Testamentary Trusts

Testamentary trusts can be very effective estate planning tools to assist in providing for spouses, children and grandchildren, and are becoming increasingly popular as more people become aware of their advantages.

A Testamentary Trust is any trust established under a will, but the term is usually used in the context of a discretionary family trust established under a will.

Why are they becoming more popular?

Their increasing popularity arises from the very considerable benefits that can flow from their establishment and use, including the fact that although assets of the trust may be controlled by the intended beneficiary, they do not form part of that beneficiary's estate. Major benefits of a testamentary trust include the ability to protect assets and to possibly reduce tax paid by the beneficiaries from income earned from their inheritance - providing a greater level of flexibility and control over the distribution of assets to beneficiaries.

Reasons why you should consider a testamentary trust include:

CGT benefits

Assets owned by the deceased that would have been subject to capital gains tax (CGT) had the deceased sold them before their death, can pass through their estate to a testamentary trust without a CGT event occurring.

If an asset was a pre-CGT asset, the trust will receive a cost base equivalent to the market value of the asset at the date of death. If the asset is a post CGT asset, then the trust will inherit the deceased's cost base. This is particularly important where the assets have significant unrealised capital gains. This also provides a good opportunity to "reset" the ownership of assets subject to CGT.

If for example, mum and dad own the shares in a company that is the corporate beneficiary of their family trust. The shares may have a nominal cost base but because of trust distributions made over a number of years (and often not paid in cash) the company may have become very valuable. All of that increased value is potentially subject to CGT if mum or dad changed the ownership of these shares during their lifetime. However, after their death the shares can be moved to a testamentary trust and dividends from the company can then be distributed by the trust to a range of beneficiaries, tax effectively.

In addition, trust assets may be transferred to beneficiaries without incurring CGT (but only in respect of assets of the trust that were owned by the deceased when they died).

Income Tax advantages

Income can be distributed from a testamentary trust to infant beneficiaries (under the age of 18) and taxed in those children's hands at adult marginal tax rates (instead of at the top marginal tax rate as would otherwise be the case). Testamentary trusts may, over time, sell and replace the original assets received from the estate and the distributions to infant beneficiaries will continue to be taxed at (more beneficial) adult rates.

With the tax free threshold of $18,200 since 2013/14, testamentary trusts are even better vehicles for clients because children and grandchildren under the age of 18 years who receive income from a testamentary trust are taxed on that income at adult rates, and enjoy a tax free threshold of $18,200 (or $20,542 if the low income tax offset applies) and the marginal tax rates which apply to adults.

Without this special provision trust distributions to minors may only access a tax free threshold of $416 and thereafter the effective tax rate applied to the minor's income is 66% of income up to $1,307 and 45% after $1,308, on the entire amount of income received.

Flexibility to the Trustee

The trustee can buy and sell underlying assets of the trust (and thereby enhance the value of the trust) without losing or endangering any tax advantage.

We suggest it is desirable that clients provide the trustee with some guidelines about the administration of the trust, but they should be carefully framed in order to avoid any confusion or legal or accounting complications.

Protection of assets

Testamentary trusts provide a level of protection to the assets held in the trust, including against creditors of the beneficiaries who may want to recover from the trust assets an amount owing to them by a beneficiary, and in the Family Law Court in the case of the divorce of a trust beneficiary.

It is quite common for a wife to guarantee her husband's business venture and vice versa, to some extent we can all be at risk whether in high risk occupations or not. However, if a bankrupt has received an inheritance through a testamentary trust it will be protected from creditors.

In the Family Court, an inheritance held within a testamentary trust is unlikely to be the subject of a Family Court order in the case of a marriage break-up.

Protecting 'at risk' beneficiaries

It is not uncommon for people suffering a variety of disabilities to be unable to properly manage their financial affairs. At the same time, families may wish to ensure that an adequate fund is set up to meet the beneficiaries' reasonable needs, and so as not to affect any pension rights they may have.

These people can be described as being 'at risk', a description that may for example include people who are drug or gambling addicted, mentally or physically disabled or simply spendthrifts who are not capable of looking after any wealth that is left to them. For these people a testamentary trust can be managed by a trustee (who should be) a responsible and capable person (or people) who take action for the benefit of the 'at risk' person.

Summary

It is becoming much more common to steer away from the traditional husband and wife will, which provides for a husband and wife giving everything to each other and then to the children, and to replace this with one or more testamentary trusts controlled by the surviving spouse and/or children under which the spouse and children are potential beneficiaries.

If the funds in the estate justify it (and remember this may include the proceeds of life insurance policies, or superannuation), wills providing for testamentary trusts can provide that on the death of the spouse, sub-trusts come into existence for the benefit of each child and that child's family - controlled by the child concerned.

Testamentary trusts are a very powerful and useful estate planning tool. The flexibility of such trusts, especially if combined with a memorandum of wishes as to how the trust should be administered, can be an appropriate arrangement as well as providing a highly advantageous tax mechanism, for many years into the future.

To find out more about how testamentary trusts can benefit you, contact us on (03) 9459 5764 or email admin@rtlegal.com.au.