

modern estate planning

why your Will should contain testamentary trusts

These notes are intended to briefly and simply explain the advantages and benefits to your beneficiaries of incorporating optional discretionary trusts in your Will. (A discretionary Will Trust is often also referred to as a "testamentary" Trust)

These notes should not be read as a statement of the requirements of Trust law or income tax law or a summary of the terms of a particular Trust (which vary from Will to Will); nor should the notes be used as a substitute for professional advice.

If you have any question concerning the matters covered in these notes please contact us for further explanation.

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ABOUT THE AUTHOR

Michael Fitzpatrick CFP has been a practicing solicitor since 1976 and has been involved in providing financial planning advice since 1988. He currently conducts a boutique law practice at Castle Hill in Sydney providing estate planning advice to clients of lawyers, accountants and financial planners.

Michael's 29 years of legal practice and 17 years of involvement in financial planning has provided him with significant broad financial and estate planning experience. He maintains a high level on-going professional interest in the areas of estate planning, testamentary trusts, Wills etc, advice on the use of appropriate tax structures for asset protection and business ventures and self managed super funds where the combination of his legal training and wide experience has seen him develop advanced levels of practitioner skills.

Michael is a member of the Law Society of NSW, a member of the Financial Planning Association of NSW, and a fellow of the Taxation Institute of Australia. He is a regular speaker at professional seminars in the area of estate planning, family trust and business structures, asset protection and self managed superannuation funds, and until recently was the chairperson of the Financial Planning Association's FPA 6 taskforce reviewing the course material for advisers in the area of estate and contingency planning.

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What is a Testamentary Trust?

A testamentary trust is a trust established by a Will. A Beneficiary Testamentary Trust can be **optional** (the beneficiary can choose not to use it) **discretionary** (the beneficiary decides who will benefit) or a **fixed** trust or a combination of these.

Optional, discretionary, testamentary trusts are widely recommended for use in modern Wills because of the taxation and asset protection advantages that they offer when compared to a 'standard' Will.

A standard Will offers little assistance to a beneficiary of an inheritance in relation to issues of tax efficiency and asset protection.

Why use a Testamentary Trust?

Establishing testamentary trusts in your Will provides your beneficiaries with maximum flexibility in dealing with their inheritance. The usefulness of a discretionary Will trust to a beneficiary will depend upon the beneficiary's specific needs and circumstances at the time of your death so it is important that the terms of the testamentary trust are sufficiently wide to offer the beneficiary as many options as possible so as to provide freedom and flexibility.

What if a Testamentary Trust turns out not to be useful to my beneficiaries?

Your Will should be drafted so that the primary beneficiary has the power to decide to

1. use the trust for all, part or none of the beneficiary's inheritance
2. wind up the trust at any time or
3. pass the control of the trust in accordance with the primary beneficiary's Will.

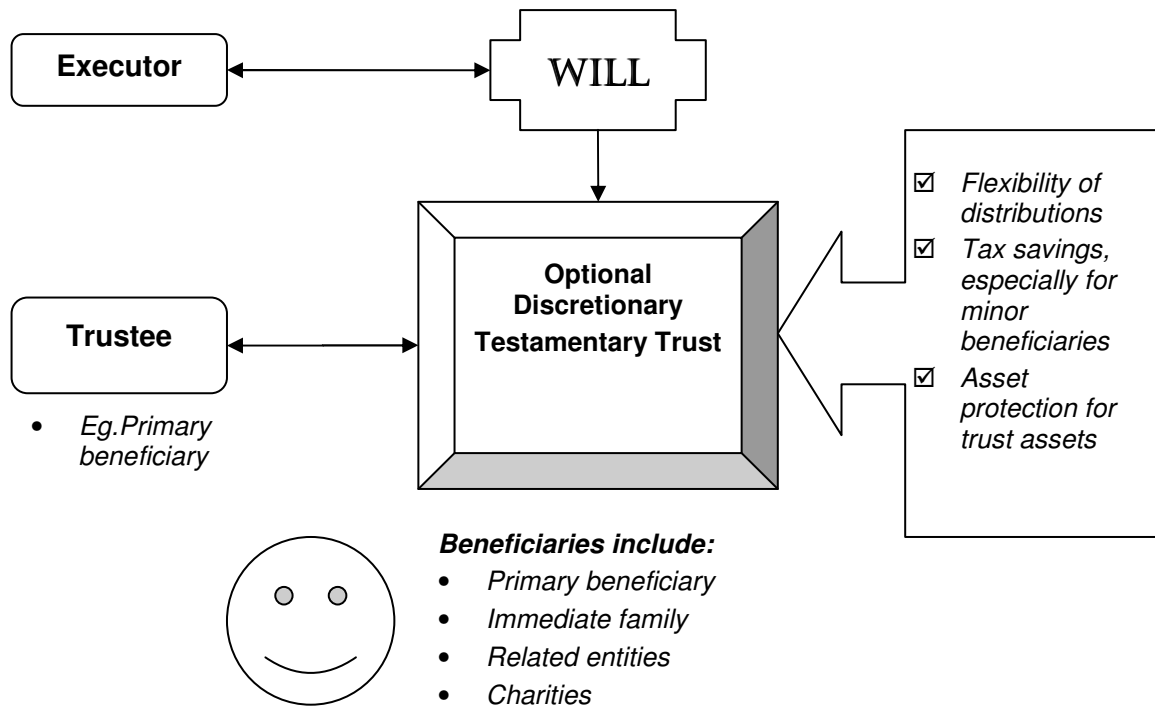
Because a testamentary trust can live for up to 80 years from your death it can provide flexibility, asset protection and taxation advantages for many generations of your family.

What does a Testamentary Trust "look like?"

The diagram on the next page depicts how a fairly typical testamentary trust is structured.

Simply instead of leaving an inheritance directly to a nominated beneficiary you leave the inheritance to your nominated beneficiary as trustee of a discretionary trust with wide discretionary powers.

Diagram - typical Beneficiary Testamentary Trust



What Assets can be put into a testamentary Trust?

Any assets belonging to you can be left to your beneficiaries via a testamentary trust on your death. Additionally payments made to your estate as a result of your death i.e. superannuation death benefits or the proceeds of life insurance can also be directed to be held within a testamentary trust.

To provide maximum flexibility to your beneficiaries, your Will however should be drafted to allow your beneficiaries to choose which assets belonging to you should be held within a testamentary trust.

How will my beneficiaries potentially benefit from a Testamentary Trust?

Your beneficiaries may potentially derive the following benefits:

➤ **Significant income tax savings for beneficiaries**

Well drafted Testamentary Trusts can give a beneficiary the option to reduce personal income tax by splitting income from the investment of inheritance between a range of family members on low tax rates.



The trustee of the testamentary trust (normally the primary beneficiary) has complete discretion to determine who receives the income of the trust. Tax is paid on the income of the trust at the marginal tax rate of the beneficiaries who receive it. Therefore, by selecting beneficiaries on low marginal tax rates, the trustee can minimise the taxation liability of the trust. The trustee can choose to distribute income to minor beneficiaries of the trust with each beneficiary being able to receive over \$6,000 of income tax-free.

The trustee can also distribute income from the trust to charitable and religious beneficiaries. As many such beneficiaries have tax deductibility status or are tax exempt, no tax is paid on allocations to such organisations.

➤ **Beneficiaries under 18 attract special tax concessions**

Normally penalty rates of tax apply to income derived from trusts which is paid to children under age 18. The Tax Act allows children under age 18 who receive income from a testamentary trust to be treated as adults for tax purposes. This could mean significant tax savings for beneficiaries who can “split income” with their minor children.

➤ **Significant capital gains tax savings for beneficiaries.**

A well drafted testamentary trust can also provide the opportunity for your beneficiaries to minimize capital Gains Tax which arises from the sale of your assets.

Capital Gains Tax is not triggered when an asset belonging to you passes via your Will to your executor or the trustee of a testamentary trust. Also there is no Capital Gains Tax when your assets are transferred from the trustee of a testamentary trust to a beneficiary – see ATO Practice Statement LA 2003/12.

As with the income of the trust, the trustee can select which of the beneficiaries of the testamentary trust should take the capital gain. By choosing to distribute the capital gain to a beneficiary on a low or nil income, the capital gains tax liability can be significantly reduced.

Holding the assets of an estate within a trust offers the beneficiaries an opportunity to defer the need for the sale of assets (and therefore capital gains tax) until later when more numerous beneficiaries come into existence. Tax deferred is tax saved.

➤ **Beneficiary's inheritance can be protected from bankruptcy**

A testamentary trust can provide protection to your beneficiaries from the repercussions of bankruptcy.

Assets that pass to a testamentary trust from an estate are held for the nominated primary beneficiary until the trustee elects to distribute such assets. At law the assets are not owned personally by the beneficiary and therefore do not form part of the beneficiary's personal estate. A creditor or other person claiming against the beneficiary, therefore, cannot obtain the assets held in the trust.



➤ **Beneficiary's inheritance can be protected from family law claims**

A testamentary trust may also provide some protection for a beneficiary who is experiencing family law difficulties.

By providing for a beneficiary's entitlement to be held in a discretionary will trust, the primary beneficiary can isolate estate entitlements from personal assets. This may protect his/her estate entitlements from family law property proceedings.

➤ **Beneficiary's inheritance can be kept in the family**

A modern well drafted testamentary trust may also help your beneficiaries keep their inheritance from passing to non family members for example by providing that on their death the control of the testamentary trust passes to their children (rather than to a spouse)

Summary

By incorporating Testamentary Trusts in your Will your beneficiaries will be able to access numerous options which will help them protect their inheritance from loss through family law dispute or bankruptcy as well as providing strategies which can help them reduce/minimise the incidence of income and Capital Gains Taxes.

Properly drafted the use of Testamentary Trusts within your Will offers your beneficiaries flexibility and options not available with standard Wills which could result in significant advantages to your beneficiaries.

Further Questions?

If you want to talk to experts in preparing modern Wills containing testamentary trusts, please feel free to contact us if or if you wish to update or amend your Will.

