Testamentary Trusts in Wills

by Ann Janssen

What is a testamentary trust?

A testamentary trust is simply, a trust established in a Will. Most trusts are discretionary trusts and this is the type we use in our Wills.

Discretionary trusts have tax advantages as well as protective features. Most trusts are discretionary trusts for these reasons. Discretionary trusts that you can establish outside of a Will are often colloquially called 'Family Trusts'. There are over 400,000 family trusts in Australia.

When the discretionary trust is placed in a Will, it is called a Testamentary Discretionary Trust (TDT). TDTs have even more advantages than Family trusts.

The main features of the TDT include:

- the TDT can buy, sell and deal with assets similar to a natural person;
- a trustee controls the TDT. The trustee determines what the TDT will sell or invest in. They also decide who will receive the income earned by the TDT, or the capital of the TDT from the pool of beneficiaries named in the TDT. You can have more than one trustee, and a trustee can be a beneficiary;
- the TDT has a pool of beneficiaries (normally family members and their entities) who the trustee can choose from (in the trustee's discretion) to give income or capital to. The trustee can give whatever amount it decides, to one or more of the beneficiaries (equally or unequally, or nothing at all);
- the TDT starts on the death of the Willmaker. The maximum life of the TDT allowable is 80 years, from its commencement. The trustee is normally given the power under the TDT to wind it up earlier if they wish.

The TDT is a very flexible entity, allowing the trustee plenty of freedom to deal with the trust fund for the benefit of the beneficiaries. Take a look at the diagrams at the end of the Fact Sheet to get an idea of how the trust is structured.

As a rule of thumb, if you are gifting more than $300,000 to a beneficiary, then you should seriously consider giving the beneficiary the option of taking their gift in a TDT. You may still wish to consider a TDT for a lesser amount, if the beneficiary is 'vulnerable' (see our discussion below).

Tax Advantages of the TDT

The TDT allows the trustee to assign income to different beneficiaries in the trust to take advantage of their different tax rates.

Further, children in TDTs are not taxed at the penalty rates they normally suffer on unearned income. They are taxed at adult rates and when combined with the tax offsets, their tax free threshold is $21,884 for the 2019/20 financial year. The concession extends to all children who are in the pool of beneficiaries in the TDT (including grandchildren, nieces and nephews, as you specify).

This is significantly more than the tax free threshold for children in the Family trust, which is currently $416 per minor.

Our examples of Michael and Mandy at the end of this Fact Sheet clearly show the tax savings they would enjoy if they were left their inheritance in a TDT by the Willmaker, rather than receive their inheritance outright.

The Table below summarises the tax savings in each scenario:

Example	Tax Saving
Example 1: Mandy doesn't work, has 2 children	$2,492 per year
Example 2: Mandy has a part time job, and 2 children	$10,725 per year
Example 3: Michael has a full time job, and 2 children	$13,250 per year
Example 4: Michael has a full time job and no children	$4,270 per year

Other Advantages of using TDTs in your Will

TDTs have the following additional benefits:

- TDTs significantly reduce the risk of the inheritance you give going to third parties or in-laws, particularly on the death of the beneficiary. For example if you leave an inheritance to your adult child in a TDT, then on that child's death the inheritance remains in the TDT for that child's children (your grandchildren) and will not pass under the child's Will to their spouse;
- Protection of the inheritance from the beneficiary's creditors and some protection against the beneficiary's spouse in a marital breakdown;
- Protection of the inheritance where the beneficiary is 'vulnerable' (for instance, has a disability, addiction or is a spendthrift, bankrupt or a 'financially at risk' person). See our fact sheet on Protective Trusts in Wills for more information.

What are the disadvantages of a TDT?

- Once the TDT comes into existence (that is, on the Willmaker's death), the TDT needs a tax file number and will need to lodge a tax return each year. This is an ongoing maintenance cost. Because the tax return will be similar to that of a family trust, most accountants are well acquainted with this process and do not see it as complex. There are no government fees or audit requirements;

- The cost of establishing the TDT is paid for now by the Willmaker, even though the benefits of the TDT will be enjoyed by the beneficiaries.

There is very little choice here, as the ability for the beneficiaries to obtain a TDT like this is not possible in any other way. There is a limited ability to obtain a post death trust, but it is very restrictive, and expensive to establish post death.

In Summary

The inheritance you leave can be significantly enhanced by placing it in a TDT which offers a tax effective environment for it to grow. In addition, the inheritance receives added protection from the ravages of imprudent beneficiaries, or unscrupulous third parties.

The ways to obtain this valuable vehicle are very limited. The TDT must be created in your Will. It is a small window of opportunity, but the benefits can last for years.

Estate First offer competitive fixed fee pricing on TDT Wills.

This information is general in nature and should not be acted upon without first obtaining legal advice on your particular situation. To find out more or to make an appointment, phone us on 1300 132 567 or email us info@estatefirst.com.au

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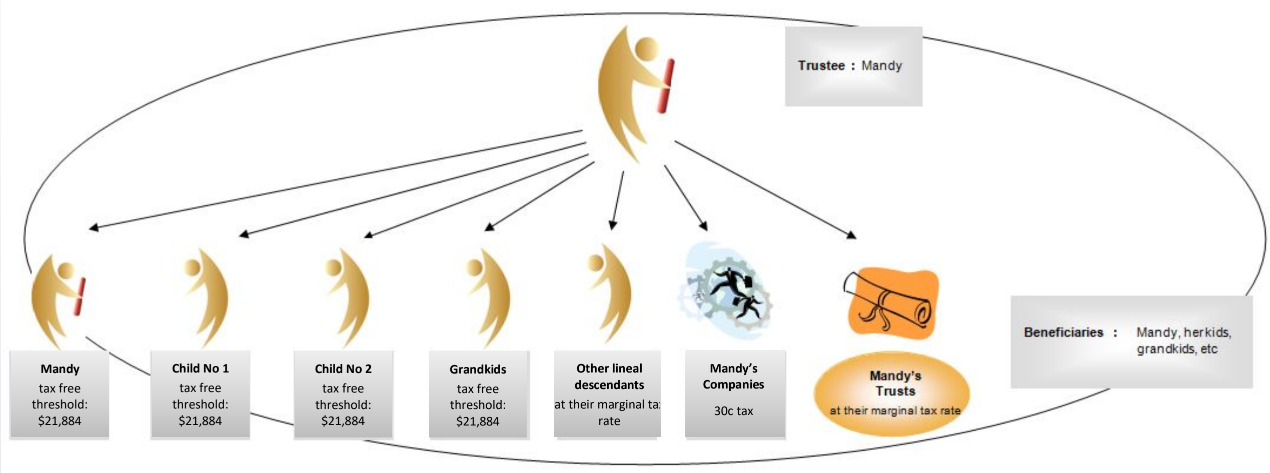
Testamentary Discretionary Trust

Example 1: Mandy + 2 kids
Mandy – no other income



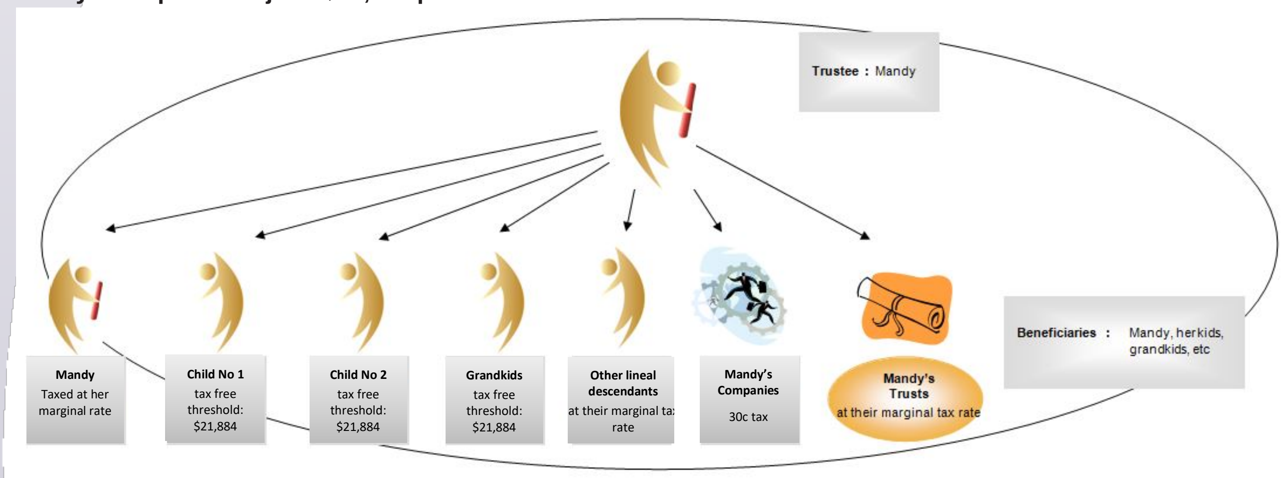
Trust receives $500, 000 inheritance, which is invested (property, shares, term deposit, etc)
Income earned each year by inheritance: $35,000
Mandy assigns the income: Mandy $21,884, Child No. 1 $6,558, Child No. 2 $6,558 → Tax on income: $NIL
Mandy's tax if inheritance in her own hands: $2,492 per year

Saving: $2,492 per year*

*(2019/20 tax rates used, including tax offsets. Excludes Medicare levy.)

Testamentary Discretionary Trust

Example 2 : Mandy + 2 kids
Mandy - has part time job : $35,000 p/a



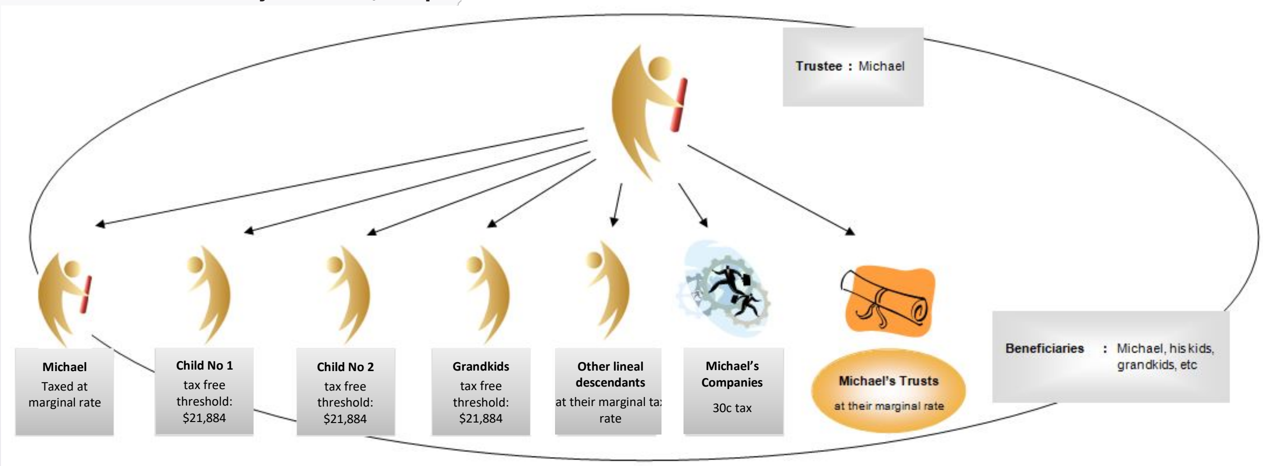
Trust receives $500,000 inheritance, which is invested (property, shares, term deposit, etc)
Income earned each year by inheritance: $35,000
Mandy assigns the income: $17,500 to Child No. 1 + $17,500 to Child No. 2 → Tax on income: $NIL
Mandy's personal tax: $2,492
Mandy's tax if inheritance in her own hands: $13,217 (based on income of $35,000 + $35,000 = $70,000).

Tax Saving $10,725 per yr*

*(2019/20 tax rates used, including tax offsets. Excludes Medicare levy.)

Testamentary Discretionary Trust

Example 3: Michael + 2 kids
Michael has a full-time job at $80,000 p/a



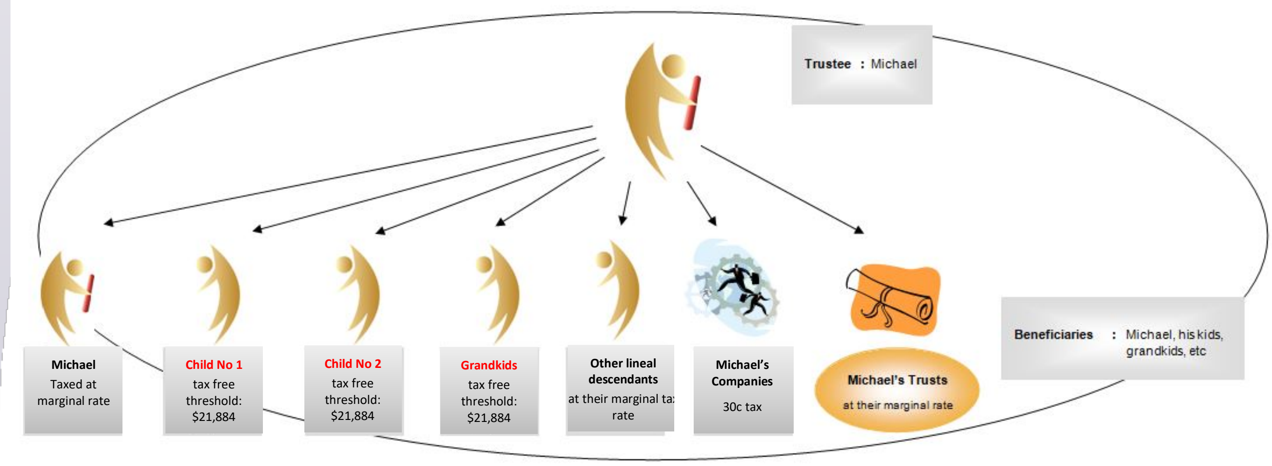
Trust receives $500,000 inheritance, which is invested (property, shares, term deposit, etc)
Income earned each year by inheritance: $35,000
Michael assigns the income: $17,500 to Child No.1, $17,500 to Child No.2 → Tax on income: $NIL
Michael's personal tax: $16,467
Tax to Michael if he received the inheritance outright = $29,717 (being tax on income of $80,000 + $35,000 = $115,000)

Tax Saving $13,250 per yr*

*(2019/20 tax rates used, including tax offsets. Excludes Medicare levy.)

Testamentary Discretionary Trust

Example 4 : Michael, but no children yet
Michael has a wife who earns $30,000 p/a | Michael earns $90,000 p/a



Trust receives $500,000 inheritance, which is invested (property, shares, term deposit, etc)
Income earned each year by inheritance: $35,000.
If Michael has no TDT the inheritance income of $35,000 will be taxed at his marginal rate. His tax on income of $90K + $35K would be $33,717. His wife's tax would be $1,542. TOTAL TAX: $35,259.
If Michael has a TDT he could decide to distribute $7,000 of inheritance income to his wife and $28,000 to a shelf company he establishes as a beneficiary. His tax would be $19,717. His wife's tax would be $2,872. His shelf company's tax would be $8,400. TOTAL TAX: $30,989.

Tax Saving $4,270 per yr*

*(2019/20 tax rates used, including tax offsets. Excludes Medicare levy.)