BARRETT WALKER

Look before you leap with testamentary trusts

A testamentary trust works in tandem with a will, and is similar to a discretionary trust, with the major difference being it only takes effect upon the death of the person who made the will. The trust can be funded by some or by all of your assets, and by payments derived as a consequence of death, such as life insurance payouts and superannuation death benefits.

Multiple testamentary trusts can be created specifically in wills or by giving the executor of the will the discretion to set up a separate testamentary trust under certain specified parameters. A well governed trust will ensure desired asset protection is achieved and family and legal disputes minimised or hopefully prevented.

A testamentary trust can exist for up to 80 years, but can also vest (be wound-up) earlier if the trustee so decides. Under a testamentary trust, the ultimate control and legal ownership of the estate is clearly with the trustee. The beneficiaries do not legally own the assets of the trust, but have a right to be considered in the distribution of the income and capital of the trust.

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Testamentary trusts are formed under the auspices of a valid will or testament rather than other trusts which are ordinarily created during life (inter vivos) under the terms of a trust deed. It is a trust structure that is often used to protect family assets by having greater control over management and distributions of the deceased estate to beneficiaries.

It is crucial that the planning and appointing process of the trustee is well governed. The decision as to who the trustee of the trust is of necessity an important one so as to ensure that the appointee is one that is trustworthy, competent and will serve to protect the beneficiaries' entitlements.

Key parties in a testamentary trust

- **Settlor:** the person who creates the trust (as part of their will).
- **Trustee:** responsible for carrying out the terms of the will.
- **Beneficiary:** person/s entitled to receive benefits of the trust.
- **Court:** the probate court oversees the handling of the trust by the trustee, ensuring the trust is properly followed.

Look before you leap with testamentary trusts *cont*

The long term success of a testamentary trust is dependent on planning and a high level of co-operation between family members.

Case study 1

Note both case studies do not consider Medicare levy. John and Jane Johnstone have two children, Jeff aged 6 and Jenny aged 9. Jane died suddenly leaving assets of $500,000 (excluding the family home). Jane's will included a testamentary discretionary trust under which John along with Jeff and Jenny are potential beneficiaries.

The annual income of the trust is $30,000 and John as trustee resolves to distribute the income equally between Jeff and Jenny. As the children have no other income, the distributions are tax free as they are under the threshold of $18,200.

If Jane's will had not included a testamentary trust, the income of $30,000 would have been added to John's taxable income to bring the total amount to $120,000 ($90,000 salary + $30,000). He would have paid tax of approximately $32,000 as opposed to tax of approximately $20,900 (on his salary). Thus, in one year alone the testamentary discretionary trust has saved the family approximately $11,100 in income tax ($32,000 – $20,900).

Case study 2

Adam, age 44, and Agnes, age 46, are married and have three children aged 8, 5 and 3. They own a house together which is valued at $900,000. They have also taken out a $550,000 mortgage over the house. Adam's annual salary is $120,000 (net $87,963) while Agnes has an annual salary of $50,000 (net $42,453). Both have wills and life insurance to the value of $1.5 million and $1 million respectively.

Using a simple will: Agnes dies and in her will leaves everything to her husband Adam without the use of a testamentary trust. If Adam uses half of Agnes's estate to pay off the outstanding mortgage on the house this will leave Adam with $450,000. To ensure a maximum future return on the remaining funds, Adam decides to invest the funds at a rate of 4% a year generating an annual income of $18,000.

Where there is no testamentary trust in place, the $18,000 will be taxed in Adam's hands at his full tax rate. That would mean that he would have a net income of $99,308, a total increase of $11,340 annually.

About this newsletter

Welcome to our monthly legal update.
We hope you require further information on how any of the content could affect you, please do not hesitate to contact Ray or Neal on (03) 9428 1033 or

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Using a testamentary trust: Let's assume that Agnes in her will leaves her estate to Adam via a testamentary trust. The trust establishes Adam as the trustee and primary beneficiary with Adam and Agnes's children also beneficiaries.

Adam generates an additional annual income of $18,000 from investing the trust funds at a rate of 4%. By splitting the income, benefits can be distributed between the children and Adam so that there would be no tax payable on the $18,000. This would be done by ensuring that no distribution to any one beneficiary was greater than the minimum tax free threshold of $18,200, which they are entitled to even though they are minors because the trust is a testamentary trust, rather than a standard discretionary trust.

By structuring their estates in this way, the family would be $6,660 better off per year until the children begin earning their own income. This extra money can be taken into consideration when calculating insurance needs.

ADVANTAGES AND DISADVANTAGES OF A TESTAMENTARY TRUST

Advantages

- Asset protection – protects from unwanted claims by creditors, spouses or partners of the testator's children
- Tax benefits – income generated by the trust can be allocated between beneficiaries in a tax effective manner. Beneficiaries under the age of 18 years will be taxed at normal tax (adult) rates, not at penalty rates normally applicable for prescribed minors
- Protection from bankruptcy – a well-structured trust will protect a beneficiary's inheritance in the event of insolvency or bankruptcy.

Disadvantages

- Complexity – a testator, trustee and beneficiaries should be able to clearly understand and approve the scope, structure and operation of the trust
- Lack of flexibility – there needs to be provision made for dispute resolution and asset devolution strategies in the event of the death of one or more primary beneficiaries
- Cost – there will be ongoing administrative costs involved in maintaining the trust, such as accountancy and tax compliance costs. ■