



## **TESTAMENTARY TRUSTS**

The term 'Testamentary Trust' refers to any trust established by a will, but has in recent years been commonly used to describe what is usually a discretionary family trust established under a will.

The popularity of such a structure arises from the considerable benefits that can flow from the possibility of a potential beneficiary controlling the assets of the trust, but such assets not forming part of that beneficiary's estate.

### **Bankruptcy**

In recent years the incidence of bankruptcy in our society has increased significantly. One spouse will often guarantee borrowings of the other, or of associated entities. However, if an inheritance has been provided to the bankrupt through a testamentary trust it will generally be protected from creditors.

### **Divorce**

As with creditors, if appropriately structured an inheritance held within a testamentary trust is unlikely to be the subject of a Family Court order in the case of a marriage breakup. It may be regarded as a financial resource and may have some effect on the terms of a property settlement, but this is far preferable to the property being available as the subject of a direct Family Court order.

### **Pension benefits**

Income from a testamentary trust is taken into account for income test purposes, but assets being held in a testamentary trust may be of benefit for pension eligibility under current means tested pension rules.

### **Spendthrifts, gamblers, addicts and people with disabilities**

It is not uncommon for people suffering a variety of disabilities to be unable to properly manage their financial affairs. In such cases families frequently wish to ensure that an adequate fund is set up to meet their reasonable needs, but if possible so as not to affect any pension rights they may have. The flexibility of a testamentary trust, especially if combined with an appropriate memorandum of wishes as to how the trust should be administered, may be an appropriate arrangement.

## Taxation advantages

Although the above features are in themselves good reasons to consider a testamentary trust in your will, the major basis for the recent popularity of the structure is the considerable tax savings which can arise under Section 102AG of the *Income Tax Assessment Act 1936* ('the Act'). The effect of this section is that children under the age of 18 years who receive income from a testamentary trust are taxed on that income as an adult and thereby enjoy the normal tax free threshold (\$6,000, or \$16,000 if the low income rebate applies) and the marginal tax rates which apply to adults.

Without this special provision of the Act trust income paid to minors receives a tax free threshold of only \$416 (or \$3,333 if the low income rebate applies) and thereafter the highest marginal rate applies to the minor's income.

The following example illustrates the tax advantages of establishing a testamentary trust as compared with a traditional will provision.

Assume a husband dies leaving a dependant wife and three infant children. His estate is valued at \$1,000,000. If this were invested at (say) 8%, it would generate an income of \$80,000 per annum.

*Example 1:* The husband's will leaves everything to his wife. Her tax position (ignoring the Medicare levy) is therefore:

<b>Beneficiary</b>	<b>Income</b>	<b>Tax</b>
Wife	\$80,000	\$18,750

*Example 2:* The husband's will establishes a testamentary trust controlled by the wife and providing for the wife and three children to be beneficiaries. The family's tax position might be:

<b>Beneficiary</b>	<b>Income</b>	<b>Tax</b>
Wife	\$20,000	\$2,100
Child 1	\$20,000	\$2,100
Child 2	\$20,000	\$2,100
Child 3	\$20,000	<u>\$2,100</u>
Total		<u>\$8,400</u>

In Example 2, the total tax bill is \$10,350 less than in Example 1, and this level of saving may be possible for many years.

## Testamentary trusts can be attacked

Even though a testamentary trust may be considered by a will-maker to be a prudent provision for family members, like all provisions of a will it may be attacked by certain 'eligible applicants' under a Family Provision application pursuant to the *Succession Act*.

The surviving spouse, children and certain dependants have a right to challenge a will in this way.

While there are strategies that may be used to frustrate or restrict family provision claims, they are unlikely to result in the same benefits as are provided by a testamentary trust.

## **Not necessarily too late!**

The Act provides a second chance to the family of a will-maker who did not establish a testamentary trust in his or her lifetime. This second chance must be taken advantage of within 3 years of the date of death of a deceased. It enables a trust to be established from assets derived from the deceased and for the income to enjoy the same tax advantages as income derived through a testamentary trust.

However, this opportunity is limited to the extent that the sum which may be used to establish the trust cannot exceed the amount which the beneficiary would have received from the deceased's estate had the deceased died intestate (ie. without a will.)

## **New trends**

Increasingly, the traditional husband and wife will (ie. each to each other and then to the children) is being replaced by a testamentary trust controlled by the surviving spouse and under which the spouse and children are potential beneficiaries. Wills along these lines can (if the funds in the trust justify it) provide that on the death of the spouse sub-trusts come into existence for the benefit of each child and that child's family (and can be controlled by the child concerned).

Increasingly, grandparents are providing education trusts for their grandchildren which have the added advantage of maximising the tax free income that can be applied for the benefit of the grandchild.

## **Conclusion**

Testamentary trusts, while largely promoted as a tax saving mechanism, have many other advantages.

Their inherent flexibility makes them worthy of consideration in your overall estate planning strategies.

If you consider that such a structure may be of benefit to you please contact our office.

**Ken Waddington**  
**GARLAND WADDINGTON**