PRIVATE CLIENT LAW

Why use Testamentary Trusts?

Modern Estate Planning

November 2010

This short paper is intended to briefly and simply explain the advantages and benefits to your beneficiaries of incorporating testamentary trusts in your Will. These notes should not be read as a statement of the requirements of trust law or income tax law or a summary of the terms of a particular Trust (which vary from Will to Will); nor should the notes be used as a substitute for professional advice. If you have any question concerning the matters covered in these notes please contact us for further explanation.

What is a Testamentary Trust?

A testamentary trust is a trust established by a Will. A Testamentary Trust can be **optional** (the beneficiary can choose not to use it), **discretionary** (the beneficiary decides who will benefit) or a **fixed** trust or a combination of these.

Whichever the type used, testamentary trusts are being used increasingly in modern Wills because of the taxation and asset protection advantages that they offer when compared to a "traditional" Will.

A "traditional" Will offers little assistance to a beneficiary of an inheritance in relation to issues of tax efficiency and asset protection.

Why use a Testamentary Trust?

Establishing testamentary trusts in your Will provides your beneficiaries with a large degree of flexibility in dealing with their inheritance. Further, in many cases these vehicles will provide significant protection for a family's wealth.

As the usefulness of a testamentary trust will depend upon the beneficiary's specific needs and circumstances at the time of your death, it is important that the terms of the testamentary trust are sufficiently wide so as to provide freedom and flexibility. Indeed, with laws around superannuation and other areas changing so frequently, it is important that estate planning documentation not be too prescriptive.

What if a Testamentary Trust turns out not to be useful to my beneficiaries?

In most cases, your Will should be drafted so that the primary beneficiary has the power to decide to:

1 Use the trust for all, part or none of the beneficiary's inheritance;

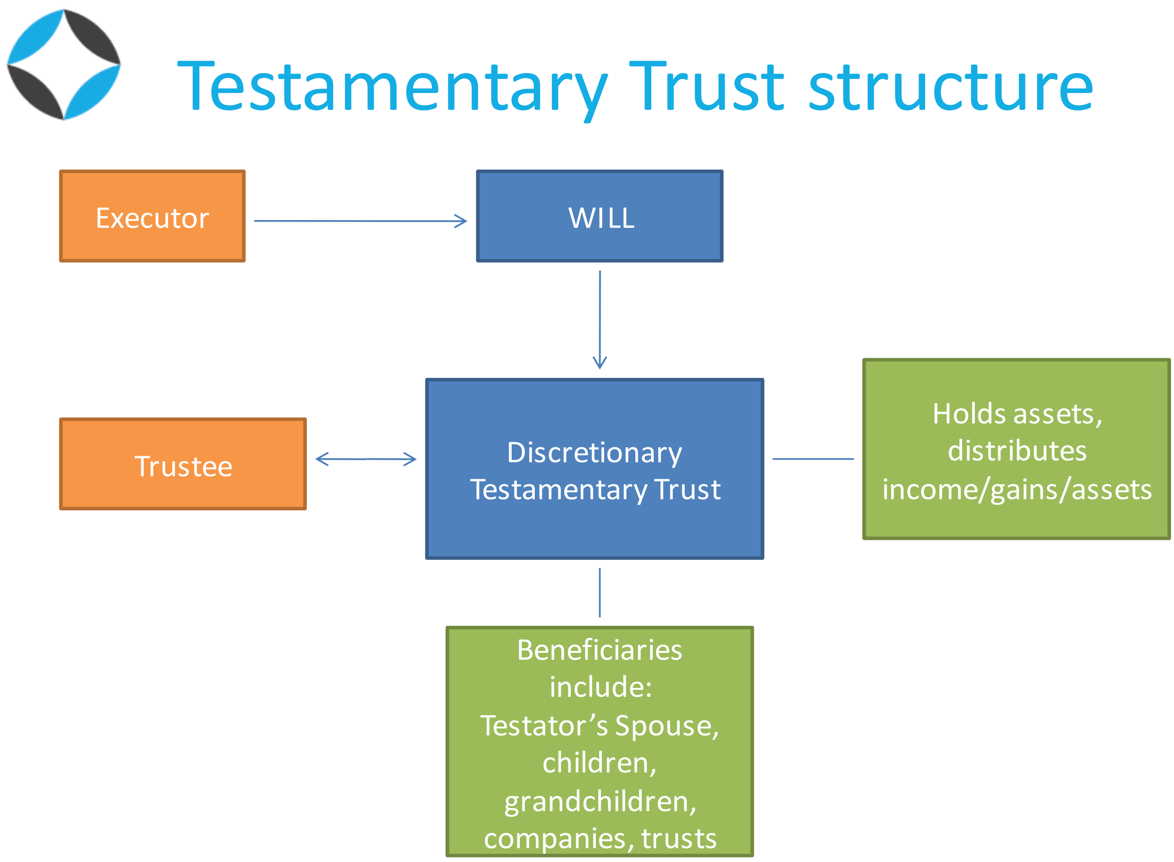
2 Wind up the trust at any time; or

3 Pass the control of the trust in accordance with the primary beneficiary's Will.

Because a testamentary trust last for 80 years once established (ie. from your death), it can provide flexibility, asset protection and taxation advantages for many generations of your family.

What does a Testamentary Trust "look like"?

Simply, instead of leaving an inheritance directly to a nominated beneficiary (ie. to them in their own names), you leave the inheritance to a discretionary trust (sitting 'inside' your Will) with wide discretionary powers for beneficiaries.



What Assets can be put into a Testamentary Trust?

Any assets belonging to you can be left to your beneficiaries via a testamentary trust on your death. Additionally, payments made to your estate as a result of your death, i.e. superannuation or life insurance benefits, can also be directed to be held within a testamentary trust.

Importantly, in many cases there are assets which will not form part of your estate without specific planning/strategies being put in place. This is particularly the case with superannuation benefits, life insurance proceeds, and assets owned as joint tenants (eg. often the family home). As there are advantages and disadvantages with each course of action, appropriate documentation (eg. Wills incorporating testamentary trusts) should be accompanied by an appropriate estate planning *strategy*.

To provide maximum flexibility to your beneficiaries, your Will should be drafted to allow your beneficiaries to choose which assets belonging to you should be held within a testamentary trust.

How will my beneficiaries potentially benefit from a Testamentary Trust?

Your beneficiaries may potentially derive the following benefits:

- **Ability to split income, and minors taxed as adults**

With the appropriate drafting, a testamentary trust Will provides the beneficiaries with the ability to legally split income and capital gains within the trust with wider family members and others – and in doing so, generally deliver very significant tax savings.

For example - the trustee of the testamentary trust (eg. the beneficiary) may have complete discretion to determine who receives the income of the trust. Where income is properly distributed from a trust, tax is not paid by the trust itself on this income, but by the beneficiary who receives this income. In this way, it is possible for income to be directed to family members on lower incomes, to reduce the overall family tax payable on the trust income.

One specific, and significant benefit of a testamentary trust is that they are treated differently to other trusts (eg. discretionary or 'family' trusts established during a person's lifetime). Ordinarily minors receiving income from trusts are taxed at highly punitive rates. Currently minors pay tax at the highest marginal rate from approximately $3,000 per annum. However with income generated within a testamentary trust, minors are taxed as adults, meaning they do not pay the highest marginal tax rate of tax until they reach income $180,000 per annum. This is a very clear example of the scale of the tax benefits provided by testamentary trusts.

- **Increased flexibility for dealing with Capital Gains Tax**

A well-drafted discretionary testamentary trust can also provide the opportunity for your beneficiaries to minimise Capital Gains Tax which arises from the sale of your assets.

Capital Gains Tax is not triggered when an asset belonging to you passes via your Will to your executor or the trustee of a testamentary trust. Also there is no Capital Gains Tax when your assets are transferred from the trustee of a testamentary trust to a beneficiary (except where assets pass to a tax-advantaged entity) - see *ATO Practice Statement LA 2003/12*.

As with the income of the trust, the trustee can select which of the beneficiaries of the testamentary trust should take a capital gain. By choosing to distribute a capital gain to a beneficiary on a low or nil income, the capital gains tax liability can be significantly reduced.

Holding the assets of an estate within a trust offers the beneficiaries an opportunity to defer the need for the sale of assets (and therefore payment of capital gains tax) until later when more numerous beneficiaries come into existence.

- **Maintenance of Main Residence CGT Exemption**

A testamentary trust can be used to preserve the CGT exemption for the main residence of the deceased if the terms of the testamentary trust provide for a right to occupy this property. The terms of the exemption need to be strictly followed - see *ATO Interpretative Decision ID 2006/34*.

- **Asset Protection**

A testamentary trust can provide a level of protection to your beneficiaries from bankruptcy.

Assets that pass to a discretionary testamentary trust from an estate are held for the beneficiaries until the trustee elects to distribute such assets. At law, the assets are not owned personally by a beneficiary and therefore do not form part of the beneficiary's personal estate. Therefore, these assets are generally protected from the claims of a creditor or other person against your beneficiary. With this said, laws are always evolving, and specific advice should be taken by each client.

- **Beneficiary’s inheritance can be protected from family law claims**

A discretionary testamentary trust may also provide some protection for a beneficiary who is experiencing family law difficulties.

By providing for a beneficiary's entitlement to be held in a discretionary testamentary trust, the primary beneficiary can isolate estate entitlements from personal assets. This provides some level of protection from family law property proceedings against the beneficiary. Once again, this is a complex area of law, and specific advice should be taken where this is an area of particular concern for clients, as there may be additional strategies which can be implemented to increase the protection around a beneficiary’s inheritance.

- **Beneficiary’s inheritance can be kept in the family**

A modern, well-drafted discretionary testamentary trust may also help your beneficiaries keep their inheritance from passing to non-family members; for example, by providing that on their death the control of the testamentary trust passes to their children (rather than to a spouse). In this way, assets of one family do not inadvertently become controlled by another family.

Summary

By incorporating Testamentary Trusts in your Will, your beneficiaries will be able to access a range of options which may help them protect their inheritance from loss through bankruptcy/professional litigation, as well as providing strategies which can help them reduce/minimise the incidence of income and Capital Gains Taxes.

Properly drafted, Testamentary Trusts offer flexibility and benefits not available with standard Wills, which could result in significant advantages to your family.

Further Questions?

If you want to talk to experts in preparing modern Wills containing Testamentary Trusts, please feel free to contact us, or if you wish to update or amend your Will.