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What is a Testamentary Discretionary Trust?

Estate Planning Information Sheet

What is a Testamentary Trust?

A Testamentary Trust is a Trust established by a Will. It starts to operate on the death of a Willmaker and its terms are set out in the Will. The terms of a Testamentary Trust can be tailored to suit the Willmaker's circumstances, including those members of the Willmaker's family that the Willmaker wishes to benefit from his or her estate.

A Testamentary Trust may be created using specified assets, a designated portion of your estate or the entire remaining balance of your estate. Multiple Trusts may be created by the one Will.

Who controls the assets?

Whoever is named in the Will as trustee controls the assets of the Testamentary Discretionary Trust. Like any Trust, a Testamentary Discretionary Trust can be drafted with as much flexibility as desired. The trustee can be given full discretion or no discretion as to who should receive income and capital from the Testamentary Discretionary Trust and when they should receive it.

The trustee may be the same person who was appointed as Executor, and can also be a beneficiary. For example, a parent can establish a Testamentary Discretionary Trust for each child's inheritance. Each adult child can be the trustee of their own Trust, and may also be an Executor.

Why use a Testamentary Discretionary Trust?

The main reasons why leaving an inheritance to a beneficiary in a Testamentary Discretionary Trust is better than a simple outright gift of the inheritance to the beneficiary are:

- Greater flexibility for the beneficiary to undertake their own estate or succession planning.
- Increased asset protection.
- Taxation advantages.

Flexibility for your beneficiaries

The trustee may distribute capital and income to any nominated beneficiary at any time and in any proportion. The Trust can be wound up at any time or kept open for an extended period of time. A Testamentary Discretionary Trust gives the beneficiaries both flexibility and control over when they take their inheritance.

Asset Protection And Estate Planning

Most people are more than happy to receive an inheritance. However, for those who have put in place asset protection strategies or who could be facing any form of litigation, directly receiving an inheritance can cause significant unnecessary difficulties.

People in financially high risk occupations, such as professionals, business owners and company directors, will often prefer not to receive inherited assets directly in their own names.

One solution is to ensure that parents and others who intend to leave assets to such at risk individuals put in place appropriate estate planning arrangements through their Wills.

Below is an example of inappropriate estate planning for an at risk individual:

- Margo was a neurologist in private practice.
- She had deliberately ensured that most of her assets were in her husband's name. This way, if she was ever sued, their home and investments would be protected.
- Unfortunately, when Margot's parents died, she received a direct gift of the family home.
- There is always the chance of a claim being made against Margot due to the high risk area she works in.

- To protect the home from any future litigation, Margo transfers it to a Family Trust and pays $75,000 stamp duty.
- The stamp duty expense (and any capital gains tax, legal and accounting fees) could have been avoided if Margot's parents had included a Testamentary Discretionary Trust in their Wills for her benefit.

Protecting Inheritances From The In-Laws

Many parents are concerned that the inheritance they leave to their children could end up in the hands of a former son-in-law or daughter-in-law if their child's marriage breaks down. The Family Court also has jurisdiction over de-facto relationships (in most States) and the following comments apply to failed relationships and failed marriages.

If a child receives an inheritance in their own name that inheritance will generally be intermingled with the child's other assets (e.g. by paying off a house mortgage). The inheritance will therefore become "matrimonial property" available for distribution by the Family Court if the child's marriage or relationship fails.

However, if a child's inheritance is held in a properly drafted Testamentary Discretionary Trust, those assets can be kept separate and protected from becoming available to the ex-spouse.

How successfully the assets are protected depends on how the Will and the Testamentary Discretionary Trust are drafted and the circumstances at the time of the relationship breakdown.

Example 1:

- When Gus died he left his only son Tom an inheritance of $1,000,000.
- Tom had been married to Frances for 12 years at the time but they separated shortly after.
- Tom and Frances' matrimonial property amounted to $900,000 after the mortgage was taken into account.
- In determining the property settlement, the Family Court took into account Tom's inheritance. However, because Tom's inheritance was held in a well drafted Testamentary Discretionary Trust, the inheritance was not available for distribution to Frances.
- Frances got $550,000 (that is, slightly more than half the matrimonial assets) rather than the $950,000 she might have otherwise received. In other words, Frances received approximately half of the matrimonial property but no part of Tom's inheritance.

Taxation Advantages

The trustee of the Testamentary Discretionary Trust, usually the child or other beneficiary ("primary beneficiary") that the Willmaker intends to mainly benefit from the Trust, is entitled to distribute the income generated by the inheritance in the Trust among the other Trust beneficiaries in whatever amounts or proportions the trustee decides. This is mainly done for tax planning reasons to reduce the overall amount of tax payable on the Trust income compared to the tax that the primary beneficiary would be required to pay if the inheritance was gifted to and invested by the primary beneficiary in his or her own name.

An important tax concession for income that is distributed by a Testamentary Trust to a child under 18 is that the child is taxed at normal adult rates (with up to $18,200 per annum tax free from the start of the 2012/13 tax year) rather than at penalty tax rates. Where additional income, above the threshold, is distributed to the child then normal tax rates apply to that income.

The child's share of the income can be applied by the trustee of the Testamentary Trust for the child's education, recreation and other daily living or other needs rather than actually being paid to the child.

Example 2:

Jim and his wife have incomes that give them both the second top marginal rate tax of 38.5% (including Medicare levy) for the 2012/13 financial year. They have three children under 18, none of whom has a personal income.

Jim is about to inherit $400,000 in a combination of shares, managed funds and fixed interest securities. The anticipated annual investment returns from the inheritance are:

Interest	$10,000
Dividends	$10,000
Imputation credits	$ 3,000
Distributions	$ 7,000
Taxable income	$30,000

From this income, the cash received will be $27,000.

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Jim compares how much disposable cash his family will have each year if the $400,000 is inherited directly by him or through a Testamentary Discretionary Trust.

Scenario 1: Jim inherits in his own name.

Tax on $30,000 (38.5% tax rate)	$11,550
Cash received	$27,000
Less tax	$11,550
Disposable cash	$15,450

Scenario 2: Jim inherits as trustee of a Testamentary Discretionary Trust.

Jim can allocate the Trust's income to the three children in equal shares. The taxable income for each child is $10,000.

Tax on $10,000	$ nil
Less imputation credits	$ 1,000
Tax refund for each child	$ 1,000
Cash received	$27,000
Add tax refund for all three children	$ 3,000
Disposable cash	$30,000

In summary, the disposable annual cash return is:

- Direct inheritance by Jim (Scenario 1): $15,450
- Testamentary Discretionary Trust (Scenario 2): $30,000

The difference is $14,550, which is the after-tax cash saving of using the Testamentary Discretionary Trust. If Jim's inheritance can be taken in a Testamentary Discretionary Trust, Jim and his family will have an additional after-tax income of $14,550 each year. This example applies to the 2012/13 tax year and assumes there will be no change in Jim's tax rate regarding the total income he receives (i.e. inheritance income and other income).

Disclaimer: This information sheet is for general information only and should not be relied on as, or substituted for, professional legal advice.