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Testamentary Trusts

What are Testamentary Trusts?

A Testamentary Trust is a trust established under a Will.

As a Will only operates upon the death of a willmaker (also referred to as a testator or testatrix), a testamentary trust only comes into operation (if at all) after the willmaker's death - generally when the Executor first transfers assets into the Testamentary Trust. A Will may make provision for one or more Testamentary Trusts. In many ways, this type of trust operates in the same manner as a Family Discretionary Trust.

The maximum life of a Testamentary Trust (as is applicable to a Family Discretionary Trust) is usually 80 years although some Wills may reduce the period of time that the trust may exist.

The management and control of the trust is undertaken by a person or persons, or company and it is their responsibility to ensure that the terms of your trust are adhered to and that your intentions are fulfilled. The trustee also has the power to distribute income and capital of the trust fund to the beneficiaries.

What is the executor's role in a Testamentary Trust?

An executor is a person who is charged with the responsibility of getting in the assets and paying the debts of the deceased and administering the estate in accordance with the terms of the will. Essentially, the executor's role is to administer the deceased's estate. Once the process of administration of the estate has been completed, where a trust has not been established by the Will, the executor transfers the gifts to the beneficiaries entitled under the Will and is discharged from their duties. However, if there are trusts established by the Will, then those trusts are managed by the trustee appointed by the Will. Usually the person/s who are appointed as the executor/s are also appointed as the trustee/s of any trusts established by the Will.

What type of Testamentary Trust may I include in my Will?

Whilst any trust established under a person's Will is technically a Testamentary Trust, the term "Testamentary Trust" is commonly used to describe a Testamentary Discretionary Trust (TDT) established by a Will that operates in a similar way to a Family Discretionary Trust. However, the following Testamentary Trusts are commonly used in order to achieve a client's estate planning objectives:-

1. Fixed Interest Testamentary Trust

2. Capital Reserved Testamentary Trust

3. Special Disability Trust

4. Protective Trust

5. Superannuation Proceeds Trust

Just as no two client objectives are the same, each estate plan is different. Testamentary Trusts are one of many tools in an estate planner's toolkit that may be tailored to suit individual needs. Whilst TDTs are an increasingly popular estate planning vehicle (as we will discuss below), they are not suitable to everyone. It is important to give careful consideration to the use of all forms of Testamentary Trust prior to their use, by seeking specialist estate planning advice.

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What are some of the advantages of establishing a TDT rather than a simple Fixed Interest Testamentary Trust?

Due to the discretionary nature of a TDT, there are several advantages in their creation. Two of the main advantages are:

1. Taxation

2. Asset Protection

We will now consider the main advantages to the inclusion of TDTs as part of your estate planning.

Taxation

The taxation advantages of a TDT can be significant. The main advantage arises because minor beneficiaries (that is beneficiaries under the age of 18 years) are taxed at normal adult rates on excepted trust income distributed to them. This is permitted by section 102AG(2)(d)(i) of the Income Tax Assessment Act 1936 (Cth) (Tax Act). This section allows children to be taxed as adults and therefore receive the benefit of the progressive taxation rates, including the adult tax free threshold.

Under this structure, the TDT regime allows for income splitting among a broad class of potential beneficiaries in accordance with the terms of the TDT.

The following simple example demonstrates the benefit of income splitting among family within a

TDT structure:

- Charlie dies leaving an estate comprised of superannuation and life insurance of $1,500,000.00.
- Charlie leaves his whole estate to his widow Lucy who already earns $120,000.00 per annum from her employment.
- Lucy is glad that Charlie left her the superannuation and life insurance proceeds which she will use to look after their 3 children, aged between 5 and 10 years. Lucy is also able to discharge the mortgage on their family home of $300,000.00.
- In the first year after Charlie's death, Lucy receives income of $72,000 from the investment of the balance of the life insurance benefits of $1,200,000.00.
- As she already has income of $120,000.00 the tax that Lucy will pay on the $72,000.00 will be approximately $27,600.00 plus the Medicare Levy.
- If Charlie had established a will containing a TDT instead, Lucy could have distributed the $72,000.00 trust income in that first year equally between their 3 children - that is, each child would have received $24,000.00 of income from the trust fund.
- As each child would have been taxed as an adult, the tax payable per child could said to be:
    1. Tax on $24,000.00 equals approximately $700.00
    2. Total tax payable 3 x $700.00 equals $2,100.00
    3. The tax saving would be $27,600.00 less $2,100.00 equals $25,500 .00

Summary

The following tables show how the taxable income may be distributed, depending upon the type of testamentary structure that is adopted.

Distribution under a Fixed Interest Testamentary Trust Will

Beneficiary	**Taxable Income**	**Tax Payable**
Lucy	$72,000.00	$27,600.00
TOTAL	**$72,000.00**	**$27,600.00**

Distribution under a TDT Will

Beneficiary	**Taxable Income**	**Tax Payable**
Lucy	$0.00	$0.00
Child A	$24,000.00	$700.00
Child B	$24,000.00	$700.00
Child C	$24,000.00	$700.00
TOTAL	**$72,000.00**	**$2,100.00**

If Lucy had received her inheritance through a Fixed Interest Testamentary Trust pursuant to a standard Will, she would be required to pay substantially more tax than if she was able to split this income between her children via a TDT.

A well drafted Will can provide this additional flexibility and this way Lucy may structure the manner in which she takes her inheritance so as to suit the needs of her family and to minimise her overall income tax liability.

Asset Protection

Testamentary Trusts also offer significant asset protection advantages.

As the beneficiary does not own the assets of a TDT this provides scope for asset protection, similar to that which a Family Discretionary Trust provides.

Your trustee, not your beneficiary, is the legal owner and controller of your estate assets and holds these assets for the benefit of your intended beneficiaries. The beneficiaries only have the right to ensure the trust is properly administered.

This difference between ownership and control of assets may have the advantage of helping to preserve your estate assets. In our experience, there are three common concerns that clients have when discussing asset protection and the distribution of their estate:

1. Protecting the estate from creditors of a beneficiary
2. Protecting the estate from marital misadventure of a beneficiary
3. Protecting the estate on behalf of a beneficiary with special circumstances

Protection from Creditors

Generally, as the beneficiary does not have a proprietary right in the assets of the TDT, the beneficiary therefore does not have a right that is capable of being vested in the trustee in bankruptcy and therefore the assets cannot be accessed by creditors. Subject to limited exceptions, the Bankruptcy Act 1966 (Cth) does not permit the trustee in bankruptcy to access funds that form part of trust property on behalf of the beneficiaries' creditors.

Protection from the breakdown of a relationship of a beneficiary

In recent years, the Family Court has shown a willingness to treat the assets of trusts as a financial resource or in some cases as property of a party to a marriage or relationship. If a willmaker is concerned that their child may after receiving their inheritance, suffer a relationship breakdown, there are a number of options that can be canvassed with the willmaker that may minimise the risk associated with the treatment of the assets of the TDT by the Family Court.

Protection from Beneficiaries with special circumstances

If a primary beneficiary has a problem such as gambling or drug dependency, a Testamentary Trust controlled by an independent trustee can protect the assets from being wasted. The trust fund can be used to look after the long term interests of the beneficiary as well as others such as the beneficiary's children.

What are the disadvantages to establishing a TDT or any other types of Testamentary Trusts?

In addition to the likely additional cost borne by the willmaker when preparing a will containing a Testamentary Trust, there will be ongoing costs including accountancy fees for taxation advice and preparation of trust taxation returns and the cost associated with the establishment of the trust. It is worth noting that the ongoing costs do not commence until after the willmaker has died.

Factors that you should take into account, include a consideration of whether the income generated by your estate will be sufficient to warrant a testamentary trust, or whether there are beneficiaries with special needs (such as a beneficiary with an intellectual impairment). If beneficiaries are vulnerable, the benefit of implementing a Testamentary Trust may well outweigh the costs associated with maintaining it.

More Information

It is important to note that the information contained in this Fact Sheet is general in nature and every family circumstance is different. It is therefore important to obtain specialist advice prior to making a decision about whether Testamentary Trusts are suitable for your family.

If you would like to discuss your estate planning, please contact us to make an appointment with Jarrad Mobbs.