

## TESTAMENTARY TRUSTS

A testamentary trust is a trust set up under a will. A testamentary trust comes into operation on the death of the will-maker.

Strictly speaking the trust can be anyone of a number of different types of trusts although the term testamentary trust is commonly used to describe a testamentary trust that is a discretionary trust. There is no stamp duty payable upon the creation of the trust and the will can be changed at any time before the death of the will-maker.

- A discretionary trust is a trust where assets are held by a person or organisation (the trustee) on behalf of a group of people (the beneficiaries), any one or more of whom can be nominated by the trustee to receive the income (or in some cases also the capital) of the trust. When the trust comes to an end (no later than 80 years after the will-maker's death) the remaining capital is paid out.
- In a purely discretionary testamentary trust, no individual in the group of beneficiaries has any legal right to receive any of the assets or income of the trust. The only right that a beneficiary has is to be considered by the trustee at the time the trustee exercises its discretion.

The trustee, therefore, has a very significant role in discretionary trusts. Although the will-maker nominates in the will the class of beneficiaries from amongst whom the trustee must make his or her selection, the discretion as to who is chosen rests with the trustee.

It is often useful, therefore, for the will-maker to give to the trustee some indication of the purposes for which the trust has been created so that the trustee can ensure that the intention of the will-maker is properly carried out. This indication is often set out in a statement of wishes prepared at the same time as the will and signed by the will-maker. This statement is not, and cannot be, legally binding on the trustee.

### **What are the advantages of a testamentary trust?**

The main advantages of a discretionary testamentary trust are that the income can be split between various beneficiaries in the most tax effective manner and the trust assets can be protected. The use of discretionary trusts to protect pension entitlements has however been severely curtailed by the introduction of the attribution rules in the Social Security Act 1991\*. It is also possible to transfer the right to use and enjoyment of trust assets free of transfer costs through this type of trust.

### **Asset Protection**

Assets held in a testamentary trust are owned by the trustee of the trust who holds them on behalf of the beneficiaries of the trust upon the terms set out in the will. Consequently, the assets are not assets of any beneficiary even though a beneficiary may have full use of them. In the event that a beneficiary suffers a relationship breakdown or is declared bankrupt, the trust structure may give protection to those assets due to their separate legal ownership, (particularly where the trustee is totally independent, as in the case of a trustee company).

## Income Splitting

Unlike inter vivos trusts (trusts set up in the lifetime of a person), testamentary trusts currently have the advantage that minors deriving income from the trust can take advantage of concessional income taxation rates. This can result in minors receiving up to \$6,000 per annum tax-free.

The benefits of income splitting in a testamentary trust are illustrated in the following example:

*Example:*

Mr & Mrs Smith have 2 adult children –

- Child A has a non-working spouse but no children.
- Child B is a widower with 3 small children, whom he wishes to privately educate. The children are employed and in the highest marginal tax bracket.

Mr & Mrs Smith leave their estates equally to their 2 children outright.

In the case of Child A, if the inheritance was invested, the income from the inheritance would be taxed at the highest marginal tax rate. If Child A's intended share was instead transferred into a testamentary trust set up for the benefit of Child A (the primary beneficiary) and family, the income could be paid to his non-working spouse who would then pay income tax on the income earned at much lower taxation rates.

Similarly, in the case of Child B, if the inheritance was invested and an income of \$18,000 is earned on that investment, this income would be taxed at the highest marginal tax rate with the private school fees to be paid out of the after-tax income. However, if a testamentary trust was set up for the benefit of Child B and \$18,000 of income was distributed equally between B's 3 children, no tax would be payable thereon and the whole \$18,000 of income would be available for payment of school fees.

## Generally

It is important where the testamentary trust structure is chosen by a will-maker that the wide trustee powers are written into the will to enable the greatest degree of flexibility in managing the trust assets for the benefit of the beneficiaries. For this reason, setting up testamentary trusts are often quite complex documents, resembling trust deeds, the cost of preparation of which is much higher than a standard will. Ultimately, however, the benefits should outweigh the cost of preparation.

However, it must be noted that the tax treatment of trusts has been the subject of government review in the past and may well be the subject of review and change in the future.

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