Aspects of Financial Planning

Testamentary trusts

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Testamentary trusts are trusts established by a person's will to enable the desired distribution of their assets upon death. Testamentary trusts have many taxation and asset protection benefits and are specifically useful for the distribution of assets and income to beneficiaries under the age of 18 years.

Background

A testamentary trust is a trust established by a person's will. This means that the trust itself comes into effect after the death of the principal and is used at this point to help retain control over who benefits from the estate. Testamentary trusts facilitate the distribution of income and assets to beneficiaries in a tax effective manner whilst enabling the protection of assets in certain circumstances.

The establishment of a properly drafted testamentary trust in a person's will can have several advantages for the beneficiaries of the estate including; financial and taxation benefits, protection of the family's assets and peace of mind for the principal. Any person who wishes to benefit children or grandchildren under the age of eighteen should strongly consider establishing a testamentary trust under their will.

Setting up a testamentary trust

Testamentary trusts are established in conjunction with your will and therefore if you wish to set up a testamentary trust, you will need to ensure your will reflects this wish. When devising a testamentary trust you will need to appoint a trustee to look after the administration of the trust and distribute benefits. It is advisable to seek advice in relation to whom you should grant the role of trustee. In many cases a neutral trustee is preferable, especially where complex family matters are involved, however, in some instances it is recommended that beneficiaries, especially the primary beneficiary, have full control of testamentary trusts to ensure taxation benefits are fully utilised.

The trustee's duty is to strictly comply with, and not step outside the terms of the trust deed. The trustee may become liable for damages for any failure in this regard. Due to this potential liability the trustee is often set up as a company structure. This allows the protection of limited liability to the controller of the trust.

Fixed or discretionary trust?

Testamentary trusts may be structured as either 'fixed trusts' or 'discretionary trusts'. A fixed trust specifically allocates all capital and income generated by the trust to the beneficiaries according to the provisions outlined in the trust deed. The trustee has no discretion to vary the distributions; each beneficiary has a fixed entitlement to either income or capital of the trust or a combination of both.

The type of trust most commonly recommended for a testamentary trust is a discretionary trust. In such a trust, the person appointed as executor, or trustee of the trust, has discretion granted in the trust deed to distribute capital and income generated within the trust to the beneficiaries in proportions that can vary from year to year. This allows beneficiaries to have maximum flexibility in dealing with their inheritance.

A discretionary testamentary trust has significant advantages in terms of the taxation benefits derived from income splitting and the protection of bequeathed assets from financial or other difficulties that the beneficiaries may suffer. The remainder of this Aspect will focus on discretionary testamentary trusts.

Beneficiaries

The next step in establishing a testamentary trust is to nominate beneficiaries. It is possible to name beneficiaries individually, thereby avoiding any confusion as to who may benefit, or you may nominate general classes of beneficiaries for example "grandchildren". In this way, the trustee will then have the discretion to distribute benefits to all grandchildren – present and future. It is important that the details of your beneficiaries are clear in your will. Only you can decide who the beneficiaries will be, this task cannot be delegated to another person.

Advantages of testamentary trusts

Income splitting

By using a discretionary testamentary trust, distributions can be made to the most appropriate members of the trust in terms of their tax status or other criterion. This allows, for example more income to be distributed to a beneficiary who is in a lower tax bracket than another; capital gains to be distributed to a beneficiary who has capital losses available; or franked dividends to be paid to a beneficiary who can use the imputation credits to eliminate or reduce tax on other income. One of the advantages of a properly drafted testamentary trust is giving the trustee discretion to allocate taxation benefits to those who can most utilise them so as to ensure maximum tax effectiveness.

This can also be achieved by splitting the trust income across family members thereby utilising the tax thresholds of each. A family of four will each benefit from the $6,000 tax free threshold, or $16,000 if the low income tax offset is included, and the trustee will be able to distribute $24,000, or $64,000, of income tax free each year if the four beneficiaries have no other taxable income. Similarly, capital gains can be split between beneficiaries and each individual may be eligible to apply the 50% capital gains discount to the assessable gain thereby reducing the capital gains tax payable.

The trustee can also distribute income from the trust to charitable and religious beneficiaries. Where such beneficiaries are tax exempt, no tax is paid on such allocations. Generally no tax deduction can be claimed for the distribution.

Beneficiaries under 18 years

Testamentary trusts are especially beneficial for people wanting to either directly or indirectly provide for children or grandchildren under the age of eighteen years. Ordinarily, trusts established by a person for the benefit of children under the age of 18 are subject to penalty rates of tax. This means a minor beneficiary would receive a tax free threshold of only $3,333 if the low income offset is taken into account and income in excess of this amount is taxed at the highest marginal rate, currently 45%. However, these penalty rates of tax do not apply to testamentary trusts.

Income and capital gains derived from a testamentary trust which was created as a result of a will or because a person died intestate are subject to normal individual tax rates. Accordingly, each resident individual who is a beneficiary of a testamentary trust, including minors, will receive the benefit of the full tax free threshold and the ordinary marginal rates of tax on distributions of taxable income above that amount. This means each child has a tax free threshold of $6,000, or $16,000 if the low income offset is taken into account, and income between \$6,000 and \$37,000 will be taxed at only 15%. As above, the minor may also be entitled to use the 50% CGT discount to reduce any capital gains. The maximum low income offset applies if the child's total taxable income is less than \$30,000. Imputation credits received can also be effectively used by the child.

An added benefit of distributing assets through a testamentary trust to a minor is the ability to be able to defer the distribution. The benefits to which a minor is entitled can be accumulated for the minor until a specified date, such as age 18, or until a specified need arises for example secondary education.

Asset protection

Many clients are concerned about protecting their assets. Assets owned by a trust are generally better protected from your, or your beneficiaries, personal or business creditors than if they were held personally. By using a testamentary trust you are able to safeguard your assets from:

- Beneficiaries who become bankrupt
- Beneficiaries who may now or in the future experience a marriage breakdown and who are consequently required to split their assets; and
- Spendthrift children.

The significant advantage of a testamentary trust is that the assets are owned by one person(s), the trustee, and the benefit of the income and capital of the trust passes to another person/s, the beneficiaries. This separation of control and benefit allows testamentary trusts to better protect assets from any legal action involving the beneficiaries and/or misuse of those assets.

This is further evidenced through the use of a discretionary as opposed to a fixed testamentary trust. At law, the assets of a fully discretionary trust are not owned personally by any beneficiary until the trustee elects to distribute such assets. These assets therefore do not form part of the beneficiary's personal estate and if a legal claim was made, the assets held in the trust for discretionary entitlement should be protected. Assets distributed under a fixed entitlement may not.

Some care is necessary with distributions which are 'credited', but not physically paid out, to beneficiaries. The undistributed amount may be regarded an asset of the beneficiary and payment may be able to be demanded by the beneficiary or their creditors thereby negating some asset protection.

In certain circumstances, a testamentary trust can be specifically tailored to ensure that the principal's assets stay within their family or their direct lineal descendants for a period of up to 80 years after their death, or less of course if they desire. This may be particularly useful for families experiencing a marriage breakdown or divorce. Properly drafted, a testamentary trust can result in assets being excluded from property settlements on marital divorce or breakdown in a de facto relationship.

Conclusion

Testamentary trusts properly drafted in a person's will allow beneficiaries access to numerous options and can have several taxation and asset protection benefits. The income derived by beneficiaries under the age of eighteen benefits from adult marginal tax rates; capital gains can be distributed to those beneficiaries who can use them to offset a loss and discretionary entitlements can be protected from a claim against a beneficiary's assets.

There is no legal limit to how many testamentary trusts a will can establish and it may be beneficial to establish a separate testamentary trust for each beneficiary. These questions and others are best answered by consulting a legal professional in conjunction with your financial adviser.

Centric Wealth Advisers Ltd may be able to be of assistance

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