Testamentary Trusts

Each and every Will creates a “testamentary trust” in the strict sense of the phrase. That is, a trust which only comes into effect through a Testamentary instrument, a Will. However, the “Testamentary Trusts” talked about by lawyers, accountants and other financial advisors are a particular breed of testamentary discretionary trust which can have enormous financial advantages for those who inherit under such a trust. Most Testamentary Trusts will give the primary beneficiaries the option of taking all or some of the funds available as a lump sum or to utilise the trust provisions over all or a part of the funds.

The primary advantages which a Testamentary Trust offers over a direct inheritance are:

a) Potentially significant tax savings; and
b) Asset protection

Tax Savings

Rather than one individual receiving a lump sum under a Will, and paying tax on the income from that sum at their top marginal rate, a Testamentary Trust can set aside that same lump sum and direct the income from its investment to a wider range of beneficiaries, thus potentially decreasing the tax payable on that income. In particular, income paid to minor children via a Testamentary Trust is taxed at the same rates as adults, rather than the very disadvantageous rates normally applied to children’s income.

For example, lets say a couple, Marge and Fred, have two children, Harry and Charlotte who are both in their 30’s, both have children of their own and both are top marginal rate taxpayers. If on the death of both Marge and Fred, their Wills ultimately leave their combined estate worth $2 million to their children equally, both Harry and Charlotte would inherit a large lump sum. Upon investing those sums, both Harry and Charlotte would pay 47% in tax and medicare levy on all income derived from that investment. If they invested the whole amount, and the income amounted to 8%, the tax bill would be $37,600 each, a total of $75,200.

If, however, Marge and Fred’s Wills provided for the benefits to be paid to Harry and Charlotte to be held upon discretionary trusts with Harry and Charlotte as primary beneficiaries, with the range of other potential beneficiaries including their spouses and children, both Harry and Charlotte could direct income to those other beneficiaries to best make use of the tax free threshold and lower marginal rates. In the example above, where each of Harry and Charlotte’s trusts had $1 million invested and producing an 8% return, if the income was paid to Harry’s two and Charlottes’ two children instead, the tax could be

PO Box 7130
Beaumaris VIC 3193
Tel: 03 9515 0271
Fax: 03 9515 0274
www.mjslaw.com.au
contact@mjslaw.com.au

zero low as $6,600 per child, a total of $26,400! The money could be used for school fees, which would otherwise come out of Harry and Charlottes after-tax income. A huge saving!

Asset Protection

Testamentary Trusts, being discretionary trusts, allow the trustees to determine which of a range of beneficiaries should benefit from income in any given year. None of the beneficiaries has an absolute right to receive income, until such time as the trust finally winds up (up to 80 years after it was created). This means that creditors of the potential beneficiaries cannot seek to recover funds from the trustees of the trust in the event that one of the potential beneficiaries is sued or becomes bankrupt. This is a significant advantage where a beneficiary is self-employed in a high risk occupation, such as builder, medical practitioner etc.

In the event of a divorce involving the primary beneficiary, a testamentary trust can protect the assets within the trust from distribution in the financial settlement.

Other Benefits

In addition to the potential tax savings and asset protection advantages, Testamentary Trusts can be specifically adapted for use in circumstances where beneficiaries are minors, have disabilities or have other special needs.

Conclusion

Testamentary Trusts have great advantages over direct inheritances for a great many reasons. An estate does not have to be particularly valuable for these advantages to be enjoyed by the beneficiaries. A Will with a well drawn Testamentary Trust provision can reap enormous financial benefits when compared with a direct inheritance yet still retain the flexibility of making capital available to your beneficiaries if capital payments would be more appropriate in their circumstances.