

ESTATE PLANNING

Testamentary Trusts

What is a Testamentary Trust?

A testamentary trust is a discretionary trust established under a Will, which does not come into effect until after the death of the Will maker. Testamentary trusts can provide considerable benefits as they can be controlled by the beneficiary without forming part of that beneficiary's estate. The terms of a testamentary trust are similar, (but not as extensive) as those contained in most family discretionary trusts. These trust terms are attached as a schedule to your Will.

Is a Testamentary Trust different from a Family Trust?

Yes. Although both testamentary and family trusts have similar features, such as the ability of the trustee to decide which beneficiaries of the trust will receive income, there are considerable taxation advantages for infant beneficiaries (under the age of 18 years) under a testamentary trust.

Income received by infant beneficiaries from a family trust will be subject to penalty tax rates if that income exceeds approximately \$416. Under a testamentary trust, infant beneficiaries receive the full tax-free threshold, and any income above that amount is taxed at normal adult rates. With the increase in the tax-free threshold from \$6,000 to \$18,200 in the 2012/2013 financial year, this makes a testamentary trust an even better inheritance vehicle. In particular, combined with the low income tax rebate, an individual can earn around \$20,542 before paying any tax.

In particular, consider the tax savings in the following scenario:

Assume an older couple die leaving a combined estate (including their superannuation) valued at \$2 million to be divided equally between their son and their daughter. If the inheritance was invested at 8%, each child's share would generate an annual income of \$80,000.

Example 1:

The Wills leave everything to the son and daughter personally (or they have no Wills). Both the son and daughter's tax position is therefore:

Beneficiary	Income	Tax (assuming no other income)
Son	\$80,000	\$17,547
Daughter	\$80,000	\$17,547

Example 2:

The Wills create a testamentary trusts for each of the son and daughter, controlled by each of them and providing for their respective families to be beneficiaries.

In respect to the son's situation, he has a wife who is currently not working and three infant children. Through the use of a testamentary trust for the son, the family's tax position might then be:

Beneficiary	Income	Tax (assuming no other income)
Son's Wife	\$20,000	\$nil
Child 1	\$20,000	\$nil
Child 2	\$20,000	\$nil
Child 3	\$20,000	\$nil

As you can see, by sharing the income amongst beneficiaries of a testamentary trust, there are significant tax savings available. It is also important to remember that these savings could apply year after year.

The income distributed to the children could be used to pay for their expenses (such as school fees) rather than cash being given to each child.

Asset Protection

An important feature of a testamentary trust is that an intended beneficiary may be able to control their inheritance but in a way that the assets do not form part of the beneficiary's estate.

This can be extremely important in the following circumstances:

1. where the intended beneficiary has a risk of becoming bankrupt and losing their inheritance to the trustee in bankruptcy;
2. setting up an adequate fund to provide for a beneficiary with a disability in such a way so as not to affect any pension rights they may have;
3. protection from Family Court orders. Whilst the testamentary trust may be regarded as a financial resource of the beneficiary and have some consequential effect on the terms of a property settlement, the property in the testamentary trust is more likely to not be at the disposal of a Family Court order; and
4. providing asset protection for individuals in high risk occupation, i.e. rather than the assets passing to that high risk individual, it is placed in a discretionary trust where the person does not have direct ownership themselves.

Who can be trustee of a Testamentary Trust?

Anyone you wish but usually the trustees are the executors of your Will, your spouse or partner, or your children.

The trustee has effective control of the trust, so the trustee should be a person whom you know, and whom you trust to act in the best interests of the beneficiaries. It is possible to establish a number of testamentary trusts under a Will and name different trustees and/or beneficiaries for each of them.

If I left my estate to a Testamentary Trust and my spouse needed the money, would my spouse be able to gain access to it?

Generally the testamentary trust is structured so that the trustee has full discretion to make distributions of capital at any time.

Usually the surviving spouse will be one of the trustees of the Testamentary Trust and will be in a position to access capital from the testamentary trust if it is needed.

Dependent on your circumstances and in order to increase the asset protection qualities of a testamentary trust, you may wish to also consider nominating an independent appointor. An appointor has the power to remove and appoint a new trustee and can play a vital role in a testamentary trust.

What should I consider before establishing a Testamentary Trust under my Will?

It is possible to structure the Will so that it provides for a testamentary trust but that the surviving spouse can decide not to implement it if there are unlikely to be sufficient benefits from the trust because of the circumstances which exist at the time of death.

You should be aware that the cost of making a Will with a testamentary trust established under it will be more expensive than putting in place a simple Will. However, this is the only establishment cost for a testamentary trust. There will also be ongoing administrative costs in maintaining the trust such as accountancy fees for the preparation of annual taxation returns, but these only start to be payable after the testamentary trust is established – which is after the death of the Will maker.

Important matters that you should consider when deciding whether a Testamentary Trust is appropriate for you are:

- the assets and likely income to be generated by your estate;
- special needs of beneficiaries with disabilities or other issues that may affect their ability to manage their financial affairs;
- the need to protect the inheritance of your children from creditors and subsequent divorce settlements; and
- the need to protect the inheritance of individuals in high risk occupations.

In order to provide your beneficiaries with the most flexibility possible, it is possible to structure your Will so that the intended beneficiary may bypass the testamentary trust as their inheritance vehicle if it is appropriate at that particular time.

Before making any decision regarding a testamentary trust, we would recommend that you take the time to speak with one of our experienced lawyers who would be able to advise you regarding the potential benefits and appropriateness for the personal circumstances of yourself and your intended beneficiaries.

What if I already have a Family Trust?

The assets of your family trust will not form part of your estate. If all of your assets are presently owned by your family trust, there may be no point in establishing a testamentary trust unless you planned to wind down your family trust and transfer the assets in it to yourself.

However, if it is likely your estate will have substantial assets in addition to those held in your existing family trust there may still be advantages in considering a testamentary trust. Further, by implementing a testamentary trust under the terms of your Will, you are able to establish a separate trust for each intended beneficiary.

This means that their inheritance is not tied in together forevermore and they will have some autonomy over decisions relating to their inheritance. Where beneficiaries' interests are separated, it is also less likely for any disputes to arise in the future regarding management of the testamentary trust.

Is it possible to set up a similar trust after my death if I don't change my Will now?

Yes, but there are limitations.

The beneficiaries of a "post-death testamentary trust" are essentially limited to your spouse and children and there is also a limit on how much can be transferred to the trust.

Your trustees also have less flexibility in dealing with income and capital of a post death testamentary trust and they can be expensive to establish.

What should you do next?

Testamentary trusts have many advantages including their flexibility, potential tax savings and protection of the inheritance of your beneficiaries. If you would like more information or an appointment to discuss an update to your wills to include testamentary trusts, please contact our office to organise a meeting with a member of our experienced Estate Planning and Asset Protection Team.

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