



# WILLPOWER PLUS

## Discretionary Testamentary Trusts



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## Discretionary Testamentary Trusts

A properly prepared discretionary testamentary trust can be valuable to the will-maker's beneficiaries. It is therefore an important part of a comprehensive estate plan. But first:

### 1. *What is a testamentary trust?*

A testamentary trust is an arrangement made in a will where one person, the trustee, is entrusted to keep (part or the whole of) the will-maker's estate for certain beneficiaries. A common example of a simple testamentary trust is where a parent leaves the whole or part of his/her estate to a trustee to hold for the will-maker's children until the children attain a certain age (such as 18 years or older).

### 2. *What are the benefits of a testamentary trust?*

There are different types of testamentary trusts, and each has its own benefits. The benefits can include the following:

**2.1. There is a preferential tax treatment for minor beneficiaries.** Usually, where the unearned income of a minor exceeds \$416 there is a prohibitive tax rate (which can be as high as 66%) that applies to the excess income. If the unearned taxable income is received by a resident minor through a testamentary trust, the income is taxed at the same rate as applies for an adult. \$18,200 is tax free and the top marginal tax rate does not apply until the income exceeds \$180,000.



Assuming the will-maker leaves a spouse and two children who are less than 18 years of age, and that the spouse and children have no other income, a testamentary trust can distribute income of \$56,000 p.a. to the family before any tax is payable. The top marginal rate will only apply when the total income exceeds \$540,000 p.a.

The advantages are also available to adult beneficiaries with little or no income. The benefits are equally available to grandchildren, nieces/nephews, cousins, and so on, provided the beneficiary is a resident minor, or has little



or no income.

The tax savings vary depending on factors such as:

- the size of the inheritance
- the income (and marginal tax rate) of the intended beneficiary
- the rate of investment return, actual or notional, and
- the number of minors or low income dependants of the intended beneficiary.

**2.2. With a beneficiary controlled discretionary testamentary trust the principal beneficiary controls the continued operation, rearrangement or dissolution of the trust.** This may be important because a beneficiary may decide to rearrange a trust to reduce the administrative work involved in the operation of the trust, or dissolve it if it is no longer offering real benefits. This control feature means that the beneficiary can use the trust to achieve his or her optimal outcome with the inheritance.

**2.3. With a discretionary testamentary trust, it is possible to target a beneficiary who will obtain the most advantage or incur the least disadvantage from the trust funds.** An example is a beneficiary who can get the most tax benefit: see 2.1 above. Another example is a beneficiary in need. Alternatively, a person who could be disadvantaged by a gift (such as a means tested pensioner) can be excluded, so as to not disadvantage that person.

**2.4. Because trusts are often considered the ideal vehicle for protecting assets, a protective testamentary trust can protect assets against unwanted claims.** Sometimes a potential beneficiary will not want assets in his or her own name. This may be because the person works in a high risk occupation. It may be due to more direct financial concerns, such as bankruptcy. It may be

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because of family breakdowns or to help resist 'gold digger' claims, and the like.

2.5. A protective testamentary trust is useful where there are issues around capacity, especially financial capacity. Examples are potential beneficiaries suffering bipolar disorder or schizophrenia. Also, a protective testamentary trust can assist where there are issues of impaired will, due to addictions (like gambling, alcohol, drugs, and the like), age or other factors.

In addition, some potential beneficiaries are particularly vulnerable to manipulation, exploitation or flattery. A testamentary trust can be tailored to protect vulnerable or incapable beneficiaries.

### 3. What are the potential disadvantages of a discretionary testamentary trust?

There are different views on what constitutes a disadvantage but some issues that can be perceived as disadvantages include:

3.1. **The greater cost of preparing the will.** The cost is greater because there is considerably more work involved in putting a discretionary trust in a will. Extra work means extra cost. This cost is born by the will maker.



3.2. **A greater administrative cost with a testamentary trust.** More work is required with the administration of a testamentary trust. For instance, separate tax returns are required. Also, depending on the person chosen as the trustee of the trust, the trust may need to pay the trustee for its time in acting as the trustee. Specialist tax advice may be needed to obtain the maximum benefit for the trust. These costs are born by the intended beneficiary, but the comments at 2.2 should be born in mind.

3.3 **The loss of tax exemptions or dispensations.** For instance, there may be a CGT event on the winding up or distribution of assets from the testamentary trust. Because the land tax threshold doesn't apply to land owned by a testamentary trust, land tax is paid on the whole of the value of any land owned by the trust.

3.4. **There may be an increased likelihood of a family provision claim.** This is perceived to be the case but it is highly debateable.



3.5. **It is not the best vehicle to run a business or hold negatively geared assets.** Neither of these are likely to occur with most testamentary trusts.

### 4. Can the benefits of a testamentary trust be obtained in any other way?

There is a partial substitute, which is called an estate proceeds trust. This must be created within 3 years of the deceased's death. It is only available if certain conditions are met. Because of changes in the law in 2010, these conditions are less likely to be met than previously. There are often additional costs in establishing such a trust in comparison to the cost of establishing a discretionary testamentary trust (such as stamp duty).

However, whilst an estate proceeds trust is a poor alternative to a testamentary trust, it should be considered where ever a minor inherits a substantial amount of assets without there being a discretionary testamentary trust in the will.

### 5. Is a properly drawn testamentary trust useful? Undoubtedly yes. Is it a panacea for all problems? No.

A respected colleague says that a testamentary trust is "what every baby boomer needs in the 21<sup>st</sup> century". There is no doubt that a testamentary trust is an important part of many estate plans. But it is only a part of a comprehensive strategy. It should not be considered in isolation. It should be considered with other important documents, including a binding death nomination, a detailed Power of Attorney, a Deed of Mutual Wills, and other relevant documents and arrangements.



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