

BACKGROUND

A testamentary trust is simply a trust established pursuant to a will. Most testamentary trusts are similar to 'normal' discretionary trusts established during the life time of a person, complete with classes of potential beneficiaries, extensive powers and unfettered discretions given as to distributions to the trustees of income and capital.

TRUST OVERVIEW

A trust is in effect simply a legal relationship where there is:

- a. a legal owner of property (the 'trustee');
- b. who holds the property ('trust property');
- c. for the benefit of others (the 'beneficiaries'); and
- d. pursuant to certain terms or rules ('trust deed').

Diagrammatically, the structure of a trust is represented below.

TRUSTEE



TRUSTEE
Controller



TRUST PROPERTY
Assets held in trust by trustee for beneficiaries



THE BENEFICIARIES
Potential to benefit



TRUST DEED
Rules

The trustee of the trust is the legal owner of the property. The trustee will therefore have the ultimate control over the assets of the trust.

The trustee can be a company or one or more individuals. Where the trustee is a company the directors of the company will have the day to day control of the trust.

Although the trustee is responsible for the day-to-day running of the trust, many trusts also have a 'principal' (also commonly known as an appointor, guardian or nominator) who retains ultimate control over the trust. The principal has the ability to appoint and remove the trustee at any time, and its consent may be required to make any amendments to the trust deed.

If the trust deed or will does not name a principal, the existing trustee will usually have the power to appoint a new trustee.

BENEFICIARIES

The discretionary trust structure enables income that is earned by the trust to be distributed to the beneficiaries of the trust in such proportions as the trustee decides.

Normally, there are a large number of beneficiaries set out, including (for example) a mother and father, their children and grandchildren, any brothers or sisters of any one mentioned before, any other trust in which any of these people are potential beneficiaries, any company in which any of these people hold any interest etc. These people are normally referred to as 'discretionary beneficiaries'. The main reason for including a large number of discretionary beneficiaries is to allow the trustee maximum flexibility when distributing income.

The trustee has the ability to decide the proportions in which the income of the trust is distributed among these potential beneficiaries on the basis of what will be appropriate given the needs of the beneficiaries and what is most tax effective in any given year.

Normally there will be one or two people who have an expectation of receiving income from the trust. These people are commonly referred to as the 'primary beneficiaries'.

TRUST DEED

Every trust is governed by a trust deed. This sets out how the trust must be run, what the trustees can do in running the trust and who the beneficiaries are. Discretionary trusts have been used as a tax effective asset owning vehicle for a long time. Consequently, there are a large number of trusts that are governed by trust deeds that were drafted when the tax and trust laws were significantly different.

As mentioned above, testamentary trusts are established under a will with the rules of the trust normally set out in the will itself.

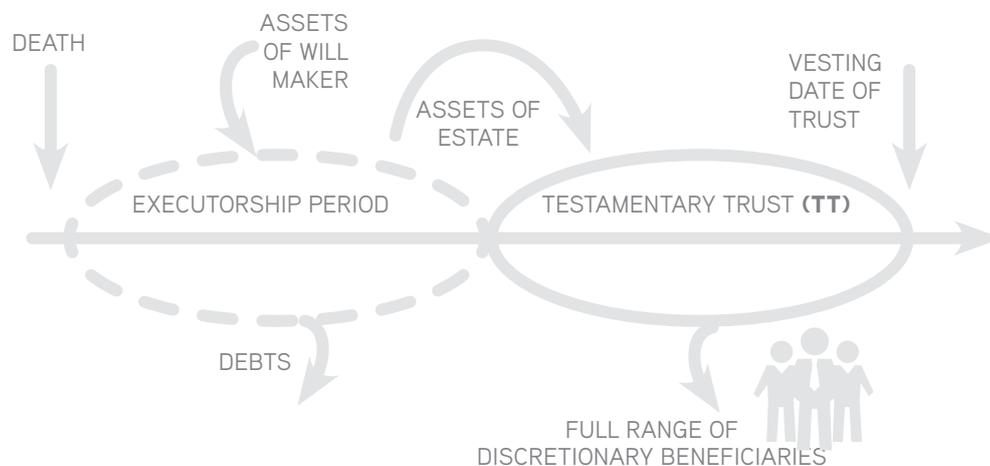
It is necessary to review a trust deed periodically to ensure that it allows the trustees to operate the trust in the most tax effective way.

It is also important to review the terms of the trust deed carefully with particular reference to issues such as:

- a. the vesting day (or ending day) of the trust. In all Australian states, other than South Australia, the maximum length of time a trust can last for is essentially 80 years;
- b. whether there is a 'principal'. As mentioned above, this person or entity has the ability to remove and appoint trustees in their total discretion;
- c. the powers the trustee has in relation to administering the trust. For example, often trustees may not have the ability to grant options in relation to trust property; and
- d. what provisions apply in the event a trustee fails to make a distribution.

TESTAMENTARY TRUSTS

A timeline of the administration of an estate and testamentary trust is summarised in the diagram below.



Essentially, the estate is administered by the executor, concluding with the designated assets or portions of the estate then held by the trustee of the testamentary trust.

Generally, testamentary trusts are seen as particularly useful in the following circumstances:

- a. to ensure concessional tax treatment is available to distributions of capital and income to infant beneficiaries;
- b. to protect accumulated wealth from wastrel or spendthrift beneficiaries;
- c. to provide for infant children and disabled beneficiaries;
- d. to help protect inheritances from attack by the Family Court and trustees in bankruptcy; and
- e. avoiding an unintended loss by a beneficiary of their government sourced pension or other benefits (there is limited scope for this).

Often testamentary trusts are structured to limit the range of beneficiaries to 'lineal descendants', whereby the will maker restricts the discretionary powers of the trustee so they may only distribute income or capital (or both) to the will maker's children and grandchildren, excluding any spouse of the children and/or grandchildren.



WHY USE A LINEAL DESCENDANT TRUST? (LDT)

A lineal descendant testamentary trust is a trust established in someone's will for the benefit of their lineal descendants – children and grandchildren, and so on down the lineal family tree.

Many parents are concerned that the inheritance they leave to their children could end up in the hands of a son-in-law or daughter-in-law if their child's marriage breaks down. A properly drafted LDT can assist in keeping an inheritance out of the reach of the Family Court where a beneficiary is involved in a family law property dispute.

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 mortgage) and, thus, will become 'matrimonial property' available for distribution by the Family Court.

However, if each child receives their inheritance in a separate LDT, those assets can be kept apart and protected from direct distribution.

How successfully the assets are protected depends on how the will and LDT are drafted, and the circumstances at the time of drafting and when a relationship of a beneficiary breaks down.

ESTATE PLANNING AND ASSET PROTECTION

For those who have put in place 'asset protection' strategies or who could be facing bankruptcy, receiving an inheritance can cause a problem. People in financially high risk occupations such as professionals, business owners and company executives, will often prefer not to receive inherited assets in their own name.

If an estate is left to an individual absolutely then it is their property and can be jeopardised by their financial position at the time of the will maker's death, or at any time in the future. Should a person suffer matrimonial or financial misfortune, the testamentary trust provides a facility whereby the inheritance can be protected.

TAX PLANNING

In Australia, death is not viewed as a tax planning strategy. It is, therefore, possible to draft a testamentary trust so as to ensure that any income allocated to minor children is not subject to the same tax rates as if it were a trust established during a person's lifetime. In particular, under a family trust created during a person's life the first \$400 distributed to a child is tax free but then any further income is taxed at the highest rate, which in some circumstances can be as much as 66%.

Income derived by infant children via a testamentary trust however is assessed at the normal, individual adult rates (each infant beneficiary can receive over \$20,000 of income tax free and the balance taxed at marginal rates) which for most families will mean significant tax planning opportunities.

Furthermore, there can be other tax advantages such as the use of corporate beneficiaries, distributing to infant children in subsequent generations and the fact that the anti-avoidance provisions under section 100A do not apply to testamentary trusts.

OTHER BENEFITS

In addition to the tax planning and asset protection benefits outlined above, appropriately structured testamentary trusts can also achieve numerous other objectives including:

- a. protecting assets from creditors, which can be a particularly important advantage where potential beneficiaries are company directors, business owners or professionals;
- b. facilitating 'generation skipping' by ensuring that the majority of wealth passes to a will maker's grandchildren, as opposed to their children;
- c. providing a structure within which it is possible to provide disproportionately for particular beneficiaries, for example, the trustees could have discretion to increase entitlements for those beneficiaries with special needs and decrease distributions to spend thrift or 'at risk' beneficiaries; and
- d. creating the ability to structure multiple testamentary trusts under a single will, with each trust tailored to achieve particular objectives in relation to the intended beneficiaries of that trust.

The above summary is based on the law as at 16 February 2023.

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