worth now?
- are you the only owner or does someone else own it with you?
- what other investments do you/the fund have?
- does your family ever ask you for money?
- does your family ever ask you to buy something specific for them?

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- where do you get your money from?
- do you ever give money to strangers?

and, of course, if you think there's a problem:

- the government sets very high standards for people to be the trustee of an SMSF – would you be prepared to appoint an attorney to be the trustee of your fund in your place rather than have all the hassle of having to meet those standards?

6. Learn how to stress test an SMSF to discover what needs to be done to protect the fund against trustee incapacity

Recap of the Legal Framework

Section 10 of the SIS Act provides that a "legal personal representative" is, among others,

- the trustee of the estate of a person under a legal disability, or
- a person who holds an enduring power of attorney ('EPoA') for the person.

This means that in the context of a mentally incapable trustee there are only two persons who can stand in the place of the incapacitated member as a trustee of the fund or director of the corporate trustee of the fund: their personal trustee or their enduring attorney.

Section 17A(3)(b) of the SIS Act provides that the fund does not fail to satisfy the definition of a self managed superannuation fund due to a legal personal representative of a member being a trustee of the fund (or a director of a body corporate that is the trustee of the fund) in place of the member during any period when:

(i) the member of the fund is under a legal disability; or
(ii) the legal personal representative has an enduring power of attorney in respect of the member of the fund.

Section 17A(3)(c) of the SIS Act provides that the fund does not fail to satisfy the definition of a self managed superannuation fund if a member of the fund is under a legal disability because of age and does not have a legal personal representative, if

(i) the parent or guardian of the member is a trustee of the fund in place of the member; or
(ii) if the trustee of the fund is a body corporate – the parent or guardian of the member is a director of the body corporate in place of the member.

Though there is no case law on the subject, it would seem that the phrase "is under a legal disability because of age" refers to minors and not to elderly members who are legally incapable due to age-related dementia, the latter falling under sub-paragraph (b).

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Section 17A(3)(d) of the SIS Act provides that the fund does not fail to satisfy the definition of a self managed superannuation fund by reason only that an appointment under section 134 of an acting trustee of the fund is in force. Section 134 deals with the appointment by the Regulator of an acting trustee following the suspension or removal of the trustees of an SMSF by the Regulator. This would be a highly unusual situation and we will not comment on it further in this paper.

Remember that if a fund ceases to satisfy the basic conditions to remain an SMSF due to the non-compliance with s.17A it has 6 months to remedy that situation (s.17A(4)(b) SIS Act).

In summary, a trustee or trustee/director who is suffering from mental incapacity must have appointed a 'legal personal representative' who can take their place or must have a personal trustee appointed under the local guardianship law to represent them and manage their affairs.

The latter is a particularly cumbersome process and is to be avoided. It is not the purpose of this paper to discuss in detail the processes relating to the appointment of a trustee of an estate of a person with legal incapacity. For a summary of those processes go to http://www.tag.nsw.gov.au/managed-clients-landing-page.html.

The appointment of an enduring attorney is by far the preferred method of dealing with the issue.

Note that in the context of a corporate trustee the fact that a member/director has appointed an enduring attorney does not automatically make that attorney a director of the trustee company. It will be necessary for the corporate law relating to the appointment of directors to be followed which may include a review of the company's constitution, resolutions by shareholders of the company, resolutions by directors of the company, signed consent forms from the attorney and formal advice to ASIC of the new appointment.

<u>Stress Testing an SMSF for Trustee Incapacity</u>

If your client is a member of an SMSF and suffers mental incapacity what will happen to the SMSF? It might be best to stress test the SMSF before that happens in order to make sure that the fund can either continue notwithstanding the incapacity or can be carefully managed to allow time for member exit and perhaps dissolution.

If there has been no planning for trustee incapacity it may be necessary to either wind-up the fund, convert the fund to a small APRA fund or, if there are other members, to roll out the person's superannuation benefit to an APRA regulated fund. Who would select that APRA regulated fund

and what power they would have to do so? In the absence of the appointment of an enduring attorney these are difficult questions.

It is far more preferable to plan for the problem. Ask the following questions and consider what the fund should do based on the answers.

Are the trustees of the fund individuals or is there a corporate trustee?

1. if individuals:

(i) does the fund deed automatically disqualify an individual trustee who becomes legally incapable due to mental incapacity?

(ii) does the fund deed permit a member to appoint an enduring attorney?

(iii) does the fund deed recognise the right and empower the enduring attorney to hold office as a trustee of the fund in the place of the incapacitated member?

(iv) can the appointment follow the ATO's guidelines in SMSFR 2010/2?

(v) does the fund deed permit the member to then retire as trustee or 'be retired'?

(vi) can the member appoint another member as their enduring attorney and replacement trustee?

(vii) is the enduring attorney eligible to be a trustee of an SMSF ie. is not disqualified and has sufficient understanding of the role to otherwise qualify?

(viii) is the enduring attorney prepared to accept the responsibilities (and liabilities) of a trustee of an SMSF and sign the ATO declaration?

(ix) has the member appointed an enduring attorney?

(x) are there any limits on the power of the enduring attorney that could affect their role as trustee of the fund?

(xi) does the power of attorney extend so far as acting as trustee of the grantor's SMSF?

(xii) have all the formalities for the proper appointment of the enduring attorney been complied with (including registration of the power if the local State law so requires)?

(xiii) does the power of attorney appoint a substitute attorney in case the original appointment is not available (important in 'mum and dad' funds where they appoint each other but then travel together in cars, planes etc)

2. if a corporate trustee:

(i) check the fund deed – does it permit the appointment of the enduring attorney as director of the corporate trustee?

(ii) has each director of the corporate trustee appointed their enduring attorney?

(iii) are there any limits on the power of the enduring attorney that could affect their role as trustee of the fund?

(iv) does the power of attorney extend so far as acting as director of a company, particularly the trustee of the grantor's SMSF?

(v) have all the formalities for the proper appointment of the enduring attorney been complied with (including registration of the power if the local State law so requires)?

(vi) does the power of attorney appoint a substitute attorney in case the original appointment is not available (important in 'mum and dad' funds where they appoint each other but then travel together in cars, planes etc)?

(vii) ensure that the local State legislation is followed strictly in respect of that appointment;

(viii) ensure the enduring attorney is not disqualified from being a trustee of an SMSF;

(ix) check the fund's deed and the constitution of the corporate trustee – is there a provision by which the mental incapacity of a director automatically disqualifies the director from being a director of the corporate trustee ***and*** automatically removes them from that office (note, disqualification may not be enough if there is not effective removal)?

(x) how will you ensure the appointment of the member's enduring attorney as a director of the corporate trustee (ie will the shareholders and other directors all vote for this appointment)?

(xi) has the member appointed an alternate director?

(xii) has that appointment been for a fixed period (SMSFR 2010/2)?

(xiii) does the constitution direct the Board of the company to send notices of all directors meetings to the alternate director from the time on which their appointment becomes effective?

(xiv) is the enduring attorney prepared to accept the responsibilities (and liabilities) of a director of an SMSF corporate trustee?

(xv) is the enduring attorney indemnified by the member for acting as director?

[end]

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