

TESTAMENTARY TRUSTS

What is a testamentary trust?

A testamentary trust is a trust established in a will. Usually testamentary trusts operate similarly to a discretionary family trust.

Why should I consider having a testamentary trust in my will?

The following are some reasons for including a testamentary trust in your will:

1. Tax minimisation

Unlike a discretionary family trust, where the trustee is only able to allocate around \$600 tax-free income a year to a beneficiary under the age of 18 (with any income over that amount being taxed at 47.5%), the trustee of a testamentary trust can, with the low-income tax-offset and rebates, allocate over \$20,000 tax-free each year to a beneficiary under 18, with any income over that amount being taxed at normal adult rates. A testamentary trust provides added value where a beneficiary inherits via a testamentary trust eg, shares or real estate carrying considerable capital gains and later disposes of those assets. The trust allows assessable income from the disposal of the assets to be dispersed amongst a range of immediate family members so the burden of tax payable on disposal is not borne by just one beneficiary.

2. Asset Protection

If a beneficiary of a will is a professional, a company director or a business owner, an inheritance received in the form of a testamentary trust is not able to be accessed by creditors should the beneficiary become bankrupt. The assets in the trust belong to the trust, not to the beneficiary personally, so creditors or litigants in professional negligence claims are unable to access the assets in the trust.

3. Protective Trust

Parents of a child with a mental impairment, or a child who is unable to manage their own finances properly (including a child with a drug problem), will often leave that child's inheritance in a testamentary trust that is controlled by someone who will make wise decisions about releasing funds for the benefit of the child, whilst retaining control of the capital and ensuring it is used for appropriate purposes.

How does a testamentary trust work?

After being set up in a will, a testamentary trust is dormant until the death of the person who has made the will. Once the executors start to administer the estate, the assets can be transferred direct to the trustee of the testamentary trust and thereafter the trustee of the testamentary trust controls the assets.

The trustee makes a decision each financial year as to which beneficiaries will be allocated income, and arranges for an annual tax return for the trust to be lodged.

Can a beneficiary access the assets in the testamentary trust, for example, if the beneficiary needs money?

Yes, the trustee can allocate capital to a beneficiary whenever the trustee chooses.

Who should be trustee of a testamentary trust?

If a trust is set up for a surviving spouse for tax reasons, then the obvious person to be trustee would be the surviving spouse.

If trusts are set up for adult children, then each child would usually be trustee of their own trust.

If a trust is set up for an impaired child, the trustee is usually someone the testator trusts to ensure the trust is used for the benefit of that child.

The trustee has control of the trust, so the trustee should be a person who you know, and whom you trust to act in the best interests of those who are to receive the main benefit of either the whole or that part of your estate that will be left to the testamentary trust.

In what circumstances would I set up a testamentary trust for my spouse?

If you are relatively young and have, eg, life insurance and superannuation, this would be an appropriate method of funding a testamentary trust. If your spouse and children survive you, your spouse could then allocate income each year to themselves and the children, thus minimising tax that would otherwise be assessable to the surviving spouse only (ie if they had received your superannuation and/or life insurance outright). The trust must, however, be carefully drafted to ensure that superannuation passes only to a tax dependant so that it is paid tax-free to your estate.

Otherwise, if you have separate assets and you have children and/or grandchildren, you could leave those assets to your spouse in a testamentary trust.

Would income allocated to a young child have to be paid to that child?

No, usually the income is used by the parent for maintenance, education, advancement or benefit of the child and is not physically paid to the child.

Are there other circumstances where I might set up a testamentary trust?

Parents will often set up testamentary trusts for adult children who have children of their own so that if neither parent survives, the adult children each have a testamentary trust of their own. Sometimes parents want one trust, with all of their children and grandchildren as beneficiaries. However, it is more common for each adult child to have their own trust with their immediate family as beneficiaries.

What if one child wants a trust and another one doesn't?

Beneficiaries are frequently given the option in the will as to whether they use a testamentary trust or not. In that way, the beneficiary makes the decision at the relevant time (ie the death of the testator). What may be suitable at the time the will is written may not be suitable when the testator dies. A beneficiary's circumstances may change during the intervening years. If the trust is optional, the beneficiary can make the decision about whether to use it at the appropriate time.

Can't a beneficiary just set up a trust with their inheritance after I have died?

Post-death trusts can be established, but only in very limited circumstances and the rules relating to distribution of capital are very restrictive. It is only if the beneficiary would have taken part of your estate under intestacy rules that a post-death trust is possible, and the capital is not able to all be used by the beneficiary but half must be distributed to the beneficiary's children. With a testamentary trust, the capital of the trust can be paid to whomsoever the trustee decides amongst the beneficiaries.

What if I already have a Family Trust?

The assets of your family trust do not form part of your estate when you die. If all assets are presently owned by your family trust, there would be no point in establishing a testamentary trust unless you planned to wind down your family trust and transfer the assets in it to yourself before you died. As this would almost certainly involve tax and perhaps stamp duty considerations, you need to obtain professional advice before doing so.

What if a beneficiary already has their own Family Trust? Can't they just use that?

Assets can be left in a will to the trustee of a Family Trust, but the tax benefits set out above would not apply. The trustee would not be able to allocate income at tax-effective rates to children under the age of 18. It is only a testamentary trust that qualifies for the tax exemption that applies to income earned by a minor from an inheritance.

Is it expensive to include a testamentary trust in a will?

Some practitioners charge considerably more than others, and you should seek quotes before instructing someone to prepare your will. Prices are included under the "Fees" tab on this website.

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