Estate Planning – Testamentary trusts

A testamentary trust is established within a will to allow an inheritance to be paid to a group of people rather than to one person directly. Someone is nominated as trustee to manage the trust and the group of people who can be potential beneficiaries is also nominated.

This separation of control and benefits may provide taxation advantages as well as protect assets from legal action involving a beneficiary and/or from being misused by a beneficiary.

Benefits

- Assets may be protected for beneficiaries who are unable to manage their own finances, such as a disabled child or a spendthrift beneficiary.
- Assets may be protected for beneficiaries who are at risk of bankruptcy or divorce.
- Income and capital may be distributed to beneficiaries in a tax effective manner, particularly if you have young children in your family.

How it works

A testamentary trust is a trust created by your will, so it does not come into effect until after your death. The will can direct that all or some of your estate assets are transferred into the trust.

The trust is usually structured as a discretionary trust which gives the trustee full discretion about distributions to beneficiaries.

You can choose anyone to be trustee, including the executors of your will, your spouse or partner, or your children. The trustee has effective control of the trust, so you should nominate a person who you know and trust will act in the best interests of the beneficiaries. You can nominate more than one person and specify whether they can act alone or if decisions must be made together.

Some things to consider when establishing a testamentary trust include:

- whether to establish one or more testamentary trusts (each trust can have a different trustee)
- who should be trustee
- the method of appointing replacement trustees
- whether to limit beneficiaries to your descendants only or also include their spouses
- whether some beneficiaries should be restricted to benefitting from income and others to capital.

For full flexibility you may wish to give the executor of your will the discretion not to set up the trust based on circumstances at the time.

Because the assets of the trust are not owned personally by the beneficiaries it may provide some asset protection to the beneficiaries from actions by creditors, ex-spouses or litigation.

Tax advantages

The primary purpose of a testamentary trust is to manage estate assets to produce income for beneficiaries however a testamentary trust may also provide tax benefits.

The trustee generally has discretion to control the distribution of capital and income to beneficiaries. The decision can take into account a beneficiary's tax rate at the time to make distributions in a tax-effective manner.

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Where income is distributed from a testamentary trust to children under age 18, it will be taxed at adult tax rates instead of the penalty tax rates that often apply to a child's income.

Department of Human Services implications

It is important to consider the impact of a testamentary trust on any person involved with the trust if that person is also receiving (or expects to receive) an income support payment from Department of Human Services or Veterans' Affairs (DVA).

If you nominate a Department of Human Services recipient as appointer, trustee or beneficiary of your testamentary trust, some or all of the trust assets and income received may be assessed against that person. This may impact their entitlements. As such you may wish to consider excluding these people from any involvement with the trust.

Risks and Consequences

- You should consider the cost of administering a testamentary trust, particularly if a professional is appointed trustee as there will be a cost for this service.
- The capital gains tax exemption that applies to a family home does not apply if a home is owned by a trust.
- You should review your will on a regular basis to ensure it continues to reflect your wishes and changes to your situation are incorporated.

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