



An Introduction to Trusts Part 2 – Testamentary Trusts

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Overview

Testamentary Trusts are not new and have re-emerged as an effective Estate Planning tool. Through the careful drafting of a Will including a Testamentary Trust a client may achieve their Estate Planning objectives in respect to estate preservation, distribution and management.

What follows is an overview of a Family Discretionary Testamentary Trust.

Testamentary Trusts

A Testamentary Trust is a Trust established by a Will that comes into effect upon the death of a Client. The term “Testamentary Trust” is used to describe a number of forms of Trusts that result from the death of a client including:

- Discretionary Family Testamentary Trusts;
- Protective Trusts;
- Proceed Trusts in respect to:
 - Superannuation;
 - Life Insurance; or
 - Other Estate Assets; and
- Discretionary life interest trusts.

The most common type of Testamentary Trust is Discretionary Testamentary Family Trust. A Discretionary Family Testamentary Trust is a Trust whereby a Trustee holds assets on Trust for the benefit of one or more Beneficiaries

and their related Beneficiaries and legal entities.

Establishment and Control of a Discretionary Family Testamentary Trust

A Discretionary Family Testamentary Trust is created by a Will. In order for a Beneficiary to have the option of a Discretionary Family Testamentary Trust, the Will must specifically provide for its establishment upon the death of the client. If no such provision is included in the Will then the assets of the estate will immediately to the nominated Beneficiaries without the flexibility of the Discretionary Family Testamentary Trust.

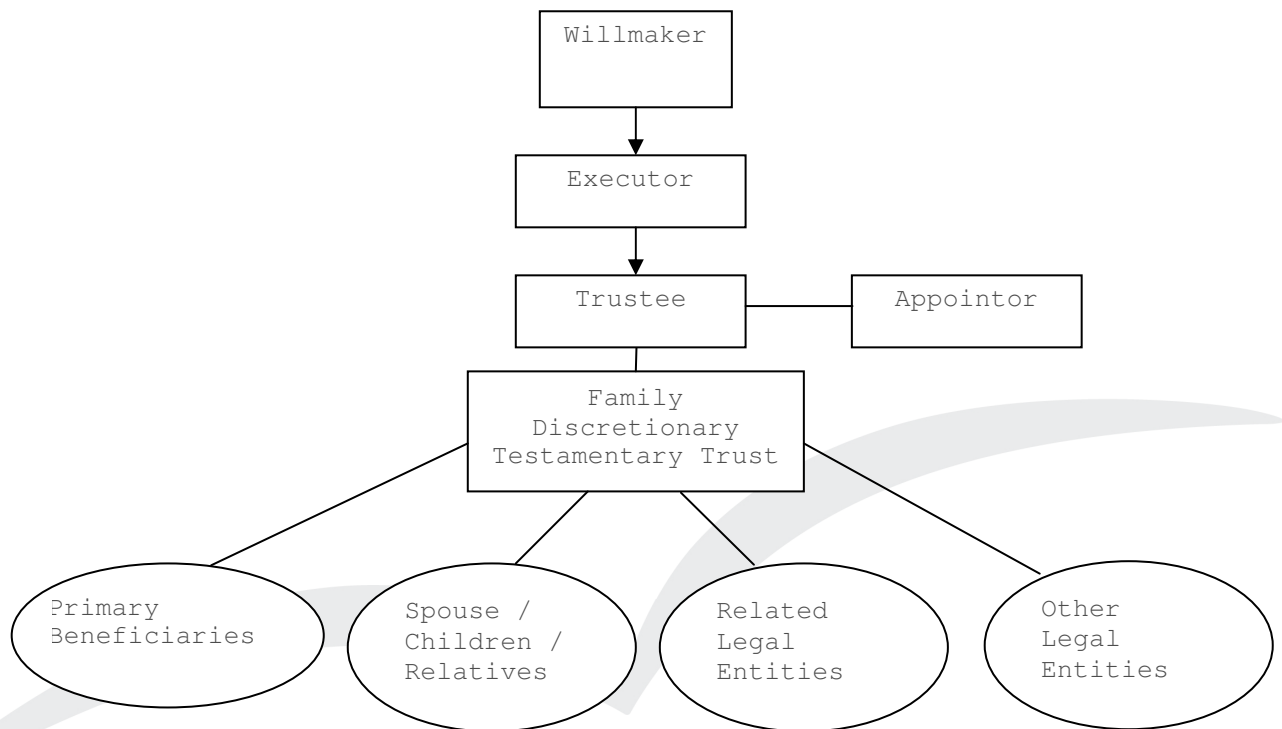
The Will usually sets out who is to have ultimate control of a Discretionary Family Testamentary Trust. The Discretionary Family Testamentary Trust is managed by the Trustee and all decisions regarding the management of the Trust are made by the Trustee. Effective control of Trust rests with the person or persons who have the power to remove and appoint the Trustee. The person is usually called the Appointor or Guardian. The power to appoint or remove a Trustee is referred to as the power of appointment.

- Typically, one of the Beneficiaries of the Estate is usually the Trustee and holds the power of appointment. However, the Trustee and the Beneficiary



can be different people. Benefit and control of a Discretionary Family Testamentary Trust may be separated where the client does not want the Beneficiary to have complete control of the Trust. This could occur

where the Beneficiary is suffering from a legal disability (See next weeks Strategy Update in respect to Protective Trusts) or is likely to be unable to appropriately manage the Trust.



In the absence of any specific restrictions imposed by the Client on the Beneficiary, a Beneficiary generally has the choice of whether to invoke the Discretionary Family Testamentary Trust upon the Client's death.

If a Beneficiary elects to establish the Discretionary Family Testamentary Trust, the Beneficiary can subsequently end the Trust and take the assets of the Trust personally. However, careful planning and advice should be obtained prior to the vesting of a Trust that has been established.

Beneficiaries of a Discretionary Family Testamentary Trust

The Beneficiaries of an Estate who are given the option of taking their entitlement as Beneficiaries of a Discretionary Family Testamentary Trust are usually termed "Primary Beneficiaries".

In addition to the primary Beneficiaries of the Trust, the Will should provide for a class of additional Discretionary Beneficiaries who can receive income and capital to the Discretionary Beneficiaries.



To maximise flexibility, the class of Discretionary Beneficiaries should be drafted widely and should include immediate family and other relatives of the primary Beneficiary. In addition, other potential Discretionary Beneficiaries such as associated Trusts, charitable organisations and related corporate entities should also be included.

To ensure that the Trust does not fail for uncertainty, care should be taken to ensure the class of Discretionary Beneficiaries are not too wide.

Examples of potential Beneficiaries of a Discretionary Family Testamentary Trust include:

- The primary Beneficiary;
- The primary Beneficiary and the primary Beneficiary's spouse, children, grandchildren and relatives;
- Related Legal Entities, Corporates and Trusts; and
- Other Legal Entities - including religious, charitable and educational institutions.

Family Trust elections are an important consideration when determining the Beneficiaries. Such an election, if made, will narrow down the choice of Beneficiaries for practical purposes.

The Will should not allow for the definition of Discretionary Beneficiaries to be amended. This prevents the Will infringing the rule against the delegation of Testamentary capacity. This is also a concern for distributions made from an Estate directly to an existing Discretionary Trust. The Trust Deed should clearly state that the definition of Beneficiaries cannot be altered.

The Will should also contain broad definition in respect to:

- Spouse - spouse should be defined to include defacto partners, and partners of the same gender.
- Children - where applicable children should include stepchildren, adopted children, ex nuptial children and children of a spouse.

Once again, the impact of a Family Trust election will need to be considered. A family group for the purposes of a Family Trust election would not include a partner of the same gender or adopted children.

Duration of a Discretionary Family Testamentary Trust

Once established, in most jurisdictions, a Discretionary Family Testamentary Trust has a maximum life span of 80 years. This should be drafted to allow the Trustee the discretion to end the Trust at any time prior to the expiration of the 80 year period.

Establishment of more than one Trust

Where the Client is leaving their Estate to more than one primary Beneficiary, the Will should make provision for each Beneficiary to take their entitlement as Trustee and Beneficiary of a separate Trust. This avoids the problem that may arise where one Discretionary Family Testamentary Trust is jointly controlled by children, and enables each Beneficiary to deal with their respective entitlements in a different manner.

For example, one Beneficiary may choose to leave the Discretionary Family Testamentary Trust in place while another may terminate the Trust and take the entitlement personally, while a third



Beneficiary may elect not to invoke the Trust at all. No consultation is required between Beneficiaries.

Future control of Discretionary Family Testamentary Trust

A Discretionary Family Testamentary Trust may outlast the primary Beneficiary. It is therefore important for the primary Beneficiary, as part of their Estate Planning, to provide for the succession of control of the Discretionary Family Testamentary Trust. This can be provided for in the Beneficiary's Will or by a separate Deed prepared during the lifetime of the primary Beneficiary.

Discretionary Family Testamentary Trust Benefits

The establishment of a Discretionary Family Testamentary Trust provides a Beneficiary of an Estate with maximum flexibility in dealing with an entitlement. The usefulness of a Discretionary Family Testamentary Trust to a Beneficiary depends upon their specific needs and objectives relating to their particular circumstances.

Income Tax Savings

Generally, minor children are subject to penalty rates of tax on unearned income. The tax free threshold extends to a maximum of \$416 and the amount between \$416 to \$1,455 the minor will be taxed at 46% and any excess is taxed at 47%.

This taxation regime is subject to certain exceptions, one of which relates specifically to income generated by a Trust that is created by a Will or Codicil.

Penalty rates of tax do not apply to "Excepted Trust Income", which includes assessable income of a Trust Estate that resulted from a

Will, Codicil or Intestacy, or a court modification of a Will, Codicil or Intestacy. When combined with a carefully drafted Discretionary Family Testamentary Trust, this allows for the tax effective treatment of Estate Income.

Note also that s102AE of the ITAA provides that adult tax rates will apply to investment earnings resulting from Bequests to minors.

A Discretionary Family Testamentary Trust allows for the splitting of the income generated by the Discretionary Family Testamentary Trust among the potential Discretionary beneficiaries of the Trust.

As mentioned previously, the Trustee of the Discretionary Family Testamentary Trust has complete discretion to determine who receives the income of the Discretionary Family Testamentary Trust. The Trustee may determine to distribute income to the primary Beneficiary or to any one or more of the Discretionary Beneficiaries 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 Beneficiaries. The Trustee may determine to distribute income to the primary Beneficiary or to any one or more of the discretionary Beneficiaries of the Trust.

The Trustee should always be aware, however, that once the income is allocated to a Beneficiary of a Discretionary Family Testamentary Trust, the Beneficiary has a legal entitlement to the amount allocated.



The Trustee can also distribute income from the Trust to charitable and religious Beneficiaries. If such Beneficiaries have tax deductibility status or are tax exempt, no tax is paid on allocations to such organisations.

The taxation treatment of a Discretionary Family Testamentary Trust should be distinguished from an Inter Vivos or lifetime Trust set up by the deceased during his/her lifetime. If a Beneficiary of such a Trust is under the age of 18 years, then any Trust income allocated to the Beneficiary is taxed at a penalty rate over and above an initial tax free threshold of \$416 (\$1,667 including the low income rebate). Superannuation pensions should be considered in some circumstances.

Capital Gains Tax (CGT)

A Discretionary Family Testamentary Trust also provides the opportunity to minimise the incident of CGT liability if an asset of the Discretionary Family Testamentary Trust is subsequently sold.

As with the income of the Trust, the Trustee can select which of the Discretionary Beneficiaries of the 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.

Protection from Insolvency and other Liabilities

Discretionary Family Testamentary Trusts also potentially provides protection from the repercussions of insolvency and other potential liabilities.

Assets that pass to a Discretionary Family

Testamentary Trust from an Estate are held for the nominated primary Beneficiary until the Trustee elects to distribute such assets. The assets are not owned personally by the Beneficiary and therefore do not form part of the Beneficiary's personal Estate. A creditor or the other person claiming against the Beneficiary should not accept the role of the Trustee but nominate another person or entity to act on his/her behalf.

The Trustee would administer the Trust Fund on the primary Beneficiary's behalf until such time as the primary Beneficiary is discharged from bankruptcy or settles other claims against him/her. The primary Beneficiary could then assume the Trusteeship of the Trust.

Preservation of Age Pension Entitlements

Assets held by a Trust over which an aged pensioner has control or into which a pensioner has transferred assets will be assessable in respect to the means test.

The relevant provisions dealing with the Centrelink treatment of Trusts are contained in Pt 3.18 on the *Social Security Act 1991*.

Pursuant to Pt 3.18, Trusts in general will be subject to two separate tests of attribution:

- A control test; and
- A source test.

The basis of the control test is that the controller of a structure should be considered for the defacto owner of the assets of the structure. Control can be both formal (where a pensioner controls the structure personally) or informal (where the structure is controlled on behalf of the pensioner).



The source test will attribute the structure's assets to the pensioner where that person transfers assets to the Trust for inadequate consideration or has provided services to the structure for inadequate remuneration.

Impact of Rules

If the Trust is a Testamentary Trust activated as a result of a person's spouse dying on or before 31 March 2001, the Trust assets and income will be attributed to the formal controller of the Trust. If the Trust is being administered for the benefit of the surviving spouse and if the surviving spouse is exercising informal control, attribution will be to the surviving spouse and the assets will be assessed for the means test.

Where Testamentary Trusts are activated as a result of death after 31 March, 2001, the surviving spouse will be attributed with the assets and income of the Trust if:

- The surviving spouse directly controls the Trust (irrespective of whether they are a Beneficiary), or
- An associate has control and the surviving spouse is a potential Beneficiary.

The rationale for the rules is that if a surviving spouse has direct control of a Trust, they can exercise their discretions as Trustee to benefit themselves. Further, if an associate for example a family member or professional adviser has control and the surviving spouse is a potential Beneficiary, it is reasonable to expect that the surviving spouse will share in the benefits of the Trust. Hence the importance of drafting Discretionary Family Testamentary Trusts to ensure that recipient Beneficiary that

is a pensioner does not have control.

Family Law Protection

A Discretionary Family Testamentary Trust may also provide some limited protection for a Beneficiary who is experiencing family law difficulties.

By providing for a Beneficiary's entitlement to be held in a Discretionary Family Testamentary Trust, the primary Beneficiary can isolate Estate entitlements from personal assets. This may protect their Estate entitlements from family law proceedings.

Caution should be exercised so as not to overstate the protection a Discretionary Family Testamentary Trust provides to a Beneficiary experiencing family law problems. If a Beneficiary has family law difficulties at the time of receiving their inheritance or at some time shortly after the receipt of the inheritance, as a general rule, the Beneficiary's spouse may have limited access to the funds.

This is largely due to the way in which the Family Court approaches the division of marital property. It should be remembered that the family law property jurisdiction is highly discretionary. The court will analyse the "fairness" of a settlement by looking at the total assets and financial resources which each party is left with or has access to. The court not only readily looks behind the "corporate veil", it tends to shred it.

The Family Court also has the power under the *Family Law Act 1975* to make Orders against third parties and can override the terms of a Trust. This may result in the court making an



order weighted against the party who has an interest in a Discretionary Family Testamentary Trust or, in some circumstance, a division of the asset of that Trust.

Technically, the first issue for the Family Court is to analyse the respective contributions of each party to the creation of the marital wealth. In most cases, the Beneficiary's spouse will be unable to prove a contribution to the inheritance and so the court will be slow to directly give the other party a share of that inheritance.

The second issue for the court is likely relative needs of the parties in the future. In determining this matter, the court will take into account that the Beneficiary has access to the inheritance as a source of wealth. This may have an impact on the way in which the court divides the balance of the marital assets, excluding the inheritance. For example, if the Beneficiary has a large inheritance, he or she may not need as much of the marital assets to support himself/herself and so the other party may get more.

To be certain that a Discretionary Family Testamentary Trust provides protection, the Will will need to be drafted to carefully to ensure that the primary Beneficiary does not have

control of the Trust. This would mean:

- Not appointing the Primary Beneficiary as Trustee of the fund;
- Removing any provisions that allows the Primary Beneficiary to assume the Trusteeship in future;
- Ensuring that the Primary Beneficiary does not hold the power to remove and appoint the Trustee; and
- Not allowing capital to be distributed to the Primary Beneficiary.

This may make the Discretionary Family Testamentary Trust less attractive to the Beneficiary as control of the fund is largely removed from them.

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