

Testamentary Trusts

Testamentary trusts are a commonly used and valuable estate planning tool. When used effectively, testamentary trusts offer a number of advantages in terms of asset protection and tax efficiency.

What is a testamentary trust?

A testamentary trust is a trust that is—

- established by a Will
- funded by assets from the deceased estate or as a result of payments to the estate as a consequence of death (e.g., superannuation proceeds), and
- administered by the executor or a trustee nominated in the Will of the deceased.

What are the advantages of a testamentary trust?

There are four potential advantages of using testamentary trusts in your Will:

- Asset protection for 'at risk' beneficiaries.
- Asset protection in family breakdowns.
- Income splitting advantages.
- Income tax advantages when distributing income to minors.

Note: not all testamentary trusts offer all of the above advantages. The terms of each person's Will need to be drafted having regard to their circumstances and those of their intended beneficiaries.

Asset protection advantages for 'at risk' professionals

By giving a beneficiary an option to inherit assets via a discretionary testamentary trust, the beneficiary does not have to inherit the assets personally. This is a very attractive feature for an intended beneficiary in any of the following situations:

- 'At risk' professionals (e.g., company directors, doctors, lawyers, accountants, engineers, medical professionals) who prefer not to own assets personally. Unfortunately, many professionals spend time and energy during their career establishing structures that protect their assets only to find that one day they inherit substantial assets in their personal name. They may then be forced to pay stamp duty and incur potential capital gains tax (CGT) liabilities on transferring assets to other vehicles.
- Beneficiaries facing bankruptcy. For example, a failed business venture might mean a potential beneficiary is facing the prospect of bankruptcy. If assets are inherited personally, then they may be lost to the trustee in bankruptcy. If they are held in a fully discretionary testamentary trust, then they could be protected.

Income splitting advantages

Testamentary trusts can be designed to allow distribution of income to two or more beneficiaries, which is an efficient tax planning mechanism.

Furthermore, different types of income can be distributed to different beneficiaries. For example, if the trust makes a substantial capital gain in one year, then the collective tax liability of the beneficiaries can be reduced by distributing the capital gain to a beneficiary who has capital losses. The capital losses can be used to reduce the CGT liability that would otherwise accrue on the capital gain distributed from the testamentary trust.

Income tax advantages when distributing income to minors

In circumstances where an intended beneficiary has children under 18 years of age, there are significant income tax concessions on income distributed to minors from testamentary trusts.

In the case of an inter vivos trust (i.e., a trust established during someone's lifetime—for example, a discretionary family trust) all but a small portion (\$416) of the income distributed to minors is taxed at 46.5 percent. However, income distributed to minors from a testamentary trust is taxed at the normal rates applicable to adults.

A simple example is as follows:

Patty has three children (ages, 4, 6 and 9) and was left \$200,000 in a testamentary trust under her father's Will. The beneficiaries of the trust are Patty and her children. The trust funds are invested and earn income of \$15,000 per annum. If Patty is on the highest marginal tax rate and the trust income was distributed to her, then almost half would be lost in tax. However, because Patty's father thoughtfully included a testamentary trust in his Will, Patty is able to distribute \$5,000 to each of her children. The children pay no tax because the amount is under the tax-free threshold.

Asset protection in family breakdowns

For parents who are concerned about their children experiencing a relationship breakdown, a testamentary trust can be a useful tool.

If a beneficiary under your Will is in the midst of a relationship breakdown when you pass away, then any assets they inherit personally may be subject to an order by the Family Court which results in part of their inheritance being paid to an ex-partner.

A properly structured testamentary trust will allow the beneficiary to benefit from the assets within the trust, but because they are not legally owned by the beneficiary (instead, they are owned by the trustee), they are not able to be included by the Family Court in any court ordered property settlement.

However, it is important to note that the court may include the assets in the trust as a 'resource' of the beneficiary in deciding the split of divisible assets between the couple. In this case, it may be wise to include the 'at risk' individual as a beneficiary of the trust but give control of the trust to a 'friendly party'. This may reduce the likelihood of a court considering the trust assets a resource of the beneficiary concerned.

Disadvantages of testamentary trusts

When using testamentary trusts there are a number of issues Willmakers and their advisers need to be aware of. Below are some of the most important.

- The assets of a testamentary trust must be sufficient to justify the expense of administering the trust. For example, accounts will need to be prepared and maintained and a tax return will need to be lodged each year.
- If the primary beneficiary (or one of them) is a pensioner, then care needs to be taken to ensure the beneficiary's pension eligibility is not jeopardised.
- If the trust restricts access to capital or income, then a beneficiary may be upset and challenge the terms of the Will. The possibility of a challenge may be reduced by the Willmaker communicating their intentions to their beneficiaries at the time they prepare their Will.
- If the trust has capital assets that are sold at a loss, then those capital losses cannot be distributed to beneficiaries but must be carried forward in the trust and set off against future capital gains (if any).
- Administration of the trust may require a level of cooperation between family members who may share the role of trustee of the trust. This could lead to potential disharmony.
- Some beneficiaries may not want (or need) a testamentary trust and consider it a burden. It is important to note this problem can be avoided in a carefully drafted Will that gives the executor the right to bypass the testamentary trust and distribute direct to the primary beneficiary. However, in some cases, the Willmaker may insist on a 'protective' testamentary trust. For example, where the beneficiary is known to have an alcohol or gambling addiction.

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