

TESTAMENTARY TRUSTS – EVERY YOUNG FAMILY SHOULD HAVE ONE

About Us

Baggiolegal is a boutique law firm, specialising in commercial, taxation and private client law. **We understand** our client's objectives and provide clear and independent advice. Service is paramount to us. **We deliver** technically sound, timely and commercially oriented solutions. **We know** and understand the South Australian landscape, but our international perspective is unique in Adelaide. Our people have excelled in the legal profession in private practice and industry all over the world. **We apply** international best practice to our local client's needs. **We work** with our clients. **We listen** to our clients. We are approachable, accessible and personable.

What is a Testamentary Trust?

It is very common for individuals during their lifetimes to establish trusts (known as *inter vivos trusts*) to hold investments, to conduct a business or for other purposes.

A **testamentary trust** is simply a trust that is established by your **will**. The testamentary trust comes into existence after you die. It is this establishment on death that distinguishes a testamentary trust from an *inter vivos* trust. The rules of *inter vivos* trusts are usually contained in a document called a **trust deed**. In contrast, the rules of a testamentary trust are contained in your will. No other legal formality or procedure is required to establish a testamentary trust.

Why You Should Have a Testamentary Trust

It has become increasingly common in recent years for wills to establish a testamentary trust for particular beneficiaries. This is because testamentary trusts allow:

- you to exercise control over the future use or disposition of your assets for various reasons including, for example, as a means of protecting and administering assets for the benefit of your children or others under a legal disability;
- your assets to be protected from a beneficiary's creditors and matrimonial claims. This is discussed in more detail below; and
- for a beneficial tax outcome. This is discussed in more detail below.

How Do Testamentary Trusts Work?

Besides being established by different means, a testamentary trust is very much like an *inter vivos* trust in that assets are given by the person making the will (the **testator**) to a **trustee** (or trustees) to be held for the benefit of a beneficiary (or beneficiaries) on the written terms of the trust. Testamentary trusts are usually **discretionary trusts** in that the terms of the trust usually provide the trustee with discretionary powers to distribute income (e.g. earnings) or capital (e.g. investments or property) to the beneficiaries or a range of persons related to the beneficiaries. Given the considerable discretion afforded the trustee, testamentary trusts usually provide for another person (or persons), known as an **appointor**, to be able in his or her discretion to remove the trustee at any time. Accordingly, selection by the testator of the most appropriate person(s) to be the appointor(s) should ensure that the testator's intentions are carried out and that control of the testamentary trust is in appropriate hands. Where there is more than one beneficiary (for example, where a surviving spouse wishes to provide for his/her children equally), the will can establish a separate testamentary trust for each child beneficiary.

Asset Protection Advantages of Testamentary Trusts

If you simply gift assets by will directly to an individual who is at risk of claims from creditors or a matrimonial dispute, those assets increase the pool of assets at risk at that time and in the future. If, on the other hand, upon your death you gift assets to a trustee with a discretionary power to benefit the intended beneficiaries, such assets will be protected from legal claims against the beneficiary. Accordingly, a testamentary trust can:

- protect your assets against matrimonial claims made by your children's spouses and/or the second husband or wife of your spouse should he or she remarry;

- protect your assets against your children's and your spouse's creditors and claimants.

Tax Advantages of Testamentary Trusts

Testamentary trusts are particularly efficient for tax purposes. Such efficiencies include the following:

- a testamentary trust has significant taxation benefits where children are concerned. Generally, the unearned income of persons under 18 years has a tax-free threshold of only \$416; after that, all income is taxed at the top marginal tax rate (currently 47%). However income distributed by a testamentary trust to a minor beneficiary will be taxed at normal adult marginal tax rates. This means that each minor beneficiary can receive a tax-free distribution of \$6,000 and normal adult marginal tax rates apply after that. This can be extremely beneficial in order to service, for example, a child beneficiary's school fees or living expenses.

By way of example, if you have 3 children under 18 years and your spouse personally receives the proceeds of your life insurance policy and invests such proceeds for a \$100,000 income stream, that income stream will be taxed at your spouse's marginal rate of tax which, for that amount and assuming there is no other income, results in a tax liability for the spouse of \$30,550 (excluding medicare levy). If such proceeds are instead inherited by a testamentary trust, the income can be streamed to the spouse and the 3 children so that the overall tax liability on the income is only \$13,440. This is an annual saving in tax of over \$17,000 (i.e. over 17% of the investment's return);

- the assets of a testamentary trust are not limited to the estate of the testator. After your death, the testamentary trust can acquire other assets that create income streams for the testamentary trust which can then be distributed to beneficiaries to take advantage of the favourable income tax treatment afforded minor beneficiaries. Accordingly, there are significant tax benefits from the use of a testamentary trust even where there are only a small number of existing assets in the trust;
- a lump sum death benefit payment by your superfund to your deceased estate will be taxed in the hands of the executor according to its respective components. However, if a superannuation proceeds testamentary trust is established in favour of your tax dependents, the lump sum death benefit paid to the trust will be exempt from tax up to your pension RBL. Assuming this RBL has not been previously utilized, this means that for the 2006 year \$1,297,886 paid from your superfund will be sheltered from tax when it is paid to your testamentary trust;
- there are no stamp duties payable on the transfer of property from your estate to your testamentary trust or on the establishment of your testamentary trust;
- there is no capital gains tax payable on the transfer of property from your estate to your testamentary trust or on the transfer of the initial trust property of your testamentary trust to a beneficiary (although the cost base and terms of acquisition rules should be considered separately).

Is it Expensive?

The documentation required to implement a testamentary trust is reasonably straightforward. Once your solicitor is fully apprised of your circumstances and your wishes, documentation ought to be able to be prepared reasonably quickly and without unreasonable cost.

Given rising property prices and the increased value of investment portfolios in recent years, your net worth is most likely quite significant. Indeed, your accountant or financial planner may already have advised you to structure your investments during your lifetime in such a way as to maximize tax efficiency as well as for other reasons such as asset protection (for example by establishing an *inter vivos* discretionary or family trust). Testamentary trusts offer unique tax planning opportunities of even greater benefit than *inter vivos* discretionary trusts. It makes considerable sense to implement a testamentary trust in your will to protect your assets from external legal claims and to ensure your assets are applied for the benefit of your beneficiaries rather than to meet unnecessary tax liabilities.

If you have any queries in relation to the above, or would like to discuss these types of documents and arrangements, please contact **Andrew Baggio** on **8232 8889** or at **andrew@baggiolegal.com.au**.

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Before acting on any of our views expressed in this publication, careful consideration of the case specific facts should be undertaken by a qualified lawyer.