TESTAMENTARY DISCRETIONARY TRUSTS – IS THIS FOR YOU?

1. WHAT IS A TESTAMENTARY DISCRETIONARY TRUST?

A Testamentary Discretionary Trust (TDT) is a trust created under a person's Will. It comes into existence following the death of the Will maker (the "testator") once all specific gifts under the Will have been distributed and all debts and liabilities of the estate are paid. A TDT is funded with the remaining assets in the testator's estate and enables the assets to be transferred at the trustee/executor's discretion for the overall benefit of one or more beneficiaries.

A TDT is distinct from a trust established during a person's lifetime (an "inter vivos trust"), however it functions in a similar way. As with inter vivos trusts, TDTs address:

- Who is to be the trustee/s – this can either be an individual or an authorised trustee company;
- Who is to be the appointor – this person has the role of 'hiring and firing' trustees;
- Who is to be a beneficiary of the trust;
- The powers of trustees to operate the trust
- When the trust is to be wound up – known as the 'vesting day'.

2. ADVANTAGES OF ESTABLISHING A TESTAMENTARY DISCRETIONARY TRUST

A TDT is often established for one or more of the following reasons:

- Asset protection;
- Safeguarding of estate funds for minor, disabled or spend-thrift beneficiaries;
- Taxation advantages.

Each are discussed in further detail below.

Asset Protection

A well structured TDT can provide significant asset protection for beneficiaries, particularly where the testator has substantial assets and plans to grow that wealth for the benefit of beneficiaries. This is achieved by the TDT structure which prevents the beneficiaries from having a legal interest in the income or capital of the TDT unless and

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until the trustee decides to make a distribution in their favour. This protects the estate assets in two respects:

- beneficiaries cannot deal with the assets of the estate until the trustee makes a distribution and even then, may only deal with those assets distributed to them, not the whole of the estate; and

- in many circumstances keeping the estate assets separate from beneficiaries personal assets protects the estate assets from third parties.

Consider these three situations:

(a) At-risk professionals

As you may be aware, certain professions attract increased risks of litigation such as doctors, lawyers, engineers and builders. A TDT may assist in protecting estate assets if a beneficiary is an 'at risk' professional by preventing the estate assets being taken into account should the beneficiary be sued in his or her professional capacity.

Alistair was a partner in a law firm that acted for a client looking to take over a company. During its investigations, Alistair's firm failed to detect significant fraud committed by the company's previous owners. The sale went through however the company went into liquidation shortly after Alistair's client took over. The client commenced action against Alistair's partnership for damages. Whilst Alistair owed very little in his own name, preferring to keep assets well out of his (and his creditor's) legal reach, his wife and father died in the same year, leaving assets to Alistair personally in their Wills. The estates' assets were totally exposed and should his client's action against the partnership be successful, Alistair will most likely lose these assets.

The risk would not have arisen had his wife and father established a TDT in their Wills.

(b) Relationship Breakdowns

In the event that a beneficiary of assets which have been distributed under a standard Will experiences a relationship breakdown, the distribution becomes part of the relationship's asset pool and is therefore taken into account by the Family Court in any property settlement.

When Jasmine died she left everything to her only child, Maree. Maree was married to Damien who was a perpetual student. Damien had completed numerous courses but had never settled on a career. They used Maree's inheritance to pay off the mortgage and travel. Prior to her death, Jasmine was constantly telling Maree that her husband was a "bludger". Eventually Maree came to the realisation that her mother was right and her relationship with Damien ended. In the property settlement Damien received roughly half of their assets, much of which had come from Jasmine.

A TDT may provide some protection of estate assets in the event of relationship breakdowns. As a general rule, TDT assets are not treated as property originating from the relationship and therefore are not considered part of the asset pool in a property settlement.

However, the testator must be mindful that if he or she appoints the same beneficiary as both trustee and appointor (effectively giving that beneficiary sole control of the TDT) the Family Court has shown a willingness to make orders that the TDT assets are no longer excluded from the relationship's asset pool.

It is noted that the Family Court's power is increasing and careful management of the estate and TDTs are required to minimise family law risks.

(c) Bankruptcy

If a beneficiary of a deceased estate is bankrupt or likely to become bankrupt, assets distributed under a standard Will are deemed to be the beneficiary's personal assets and will be dealt with accordingly by the Trustee in Bankruptcy. However, under a TDT estate assets are unlikely to be considered personal assets for bankruptcy purposes. Again, the testator must be mindful to avoid appointing the bankrupt beneficiary as both trustee and appointor of the TDT.

Safeguarding Estate Assets for Minor, Disabled or Spend-Thrift Beneficiaries

A TDT may be beneficial where a beneficiary is either a minor, has special needs or has a history of difficulties in managing their financial affairs. In these circumstances, it is important to appoint an independent trustee charged with administering and protecting the beneficiary's inheritance. Such a TDT may be structured to provide either a fixed distribution (eg. annually) or discretionary distributions to the beneficiary.

Taxation Advantages

From a taxation perspective, a TDT may provide benefits with respect to:

(a) Income Tax

A TDT allows the trustee to stream or split income amongst the beneficiaries in a way that minimises the overall tax paid on the TDT's income. In short, as a tax saving exercise, the trustee may, in any given financial year, distribute only to the beneficiaries who fall under the lowest marginal tax rate. The beneficiaries that receive this income then include this income in their own assessable income which is taxed at that individual's marginal tax rate.

A TDT also provides greater tax savings in providing income to a child or grandchild under 18 years of age, if income is distributed towards their education, maintenance or advancement.

Your spouse has predeceased you. You have a TDT in place. Upon your death, you leave everything to your two children – a daughter and a son. Your daughter has 5 children (all under 18 years of age) and works part time. She is on the lowest marginal tax rate. Your son works in the mines and is on the highest marginal tax rate. Both children earn an income of $150,000.00 the following year on the inheritance.

After legal and accounting advice, your daughter decides to set up a TDT, naming her children as beneficiaries. However, her children never see any of the money. It is an accounting entry. The income distributed from the TDT to the children is not paid to them directly or, nor is it held in trust for them. Instead, it is applied towards the children's living expenses, school fees, holidays and birthday presents. Additionally, your daughter may use some of the funds to *purchase a new 4WD to drive the children to school. They pay less than $7,000.00 in tax.*

Conversely, your son wants to take all of his $150,000.00 in hand. He is taxed at 46.5%, therefore losing $69,750.00 in tax.

(b) Capital Gains Tax

As it presently stands, any capital gain made by a trustee of a TDT arising out of a CGT asset being passed to a beneficiary of the TDT will be disregarded by the Australian Taxation Office. Any CGT payable is not assessed until the beneficiary disposes of the asset.

Similar to TDT income, any capital gains from the sale of CGT assets can also be minimised by streaming the capital gains to those beneficiaries of the TDT with lower marginal tax rates.

As with any other trust, the trustee of a TDT must file a tax return each financial year that the trust is in existence and maintain proper trust account records. Given that taxation rules are constantly changing, it is prudent to review one's estate and succession plans at least every three years.

3. THE FLEXIBILITY AND LONGEVITY OF A TESTAMENTARY DISCRETIONARY TRUST

A TDT is flexible to meet changing circumstances and can continue for a maximum of 80 years. The beneficial enjoyment of the trust assets can change from year to year to suit the particular needs of beneficiaries as required.