Estate planning

Testamentary trusts - features and operations

Key points

- A testamentary trust is a trust established under a Will, which only comes into existence after your death
- Testamentary trusts can be useful for a variety of reasons including asset protection, income splitting, financial management and matrimonial property disputes
- Unlike a normal family trust, all beneficiaries, including those under 18, receive the benefit of the full income tax free threshold

What is a testamentary trust?

1. A testamentary trust is a trust established under a Will, which does not come into effect until after the death of the person making the Will.

2. 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.

3. Testamentary trusts are useful where:

   (a) your beneficiaries (surviving spouse or adult children) have potential risk issues (for example they have a business or are professionals)

   (b) your beneficiaries have children under 18

   (c) your intention is to protect assets for your children but still provide for your surviving spouse

   (d) you would like to protect the assets in the testamentary trust from claims by spouses or partners if any of your children are involved in a matrimonial property dispute.

Benefits of testamentary trusts

Asset protection

4. A testamentary trust can provide significant asset protection, which will be important if your surviving spouse or an adult child is engaged in an occupation that carries significant risk of litigation or owns a business.

5. 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 exposed.

6. If instead, the assets are held in a testamentary trust, your surviving spouse can control the assets and ensure that any income and capital from the estate is used for the benefit of your children and family members but your spouse will not have direct ownership, which means that the assets themselves should be protected to some extent.

7. The same issues arise if adult children have high risk profiles.

8. Testamentary trusts can also provide some protection for adult children in a matrimonial property settlement – provided they do not have sole control of the trust.

Income splitting

9. Income received by beneficiaries who are under 18 from a family trust will be subject to maximum tax rates if that income exceeds $416.

10. Under a testamentary trust, all beneficiaries, including those under 18, receive the benefit of the full income tax free threshold, and income above that amount is taxed at normal adult rates. This means that approximately $20,000 can be distributed to each beneficiary free of tax each year.

11. This can be of significant benefit to beneficiaries who have children under 18 as they can effectively pay living and educational expenses for their children out of pre-tax income.

Flexibility

12. You can tailor the terms of a testamentary trust to suit your particular circumstances.

13. For example, you can restrict access to the assets in a testamentary trust in appropriate circumstances, such as where a major beneficiary has an addiction or is unable to manage a significant inheritance.

14. Testamentary trusts can also provide that a beneficiary has a right to live in a house while preserving the assets for the ultimate beneficiaries (effectively a life interest).

Who can be the trustee?

15. 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.

16. 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 all of the beneficiaries.

17. The trustee can also be someone independent to protect beneficiaries if they cannot look after the assets themselves. Sometimes it may not be appropriate for a surviving spouse or a child to be the sole trustee of their trust, or to be a trustee at all.

18. For trusts established for adult children, all the children are usually the trustees of each of the trusts. It is important to have more than one trustee if you want to give some protection for your children in a matrimonial property settlement. However, each child can have the power to appoint themselves as the sole trustee of their own trust.

Beneficiaries of testamentary trusts

19. For a testamentary trust established for a 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.

20. Generally, a testamentary trust is structured so that the trustee has full discretion to make distributions of capital at any time.

21. However, the trust can be structured so that the children are the main beneficiaries and the surviving spouse is an income only beneficiary.

22. This means that the surviving spouse can decide how to distribute the income from the trust but the capital is preserved for the children.

23. 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. 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.

What to consider before establishing a testamentary trust

24. There will be ongoing administrative costs involved in maintaining the trust after your death, such as accountancy fees and financial planning fees. However, these are generally not significant.

25. Factors that you should take into account include whether:

    (a) you hold or your estate is likely to involve significant assets (including possibly life insurance or superannuation)

    (b) the income generated by your estate is likely to be sufficient to warrant a testamentary trust

    (c) there are special needs such as a beneficiary with an intellectual disability or inability to manage money

(d) the risk profile of a beneficiary justifies a testamentary trust as part of an asset protection strategy.

26. Testamentary trusts can generally be wound up without tax or duty consequences if the trustee decides it will be of no use.

What if I already have a trust?

27. The assets of your existing trust will not form part of your estate. If all of your assets are presently owned by your trust, there may be no point in establishing a testamentary trust unless you plan to wind down your existing trust or the trust owes you a significant amount.

28. However, if it is likely your estate will have substantial assets in addition to those held in your existing trust there may still be advantages in establishing a testamentary trust.

Is it possible to set up a similar trust after my death if I don't change my Will now?

29. Yes, but there are limitations:

(a) The beneficiaries of a ‘post-death testamentary trust’ are essentially limited to your spouse and children.

(b) There is a time limit on establishing such a trust.

(c) There is also a limit on how much can be transferred to the trust.

30. Your trustees also have less flexibility in dealing with income and capital of a post-death testamentary trust.