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Technical News

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Financial planning aspects of testamentary trusts

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Damian Revell outlines the benefits of testamentary trusts from a financial planning perspective and some key issues to consider.

Overview

Effective estate planning ensures that clients' assets are directed to the right beneficiaries at the most appropriate time.

One potentially powerful way clients can achieve this objective is to include carefully drafted provisions in their Will that enable a testamentary trust to be established when they pass away.

Testamentary trusts can facilitate a tax-effective distribution of income and capital to beneficiaries and provide asset protection in certain situations.

In this article we outline the financial planning benefits of testamentary trusts and some key issues to raise with clients who are thinking of using this strategy.

Note: While testamentary trusts, as a part of estate planning, are a key component of financial planning advice, your clients should seek specialist taxation and legal advice when implementing anything outlined in this article.

What's a testamentary trust?

A testamentary trust is a trust established via a Will, where estate assets are owned and controlled by the trustee and not the beneficiaries in their own right.

A testamentary trust can be fully discretionary, which would allow the trustee to decide how the income and capital is distributed to beneficiaries.

Alternatively, a testamentary trust can be a fixed trust providing beneficiaries with a fixed entitlement to income or capital, or a combination of both. Generally fixed trusts are not commonly used unless there is an intention to set up a 'special purpose' trust like a superannuation proceeds trust or special disability trust.

For the purpose of this article, we will only address the benefits of discretionary testamentary trusts.

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How are they established?

A testamentary trust is established from instructions in a client's Will. It is therefore important to have a solicitor correctly draft the Will to ensure the testamentary trust achieves the client's goals.

The trust can only be established with the net assets of a deceased estate after taxes and liabilities have been paid out by the executor.

In some cases, the Will may be drafted to give the executor the option of creating a testamentary trust rather than making it compulsory.

Consideration may be given to having more than one testamentary trust where there is more than one beneficiary. This allows the executor and/or trustee to deal with the entitlements of beneficiaries in different ways.

More information on the key legal requirements and principles of setting up trusts is contained in our article titled **'Financial planning aspects of discretionary family trusts'**. This article can be accessed in the Technical section of the secure adviser site at [mlc.com.au](mlc.com.au)

What are the benefits?

Tax-effective income splitting

A discretionary testamentary trust allows for the splitting of income generated by the trust's assets between the beneficiaries on a year-by-year basis.

By selecting beneficiaries on low marginal rates, the trustee can manage the taxation of income earned by the trust.

Because no beneficiary of a discretionary testamentary trust has a fixed entitlement to the trust assets, a CGT event would occur when a trust asset is disposed of by sale or transfer.

Capital gains made on disposal of trust assets can, however, be split between beneficiaries who may be eligible to apply the 50% discount to the assessable gain, thus reducing the CGT payable.

Income and capital gains that are distributed from a testamentary trust directly or indirectly to children or grandchildren under the age of 18 is subject to normal individual tax rates, not the child tax rates.

Note: Any income not distributed from the trust will be taxed in the hands of the trustee at 46.5% (including Medicare levy).

Asset protection – relationship breakdown

A testamentary trust allows the assets to remain within the family bloodline. For example, a future spouse of a child would not be a trust beneficiary.

The assets in the testamentary trust are generally not considered a financial resource for the division of assets upon a relationship breakdown and cannot be divided as part of a property settlement, unless the beneficiary is the sole beneficiary.

Asset protection – upon bankruptcy

The assets in a testamentary trust will generally be protected from claims by creditors if a beneficiary becomes bankrupt.

A key exception is where there is an unpaid present entitlement, which may arise when distributions are notionally made to (and taxed in the hands of) a beneficiary and the money is retained in the trust.

Income from a trust would not be protected, but the trustee has the option to not distribute income to beneficiaries who are (or have the potential to become) bankrupt or limit the distributions to such people.

Control 'beyond the grave'

A carefully drafted testamentary trust may specify that capital cannot be distributed to a beneficiary until they are a particular age (eg 21, 25 or older).

Alternatively, the rules may leave it to the trustee to determine when capital is payable. This discretion would enable the trustee to consider beneficiaries' circumstances before paying out the capital rather than relying only on the beneficiary turning a particular age.

The discretion of a trustee may also extend to special need beneficiaries, including those who are spendthrift or have a gambling, alcohol or drug addiction.

Other key issues to consider

Trustee considerations

When a discretionary testamentary trust is considered as apart of any estate planning strategy for clients, it is important they also consider who is nominated as the trustee of the testamentary trust.

The trustee will be responsible for managing the assets of the trust until payable to the beneficiaries. The trustee needs to understand what the client is hoping to achieve and details should be provided in the Will or deed of wishes.

Cost and ongoing advice

As a testamentary trust is a legal structure, it will need to satisfy certain requirements, such as completing annual tax returns. The trustee may need to seek professional advice (eg legal, accounting or financial planning) and the costs paid by the trust should be compared to the benefits of maintaining the trust.

Who should consider them?

A testamentary trust could suit clients who:

- have (or will potentially have) substantial assets other than their principal place of residence and superannuation interests, and
- want to arrange effective tax planning and asset protection for their beneficiaries.

In addition, where a client has a blended family or minor children there may be other circumstances where a testamentary trust is appropriate. However, the benefits of having a testamentary trust as apart of an estate planning strategy must be considered in consultation with legal advice.

Contact details

For further information, please contact MLC Technical Services on **1800 645 597.**