WHAT ARE TESTAMENTARY TRUSTS?

Testamentary Trusts are trusts created within a Will that only take effect upon the death of the Willmaker.

A **Testamentary Discretionary Trust** provides the Trustee with discretion as to how, when and in what proportions the income and capital of the trust is distributed to the beneficiaries. For the purposes of this discussion, all future reference to Testamentary Trusts means Testamentary Discretionary Trusts.

HOW DOES A TESTAMENTARY TRUST DIFFER FROM A NORMAL WILL?

In a standard "Mum & Dad Will" the estate assets pass directly to the beneficiaries so that they become the legal owners of the assets with complete control over what they do with those assets.

In a **Testamentary Trust**, the assets pass to the trustee who holds those assets on behalf of the beneficiary or beneficiaries. Typically, a spouse, children or grandchildren are the intended beneficiaries (the Primary Beneficiaries) with a wider class of potential beneficiaries being included (such as children, grandchildren and other relatives of the Primary Beneficiary along with entities such as trusts and companies in which the Primary Beneficiary holds an interest). This means that the trustee has a very broad discretion as to who income and capital distributions will be made and in what proportions.

The terms of the trust are set out in the Will.

You can establish a number of Testamentary Trusts within your Will (for example a separate trust for each child) with different trustees for each trust.

WHO CAN BE TRUSTEE?

A Willmaker can appoint a family member, friend or professional person or trustee company as trustee. There can be more than one trustee. As the trustee has effective control over the trust it is very important that the Willmaker appoints someone they trust implicitly to act in the best interests of the Primary Beneficiary.

WHO CONTROLS THE TRUSTEE?

Under the terms of the trust deed the **appointor** has the right to remove and appoint a new trustee. As such, the ultimate control of the trust rests with the appointor.

Many Willmaker's appoint a spouse or child/ren as the appointor/s.

BENEFITS OF TESTAMENTARY TRUSTS

A Testamentary Trust operates very similarly to a family trust but with added benefits:

Asset Protection:

- **Bankruptcy** – If a bankrupt beneficiary inherits assets in his or her own name, then those assets will pass to the trustee in bankruptcy. If on the other hand, the assets remain in the hands of the trustees rather than the beneficiaries, then the inheritance will not form part of the beneficiary's assets for bankruptcy purposes. It is essential in these circumstances that the beneficiary is not the trustee or sole appointor under the terms of the trust deed as they must not be seen to have effective sole control of the trust.

- **Creditors –** A testamentary trust provides significant protection to beneficiaries who are engaged in an occupation that carries significant risk of litigation, if they are directors of a company or own their own business. Holding estate assets within a testamentary trust generally protects the assets from creditors.

- **Vulnerable Beneficiaries –** It is not uncommon for a Willmaker to be concerned about a beneficiary's ability to manage their financial affairs. This may be due to alcohol, drug or a gambling addiction, an intellectual disability or simply a history of being unable to manage money. A testamentary trust provides the flexibility to restrict access to assets by enabling the trustee to have the discretion as to what capital and income distributions are made to that vulnerable beneficiary.

- **Divorce and Family Breakdowns** – An inheritance held within a properly structured testamentary trust is unlikely to be subject to a Family Court order. It may be taken into account as a financial resource of the beneficiary but under the present law, will not result in estate assets being transferred to a former spouse or defacto partner. Once again, it is important that the trust deed is drafted so that the beneficiary does not have sole control of the trust.

Tax Advantages:

Unlike income generated under a Family Trust, all beneficiaries, whether they are under the age of 18 or not, pay income tax on the income generated in a testamentary trust at normal adult rates.

What does this mean? Income received by a beneficiary under the age of 18 from a Family Trust that exceeds $416 is subject to maximum tax rates (currently 45%).

Under Testamentary Trusts, children (and grandchildren) enjoy the normal adult tax free threshold ($18,200) and marginal tax rates of adults.

An example:

Thomas and Elizabeth Smith have 3 children – Jack (aged 9), Jane (aged 7) and Mary (aged 5). Thomas dies suddenly leaving assets of $1,000,000.00 excluding the home, car and personal items. Elizabeth works full time and earns $80,000.00 per year. The $1,000,000.00 is invested and earns $60,000.00 per annum in income.

Standard Will

Elizabeth's must pay tax on both her employment income and investment income
$80,000.00 + $60,000.00 = $140,000.00
Total tax = $39,747.00

Testamentary Trust

Elizabeth pays tax on her employment income and she distributes the income from the trust equally between her 3 children. As the children enjoy the tax free threshold of $18,200.00 tax is only paid by each of them on $1,800 which equates to a total of $1.026.00 (being $342.00 each)
Total Tax = $17,547.00 + $1,026.00 = $18,573.00

That's a saving of $21,174.00

(Name and figures for the purposes of illustration only and is based on 2015/16 tax year)

POSSIBLE DISADVANTAGES OF TESTAMENTARY TRUSTS

Whist there are many advantages to setting up a Testamentary Trust within your Will, it may not necessarily be the right thing for you:

- **Costs** – the costs of preparing a Will that incorporates a Testamentary Trust is more expensive than the traditional 'standard' Will. There will also be ongoing administrative costs involved in maintaining the trust after your death (eg. Accounting fees) but these are generally not too significant.

- **Complexity** – not only can the document be quite an intimidating and complex document to read and understand, but the process of administering the estate is likely to be more complex.

- **Insufficient assets in the estate** – if assets are held outside of the estate (such as through existing trust structures), then there may be no point in establishing a testamentary trust. It is only if there are substantial assets within your estate (which can include superannuation and life insurance if paid into your estate) that setting up a testamentary trust will be worthwhile.

WHAT IF MY BENEFICIARIES DON'T WANT A TESTAMENTARY TRUST?

The beneficiaries of your Will may decide that they would prefer that specific assets be distributed to them absolutely rather than to a trust. They have this discretion under the terms of the Will.

FINANCIAL ADVICE

We are not financial advisors or tax specialists. We recommend that you seek the advice of your accountant, financial planner or tax specialist when considering making a testamentary discretionary trust.

We hope you have found this information useful.

If you have any questions at all or would like to make an appointment to meet with me to discuss your estate planning requirements, please contact me on 0417 531 924 or meagan@devoillaw.com.au

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