

TESTAMENTARY TRUST

What is it?

Simplistically, a testamentary trust is a trust created by a will. Generally it is a discretionary trust – this is where the Trustee has full discretion about who benefits, and to what extent, under the trust.

A testamentary trust has two main and significant advantages for the nominated beneficiaries. In reality it is of no benefit for the deceased who made the will.

1. Taxation advantages in that it allows income splitting; and
2. Asset or Risk Management - protection of the assets from any financial or other difficulties that the beneficiaries may suffer for various business and or personal reasons within and without their control.

Taxation advantages

The Tax Act provides that income and capital gains derived by children under the age of 18 years from assets received as a result of a will are not subject to penalty tax rates. Children who benefit under a will are taxed at the normal (adult) marginal rates.

This has the following significant tax advantages:

Each child has a tax-free threshold of \$6,000 (or \$6,880 if the low income rebate is taken into account). Taxable income between \$6,000 and \$20,000 will be taxed at the low rate of 17%. If the child's total taxable income is less than \$20,700 then they will be entitled to the low income rebate of \$150. Medicare levy of 1.5% will also be payable by the child if their taxable income is in excess of \$14,539 (the threshold for 2002/03).

Imputation credits attaching to franked dividends received can be effectively used by the child.

The main advantage of using a discretionary, testamentary trust for bequeathed assets is that any income gains, capital gains and franked dividends can be distributed among all the family beneficiaries each year in the most tax-efficient way.

The tax concessions do not apply solely to income and capital gains derived by the trust from inherited assets. They also apply to any income and capital gains derived from assets acquired from the reinvestment of moneys received from the original inherited assets.

There is no legal limit to how many testamentary trusts a will can establish. Ideally, a will would establish a separate testamentary trust for each beneficiary.

Asset or Risk Management

Many clients are concerned about protecting their assets. They want to make sure that the assets remain within the family and are used to benefit family members.

In particular, clients are concerned about:

- their beneficiaries becoming bankrupt, especially those that are involved in highly leveraged businesses;
- their beneficiaries becoming divorced and their assets being split in the divorce;
- spendthrift children;
- ensuring that the surviving spouse will pass on their assets to their children upon that person's death; or
- looking after physically or intellectually impaired 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 protect assets from any legal action involving the beneficiaries and/or misuse of those assets.

The terms of the testamentary trust are set out in the will. These terms can restrict the ability of any of the beneficiaries to control the activities and investments of the trust or give them complete control.

The only way that a client can ensure that the assets are fully protected is to have at least two trustees, an independent trustee together with the primary beneficiary.

The client therefore needs to decide whether he/she wishes to sacrifice the independence of the beneficiary to ensure that the inherited assets are protected and used sensibly for the benefit of the primary beneficiary and their family. We prefer that clients give their beneficiaries full control of their testamentary trusts. This allows the beneficiaries to use the trusts for income splitting and asset protection.

However, if the clients wish to ensure that their assets are invested and managed for the benefit of their beneficiaries then it is appropriate to have an independent person in control of the testamentary trust. This should only be done after careful consideration of the implications.