

## ***Estate Planning***

### **Testamentary Trusts Features & Operation**

#### **1. What is a Testamentary Trust?**

- (a) It is a trust established under a Will and it does not come into effect until after the death of the person making the Will.
- (b) The terms of the Testamentary Trust are similar (but not as extensive) as those contained in most family discretionary trusts. The trust terms are attached as a schedule to the Will.
- (c) Testamentary Trusts are useful where:
  - (i) the beneficiaries have potential liability issues (for example they have a business or are professionals);
  - (ii) the beneficiaries (surviving spouse or adult children) have children under 18;
  - (iii) the intention is to protect assets for children but still provide for the surviving spouse; or
  - (iv) there are a significant amount of assets in the estate.

#### **2. Benefits of Testamentary Trusts**

##### **(a) Asset Protection**

- (i) A Testamentary Trust can provide significant asset protection which will be important if the surviving spouse or an adult child is engaged in an occupation which carries significant risk of litigation or owns a business.
- (ii) Couples generally acquire assets in the name of the spouse who has the lower risk profile. However, if that person dies and leaves all their assets to the spouse with the higher risk profile, the family's assets may be vulnerable as a result of litigation.
- (iii) If instead, the Will provides that the assets are to be held in a Testamentary Trust, the surviving spouse can effectively have control of those assets and ensure that any income and capital from the estate is used for the benefit of the children and family members. They will not have direct ownership, which means that the assets themselves should be protected from litigation arising out of any business or investment risk of the surviving spouse.
- (iv) Also, parents of adult children who have high risk profiles will want the assets they leave to their child to be protected from the child's creditors.
- (v) Testamentary Trusts can also provide some protection for adult children in a matrimonial property settlement.

##### **(b) Income Splitting**

- (i) Although both testamentary and family trusts have similar features, such as the ability of the trustee to decide which beneficiaries of the trust will receive income, there are considerable taxation advantages for beneficiaries under 18 under a Testamentary Trust.



- (ii) Income received by beneficiaries who are under 18 from a family trust will be subject to maximum tax rates if that income exceeds approximately \$1,000.
- (iii) Under a Testamentary Trust, all beneficiaries including those who are under 18 receive the full income tax free threshold, and income above that amount is taxed at normal adult rates. This means that approximately \$6,000 can be distributed to each beneficiary free of tax per annum.
- (iv) This can be of significant benefit to beneficiaries who have children under 18 as they can pay expenses for their children (e.g. school fees) from the trust and the child is taxed. If the child has no other income, up to \$6,000 of these expenses could be paid tax free.
- (v) By dividing the income each year between family members, the beneficiary could significantly reduce the tax their family group will pay.

**(c) Flexibility**

- (i) A major benefit of establishing a Testamentary Trust in your Will is that you can create the terms of the trust to suit your particular circumstances.
- (ii) We can restrict access to the assets in a Testamentary Trust in appropriate circumstances, for example if the major beneficiary has an addiction or is unable to manage a significant inheritance.
- (iii) Testamentary Trusts can also include a right to income from an asset and a right to live in a house while preserving the assets for the ultimate beneficiaries (effectively a life interest).

**3. Who can be the Trustee of a Testamentary Trust?**

- (a) Anyone over the age of 18 can be the trustee, but usually the trustees are the executors of your Will. You can have more than one trustee.
- (b) The trustee has effective control of the trust, so the trustee should be a person whom you know and trust to act in the best interests of the beneficiaries.
- (c) The trustee of the Testamentary Trust can also be someone independent to protect beneficiaries if they cannot look after the assets themselves. In certain circumstances it may be appropriate for the surviving spouse/children not to be the sole trustee of their trust, or not to be a trustee at all.
- (d) For trusts established for adult children, all the children are usually the trustees of each of the trusts. However each child has the power to appoint themselves as the sole trustee of their own trust.

**4. Beneficiaries of Testamentary Trusts**

- (a) For a Testamentary Trust established for the surviving spouse, the main beneficiary will either be the spouse or the children (depending on whether the intention is to preserve the assets for the children) and your blood descendants.
- (b) Generally the Testamentary Trust is structured so that the trustee has full discretion to make distributions of capital at any time.
- (c) However Testamentary Trusts can be used to protect assets in the trust from future spouses.
- (d) The trust can be structured so that the children are the main beneficiaries of the trust and the surviving spouse can be an income only beneficiary. This means that the surviving spouse can decide how to distribute the income from the trust but the capital is preserved for the children.



- (e) For Testamentary Trusts established for adult children, the beneficiaries are usually the child, their children and their grandchildren. The spouses of these people are usually potential income beneficiaries.
- (f) This means that income can be distributed to them to reduce the tax that the child's family group will pay. However spouses do not have a right to a distribution from the trust unless the trustee decides to distribute to them.

#### **5. What to consider before establishing a Testamentary Trust under your Will**

- (a) There will be ongoing administrative costs involved in maintaining a trust once it has been established (after your death), such as accountancy fees for preparation of trust taxation returns and an annual financial planning review fee. However these are not significant expenses and are normally a legitimate trust expense.
- (b) Factors that you should take into account include whether:
  - (i) you hold significant assets;
  - (ii) the income generated by your estate would be sufficient to warrant a Testamentary Trust;
  - (iii) there are special needs such as a beneficiary with an intellectual disability or inability to manage money; or
  - (iv) the risk profile of a beneficiary justifies a Testamentary Trust as part of an asset protection strategy.
- (c) Testamentary Trusts can generally be wound up without consequences if the trustee decides it will be of no use.

#### **6. What if I already have a Family Trust?**

- (a) The assets of your family trust will not form part of your estate. If all of your assets are presently owned by your family trust, there would be no point in establishing a Testamentary Trust unless you planned to wind down your family trust or you are owed an amount by your family trust.
- (b) However, if it is likely your estate will have substantial assets in addition to those held in your existing family trust there may still be advantages in establishing a Testamentary Trust.

#### **7. Is it possible to set up a similar Trust after my death if I don't change my Will now?**

- (a) Yes, but there are limitations.
- (b) The beneficiaries of a "post-death Testamentary Trust" are essentially limited to your spouse and children, there is a time limit on establishing such a trust and a limit on how much can be transferred to the trust.
- (c) Your trustees also have less flexibility in dealing with income and capital of a post-death Testamentary Trust.

CPM 3584v1

*These comments and opinions are of a general nature and are based on Cooper Grace Ward's interpretation of the law as at the date the document was prepared. The position may alter if the law changes as a result of legislation, new rulings or cases. Clients contemplating establishing a trust should obtain specific advice on the implications of that strategy.*

