# TESTAMENTARY TRUSTS – A SUMMARY

## A. WHAT ARE THEY?

In essence Testamentary Trusts are Trusts created by Wills, which come into existence upon a Will maker's death.

Rather than assets passing directly to the intended Beneficiaries of an estate, they pass to the trustee(s) of the Testamentary Trust'.

## B. BENEFICIARIES

The intended beneficiary ordinarily becomes the 'Primary Beneficiary' of a testamentary trust.

Where appropriate, the Primary Beneficiary can be the trustee and appointor of the testamentary trust (refer below for explanations of these positions).

The beneficiaries of each of the testamentary trusts include the following (definition of 'General Beneficiary' in the first clause of the Schedule to the draft Wills):

relatives of the Primary Beneficiary (including parents, spouses, siblings, children, grandchildren, uncles, aunts and cousins);
companies in which any of the persons in (a) have an interest;
trusts in which any of the persons in (a) are a beneficiary; and
charities.

Please note that the definitions of:

a) 'Spouse' includes legally married spouses, de facto spouses, widowed spouses and De facto or same sex spouses (if living together on a bona fide domestic basis); and

b) 'Child' and 'Children' includes natural, adopted, step and former step children.

The fact that someone is included as a Beneficiary of a Testamentary Trust, does not mean they have any actual entitlement to the assets of the Testamentary Trust.

Entitlements to income and capital of a Testamentary Trust arise only where the Trustee exercises its discretion to pass these entitlements to a particular Beneficiary.



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## C. CONTROL – TRUSTEE AND APPOINTOR POSITIONS

Control of a testamentary trust is exercised by the:

Trustee - the person(s) or entity with responsibility for the day to day management of the Trust; and

Appointor - the person(s) with ultimate control as they can remove the Trustee and appoint a new one.

Therefore, the decision as to who fulfils these roles is of critical importance in ensuring the full benefits of the Testamentary Trust are realised.

## D. MAIN TYPES

**Discretionary**

A Trust under which the Trustee has discretion or the ability to decide how the wealth in the Trust is distributed according to your wishes.

**Protective**

This type controls the disbursement of income (and/or capital) generated from the Trust, and are suitable where beneficiaries cannot control their own finances, including where they are incapacitated or vulnerable, for example involved with drugs of addiction or gambling.

**Minors**

Provides for beneficiaries under 18 years old, ensuring their income and capital is protected and managed to their advantage.

## E. DISCRETIONARY TESTAMENTARY TRUSTS

This is the most popular type, and can cater for Protective and Minor requirements at the same time.

You can either leave discretion to your Trustee/s, or provide detailed rules and instructions to your Trustee/s in your Will, as to how you wish your Estate to be dealt with.



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**Advantages**

*Flexibility*

Allowing the Trustee and Beneficiaries a great deal of choice determining who, how and when they will benefit from the Estate.

*Relationship Breakdowns*

The Estate can be preserved to a certain degree in the event a Beneficiary suffers a relationship breakdown, preventing dissipation of the Estate through separation or divorce.

Where a Beneficiary of a Testamentary Trust is the subject of Family Court property proceedings, the assets of the Testamentary Trust may not be considered 'assets of the de facto relationship or marriage for the purposes of any Court proceeding. Assets of the relationship or marriage are assets that the parties to the relationship brought to the relationship, or accumulated during the relationship. Retaining assets in a Testamentary Trust can assist in persuading the Court that they should be quarantined from the other assets of the relationship which are to be divided.

The Family Court makes orders in relation to assets of the relationship based on a variety of factors including the contributions (financial and non-financial) of the parties, the length of the relationship and the future needs of the parties.

However, where the relevant Beneficiary of a Testamentary Trust controls the Trust, or has or is likely to receive some or all of the benefit of it, the Family Court can take account of the Testamentary Trust as a 'financial resource' of the Beneficiary involved in the Family Court proceedings.

It may be possible (but very much dependant on the circumstances) for assets held in a Testamentary Trust to be 'quarantined' and not be considered as property to be divided up by the Family Court following the breakdown of a relationship.

The Family Court also has the power to make orders against third parties to a property proceeding, such as Trustees of Testamentary Trusts.

*Asset Protection*

Where a Beneficiary is a business owner or bankrupt they can protect the Estate assets from third party creditors or a trustee in bankruptcy.

Where a trustee in bankruptcy is appointed over a person's assets, they can only call in assets in that person's name to satisfy obligations owed to creditors. Where assets are held in a Testamentary Trust, the potential Beneficiaries are very broad so no particular Beneficiary has any assets attributable to them while assets remain within the Testamentary Trust. Therefore, assets held in a Testamentary Trust are protected against claims of creditors even though the bankrupt is one of the Beneficiaries of the Testamentary Trust.


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*Tax Effective*

Payments can be made to Beneficiaries in lower tax brackets (eg minors) thereby minimizing income tax. Without a Testamentary Trust minors pay income tax on almost all estate earnings at the top marginal rate. Please see example below.

*General*

Testamentary Trusts are usually 'discretionary' which means that the Trustee decides how the Trust assets are invested and distributed. The Trustee can decide which of the Beneficiaries receives the income from the Trust. This means that the Trustee can make distributions from the Trust in a tax effective manner, for example, by distributing income to Beneficiaries having the most attractive marginal tax rates.

*Concessional tax rates for minors*

Beneficiaries under the age of 18 (eg children and grandchildren) receiving distributions from a testamentary trust are not subject to the usual penalty tax rates applicable to minors and instead have an adult's tax rate.

Passive income derived by children under the age of 18 years (such as discretionary trust distributions, dividends and interest) has a tax-free threshold of $416. Any passive income derived in excess of $416 up to $1,307 is taxed at 66%. If the passive income derived exceeds $1,307, the whole amount is taxed at 45% (as at 1 July 2012):

The medicare levy will also apply where income exceeds $19,404.

The low income tax offset is no longer available from 1 July 2011 for passive income derived by children under the age of 18.

These penalty tax rates do not apply to income which comes from testamentary trusts. When children receive income from testamentary trusts, they are taxed at ordinary marginal rates. This means that children can take advantage of the tax free threshold. The low income tax offset also continues to apply to income earned from property transferred to children through an inheritance. The combined effect of this is that a child can receive up to $20,542 of income from a testamentary trust without income tax being payable (as at 1 July 2012 and assuming they receive no other income).

By way of an example assuming:

a) the adult pays the top marginal tax rate on their non-inheritance income;

b) the beneficiaries of the testamentary trust include three minors;

c) the low income rebate applies to the distributions to minors; and

d) the inheritance earns income of $60,000 per annum.

**No Testamentary Trust**

| | Income distributed ($60,000) | Tax payable |
|---|---|---|
| Adult | $60,000 | $27,900 |

**Testamentary Trust**

| Beneficiary | Income distributed ($60,000) | Tax payable |
|---|---|---|
| Child 1 | $20,000 | $0 |
| Child 2 | $20,000 | $0 |
| Child 3 | $20,000 | $0 |
| Total | $60,000 | $0 |

**Tax saving = $27,900**

*Control of Spending*

If a Beneficiary has a habit of being unable to budget, gambles and/or squanders their money.

*Incapacity, Disability or Vulnerability*

Control of money flows and requirements for a Beneficiary unable to take care of their own affairs including those intellectually disabled, suffering Dementia or Alzheimers, or suffering an addiction.



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**Disadvantages**

*Additional Administration*

Tax Return/s, Australian Business Number/s and Accounting.

*Cost of Establishment*

At least twice as much as a simple Will.

*Loss of 15% Tax Rebate*

As opposed to superannuation pensions.

*Complexity*

They can be difficult to understand and therefore to progress and finalise.

*Funding*

Willmaker needs a sufficient level of wealth.

## F. SUPER BINDING DEATH BENEFIT NOMINATIONS

Nominating with these Forms to Beneficiaries has the advantage of providing certainty and tax benefit, and the disadvantage of a lack of flexibility.

## G. SUMMARY

In certain circumstances Testamentary Trusts can provide significant benefits to a Willmaker's Beneficiaries.

Legal and accounting advice is vital to ensure appropriate Wills are created given a Will maker's personal situation.





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