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TESTAMENTARY TRUSTS

Testamentary trusts are created by a Will to provide a greater level of control over the distribution of assets to beneficiaries. There are also tax advantages available through testamentary trusts, making them an effective estate planning tool. A Trust is not established setup until the will-maker has passed.

Here are two common types of testamentary trusts:

1. **Discretionary testamentary trusts.**
   Executor gives the beneficiary the option to take part or all of their inheritance via testamentary trust. The primary beneficiary has the power to remove and appoint the trustee and they can appoint themselves to manage their inheritance inside the trust.
2. **Protective testamentary trusts.**
   Beneficiary must take their inheritance via the trust and does not have the option to appoint or remove trustees. May be useful where the beneficiary is not in a position to responsibly manage their inheritance due to age, disability or spendthrift tendencies.

What is appropriate for your intentions?

Benefits of Testamentary Trusts

The main benefits of testamentary trusts are their ability to protect assets and to reduce tax paid by beneficiaries from income earned from the inheritance.

Reducing Tax Using Income Splitting

If a beneficiary takes their inheritance in their personal name, they will pay tax on the income generated from their inheritance at their personal marginal tax rate.

There may be significant tax advantages in taking an inheritance through a testamentary trust, particularly where the beneficiary has:

- a high personal marginal tax rate
- a partner on a lower income
- minor children and grandchildren; and/or
- children or grandchildren with no, or lower, taxable income.

There are limitations regarding the concession to minors, however, this limitation does not apply where the income was received by a minor directly from a deceased estate. This can prove to be very tax effective, for the support and financial provision of grandchildren.

How Does It Work?

A discretionary testamentary trust allows your beneficiary to split the income generated from their inheritance amongst the beneficiaries of their trust.

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This allows the beneficiary to distribute income more tax effectively. To minimise the amount of tax paid, income generated from the inheritance can be split and streamed to beneficiaries of the trust who have a lower marginal tax rate.

Income distributed from a discretionary testamentary trust to any minor beneficiaries, such as children or grandchildren, has further potential for significant tax savings.

Unearned income distributed to minors under trusts created during a Testator's lifetime (such as family trusts) is taxed at high rates (45% for every dollar over $3,000).

However, income distributed to minors from testamentary trusts is 'excepted' from the higher rates usually applicable to unearned income.

Minors are instead treated like adults. They have a tax free threshold of $18,200 and normal marginal tax rates apply to every dollar above the threshold. If a minor child claims the low income tax offset, their tax free threshold is effectively raised to $20,542.

Protecting Your Assets

A common and sensible objective for all Testators is to ensure that each beneficiary's inheritance is protected and preserved from:

- waste and dissipation by the beneficiary
- claims on the beneficiary's assets due to marital or commercial breakdown.

Testamentary trusts can help protect your assets when they pass to your beneficiaries.

Primary Beneficiary

This is the beneficiary receiving the inheritance. The trust is created for the primary benefit of this person.

Potential Beneficiaries

These are the people, in addition to the primary beneficiary, who are eligible to receive distributions of capital and income from the trust.

Potential beneficiaries include anyone who falls within a class of persons defined in relation to the primary beneficiary. These classes include the 'siblings', 'partner', 'children' and 'grandchildren' of the primary beneficiary, as well as 'any companies or trusts' of which the primary beneficiary is a director or trustee.

By nominating potential beneficiaries by class instead of name, the Testator ensures that the trust endures changes to the circumstances of the primary beneficiary.

For example, should a class of potential beneficiaries not exist at the time of drafting the Will, any persons who later come into existence and subsequently fall into a class (whether they come into existence before or after the Testator's death) will automatically become a potential beneficiary of the trust.

Trustee

The trustee controls the trust. The trustee manages the inheritance inside the trust and decides who amongst the beneficiaries of the trust receives distributions of capital and income. The trust is drafted so that the primary beneficiary chooses the trustee (unless the trust is protective, in which case the Executor appoints the trustee).

In this way, the primary beneficiary controls their inheritance held inside the trust. The primary beneficiary also has the power to remove and appoint the trustee (the "power of appointment").

If the beneficiary elects to take their inheritance (or part of it) via the trust, the inheritance is given to them as trustee of their own discretionary testamentary trust. The beneficiary (as trustee) can then invest the trust property (the inheritance).

Each year, the trustee distributes income generated from the trust property. The trustee can distribute the trust income and capital between the primary beneficiary and potential beneficiaries. The trustee has discretionary power to choose which beneficiaries of the trust benefit from the trust.

Beneficiaries have no right to demand any income or capital. The beneficiaries merely have a right to be considered by the trustee to receive some income or capital from the trust. Each beneficiary who receives a distribution from the trust is taxed on the income at their personal marginal tax rate. The income distributions can be varied depending on the tax position of each particular beneficiary to achieve the most tax effective distribution.