

WHAT IS a testamentary trust?

A testamentary trust is incorporated in a will and doesn't come into force until the death of the will maker. Instead of leaving assets directly to a beneficiary, they are transferred into a trust and held on behalf of a single beneficiary or group of beneficiaries. The will maker decides which assets are transferred and who is a beneficiary. This may provide tax advantages as well as asset protection benefits.

How does a testamentary trust work?

- Once a testamentary trust comes into force, the assets can be transferred into the trust. The nominated trustee (or trustees) then holds the assets on behalf of the specified beneficiaries, with discretion on how to manage the trust. However, the trustee must act within the rules of the trust deed (which were designed by the will maker).

The trustee generally has discretion to decide which of the nominated beneficiaries receive income and capital distributions each financial year.

It is therefore important you appoint someone you trust to act as trustee (for example your spouse or adult children) or use the services of a trustee company.

Who should create a testamentary trust?

It might be prudent for you to consider using a testamentary trust, rather than direct distributions, if you are concerned:

- your beneficiaries do not have the ability to manage or protect your assets after you die – for example, they might have lost mental capacity, have substance abuse/gambling issues, or they might be a spendthrift;
- your beneficiaries could face bankruptcy, divorce or legal action;
- your beneficiaries will not receive the full benefit of the income generated by your assets because they are high income earners and will pay high rates of tax.

Note:
it is possible to draft the will to allow beneficiaries to choose to receive their share of the estate directly instead of through a testamentary trust.

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How does a testamentary trust protect assets?

The trustee of the testamentary trust legally owns the assets you place in the trust. Your beneficiaries do not.

Therefore, those assets may be protected from your beneficiaries' creditors in the event of their bankruptcy or successful legal action against them.

Similarly, holding assets in a testamentary trust may provide protection in a potential divorce property settlement, although the existence of a testamentary trust may create an offset with other property in the settlement.

If not also the trustee, your beneficiaries will not have access to your assets in the trust to liquidate and spend as they see fit. This can help protect your assets from beneficiaries who might misuse their inheritance because they are poor money managers.

Providing these protections will require careful drafting of your will. The terms of the testamentary trust and receiving proper legal advice is key.

How will Centrelink treat a testamentary trust?

It is important to consider the Centrelink outcomes for the people you are including in your testamentary trust, especially if they have control of the trust.

If you include your spouse in a testamentary trust, Centrelink will attribute the trust's assets and income to your spouse if he/she either controls or potentially benefits from the trust. This means that the income and assets will be treated as belonging to your spouse.

If your spouse is not included in the testamentary trust, Centrelink uses a control test to decide the share of income or assets attributed to the other beneficiaries.

If the beneficiaries are the trustee or appointor of the trust, they will be the "controller" and are likely to have all (or a proportion) of the income and assets attributed in their means-tested assessments. This can also still apply, if they are not the trustee but an associate is the trustee. Distributions to others can be deemed to be gifts.

Beneficiaries who don't control the trust, will have income distributions assessed under the Centrelink income test.

If your beneficiaries receive Centrelink benefits, you should seek advice on the implications for them of an inheritance.

How can a testamentary trust be tax effective?

Depending on the circumstances of your beneficiaries, a testamentary trust could assist them with income splitting for tax purposes, i.e., distributing income to beneficiaries who earn little or no other income. This may allow the income to be taxed less harshly than if it was distributed to a beneficiary who is on a high marginal tax rate.

Importantly, any income allocated to a child under 18 from a testamentary trust is subject to adult tax rates (including the $18,200 tax free threshold) instead of the child penalty tax rates.

The following is an example to explain the potential tax effectiveness of distributions from testamentary trusts. In our indicative example, Eve dies leaving behind two sons and three grandchildren. Eve has set aside $1 million dollars for each son. Both sons are on the highest marginal tax rate of 45% (plus Medicare levy).*

If Eve distributes this money via her will, and the sons invest this to generate an income of say 4% p.a., almost half of that income will be lost to tax (see Chart 1).

If, however, Eve uses a testamentary trust, the amount of tax paid could be significantly reduced. For example, the trustee could choose to distribute no income to the two sons, instead distributing the income to their spouses and children who earn no other income (see Chart 2).

As a result, the families would pay no tax on the income distributed by the testamentary trust.

Furthermore, should one of the sons face bankruptcy, divorce or legal proceedings, Eve's assets may be protected.

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Chart 1: Indicative example – Distributing an inheritance via a will

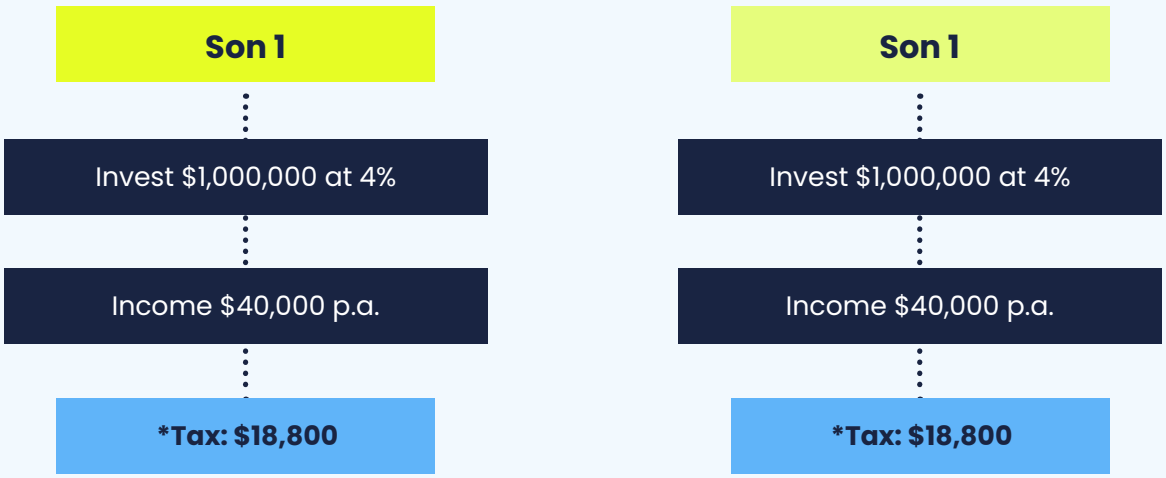
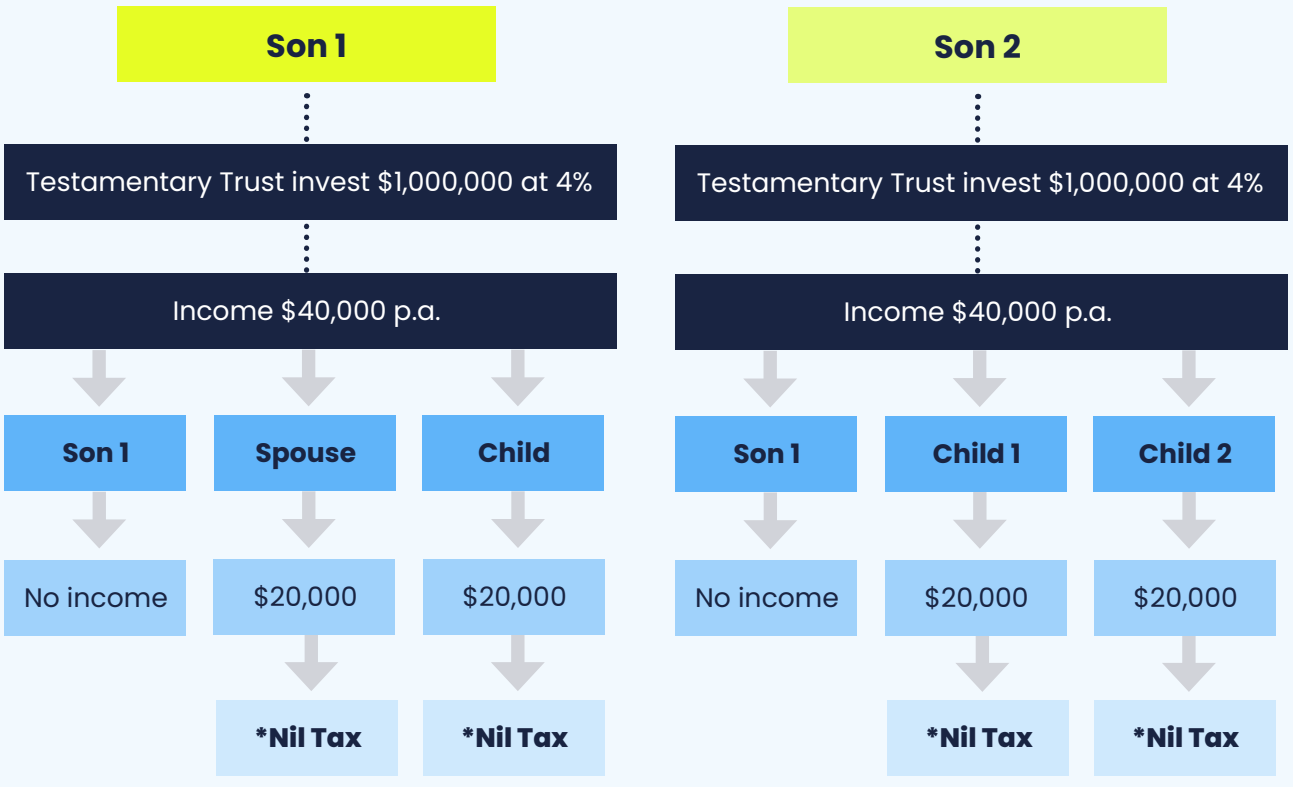


Chart 2: Indicative example – Using a testamentary trust



* This is an indicative example. Each individual's circumstances may differ and impact any tax liability. You should obtain your own tax advice. It assumes the sons pay 47% tax and the spouse/children has no other income and pay no tax.

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What else should you consider before establishing a testamentary trust?

- Before establishing a testamentary trust, you should decide whether the level of your assets warrant such a structure. There are no minimum limits however you should consider the benefits compared to the costs. Testamentary trusts can only be established with estate assets. If most of your assets are owned jointly or by a family trust, these assets won't form part of your estate and cannot be used to establish a testamentary trust.
- Consider what might happen to the trust and trust assets on the death of the first line of beneficiaries.
- The cost of administering a trust can include the services of a professionally appointed trustee, as well as ongoing administrative costs such as accountancy fees for preparation and lodgement of tax returns.

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