
TESTAMENTARY TRUSTS



Testamentary trusts are fixed or non-fixed trusts that are:

- established by a Will
- funded by:
 - the assets of a deceased estate; or
 - by payments to the estate in consequence of death, eg superannuation death benefits or insurance proceeds paid to a deceased estate rather than directly to dependants or nominated beneficiaries; and
- to be administered by the executor of the estate or a trustee appointed in accordance with the Will and (in both cases) subject to the terms of the Will.

Types of Testamentary Trusts

Testamentary trusts can be divided into several main categories, ranging from the usually executor controlled very restricted trusts designed to protect a vulnerable beneficiary to the beneficiary controlled fully discretionary trusts that offer flexibility, asset protection attributes and income tax advantages.

Probably the greatest advantages associated with testamentary trusts are:

- the ability to provide creditor asset protection for intended beneficiaries (nonfixed and split fixed testamentary trusts only);
- the tendency of the Family Court to view a testamentary trust as a resource available to a party in a domestic relationship, rather than as a divisible asset (non-fixed and split fixed testamentary trusts only);
- the ability to transfer use, enjoyment and benefit (and any resultant income tax or CGT liability) derived from the trust free of transfer costs in a vehicle that usually offers ease of access to funds (non-fixed and split fixed testamentary trusts only); and
- income tax advantages from the splitting of income and taxable capital gains (all fixed and non-fixed testamentary trusts with adult and especially minor [ie under 18 years of age] beneficiaries).

Note: to the extent that they are funded by other sources, eg gifts or non-arm's length loans, testamentary trusts are unlikely to qualify for the excepted income tax concessions that usually apply to testamentary trusts - see paragraph 102AG(a) of the Income Tax Assessment Act 1936 ("ITAA 1936").

These advantages come with accompanying potential pitfalls that need to be avoided if the testamentary trusts are to achieve their purpose. These pitfalls (including tax considerations such as eligibility for the main residence exemption for CGT and land tax purposes, family

trust election rules and future tax laws) mean that it is important that the executor is given a menu of defined options as to the form and administration of each testamentary trust.

Asset Protection Advantages

By giving a primary beneficiary of the estate the default option to inherit via a discretionary testamentary trust, the primary beneficiary does not have to inherit assets personally. This will be an attractive attribute for a primary beneficiary who:

- faces the prospect of bankruptcy in a worst case scenario, eg because of personal guarantees in force or because the nature of the person's occupation or circumstances carries a risk of litigation;
- is faced with difficult family or domestic circumstances, eg the breakdown of a marriage or de facto relationship; or
- has the prospect of a contested personal estate when the primary beneficiary subsequently dies.

The primary beneficiary can still, however, either have control of the inherited assets as trustee or appointor of the trust or, in the event of insolvency or health or other crisis being in place when the Willmaker dies or subsequently occurring, have the assets controlled by a “friendly” party.

It should be noted that a Family Court has the discretion to disregard a trust, company or other ownership structure and to treat assets as part of the joint assets of a domestic relationship, notwithstanding their formal legal ownership. The Court can also make orders that are binding on 3rd parties such as relatives, accountants and lawyers. An indicator of the Family Court's usual view of a testamentary trust can be seen in the decision in *Ward and Ward [2004] FCMA 193*. In that case the Court did not view the discretionary and non-capital reserved testamentary trust created by the late parent of the husband as a divisible asset of the relationship, but did view the trust as a financial resource available to the husband.

Income Tax Advantages

The potential for tax savings when income from a fixed or non-fixed testamentary trust (or a child superannuation pension or annuity) is distributed to benefit a child or grandchild under 18 is significant. This is because the income is “excepted” by section 102AG of the ITAA 1936 from the higher income tax rates that otherwise apply to minors under 18 years.

The marginal income tax rates currently applicable to the first \$75,000 of testamentary trust income per individual beneficiary (beneficiary not also receiving other forms of income) regardless of age currently are:

- if the parent or grandparent of the minor beneficiaries would face relatively high marginal tax rates on any income from inherited assets, testamentary trusts can be particularly attractive. The potential tax savings from income of a testamentary trust being spent on the child or grandchild instead of forming part of the adult's income may effectively subsidise the education and maintenance of the child or grandchild.

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- on 17 October 2006 the Federal Government announced that new rules are to apply to capital gains in testamentary trusts from 1 July 2005, removing the requirement that still applies to family and unit trusts established by Deed for income beneficiaries to pay tax on capital gains. Presumably these new rules will also apply to an accumulation of a capital gain for the benefit of no particular beneficiary.

Income Tax Streaming

For the time being at least, the trustees of non-fixed testamentary trusts can be given the power to stream different types of income or deemed income (for example taxable capital gains and interest income) to different beneficiaries. Franking credits from dividend income, however, must be distributed in the same proportions as the dividends and will be forfeited when the dividend is distributed from a non-fixed trust to beneficiaries, unless certain conditions are satisfied, eg the:

- beneficiaries have a fixed entitlement to the trust capital, ie the trust is a capital reserved trust;
- trust is a deceased estate or an executor managed testamentary trust of less than 5 years duration; or
- trustee has made an election to become a “family trust” for taxation purposes and be subject to the rules that apply to trusts that have made those elections.

Comparison with Child Pensions and Annuities

Unlike most superannuation pensions and annuities, however, testamentary trust income does not also qualify for income tax exemption for beneficiaries aged at least 60 or for a 15% income tax offset for younger individual beneficiaries. This means that testamentary trusts may only be a preferred income tax option when:

- child superannuation pensions or options are not available, eg because of an inflexible superannuation fund, lack of superannuation funding or because the minor beneficiaries are grandchildren of the deceased and were not also death benefit dependants (within the meaning of section 302-195 of the *Income Tax Assessment Act 1997*) of the deceased; or
- regular access to the capital is needed, eg to provide security for a family business.

Transfer Cost Advantages

1. Changing Beneficiaries from year to year (non-fixed testamentary trusts only)

Like other non-fixed trusts, a non-fixed testamentary trust can in most circumstances transfer the beneficial enjoyment of the trust, eg the income generated from year to year, from one discretionary beneficiary to another without incurring transfer costs such as capital gains tax (“CGT”), goods and services tax (“GST”) and State duty.

2. Assets passing into a testamentary trust

There is also no CGT (by virtue of sections 128-10 and 128-15 of the *Income Tax Assessment Act 1997*), GST or State Duty on the transfer of assets from legal ownership by the deceased to legal ownership by the executor or administrator of the deceased estate and then to the trustee of the testamentary trust or cash proceeds (if within bankruptcy reasonable benefit limits) of a life insurance policy or superannuation death benefit.

3. Assets passing from a testamentary trust to a beneficiary

There would also appear to be significant CGT relief under section 128-10 when assets originally belonging to the deceased are transferred from the trustee of a testamentary trust to a beneficiary - this relief was confirmed by the ATO in Practice Statement LA 2003/12. That relief does not extend to assets acquired by the executor of the deceased estate or the trustee of the testamentary trust. A transfer of trust assets from a trustee to a beneficiary should not normally be a taxable supply for GST purposes, but State duty on such a transfer may be an issue in States and Territories.

Depending on the terms of the Will creating the testamentary trust, it may also be possible to clone or split the trust without triggering a capital gains tax liability.

Categories of Testamentary Trusts

Testamentary trusts come in many forms, ranging from trusts with very simple or rigid administration requirements to very flexible non-fixed trusts. For taxation, asset protection and other reasons, it can be very important to identify just what type of testamentary trust is included or is available in a Will.

A suggested categorisation of the various types of testamentary and other trusts is set out below. Category 1 is a fixed trust under section 272-65 of Schedule 2F of ITAA 1936, category 2 is excluded for the purposes of claiming franking credits and the remaining 6 categories are non-fixed trusts under section 272-70 and the trustees of these non-fixed trusts will be faced with taxation issues such as family trust elections.

1. "Absolute" fixed.
2. Fixed life interests.
3. Defeasible.
4. Contingent.
5. "Absolute" capital reserved (all capital).
6. "Residual" capital reserved (residual capital only)
7. Restricted discretionary.
8. Fully discretionary.

Testamentary Trusts in Wills

The two most frequent reasons for creating testamentary trusts in Wills (and non-fixed trusts in particular) are to:

- ensure that the Will is, as far as is possible, adaptable to meet changing circumstances of the intended beneficiaries of the estate; or
- enable the Willmaker to "rule from the grave" and impose restrictions on beneficiaries. While ruling from the grave via a Will can add to the costs involved in the initial and ongoing administration of a deceased estate, it can be particularly important if there are vulnerable beneficiaries to be considered.

A Will creating testamentary trusts with a view to ensuring that the Will is, as far as is possible, adaptable to meet changing circumstances (but not primarily designed to enable the Willmaker to extensively "rule from the grave") would usually include a framework of several regularly used types of testamentary trusts. These trusts, many of them options for the executor to utilise if appropriate, are designed to cater for a range of different circumstances applicable to the intended primary beneficiaries:

Type	Probable Beneficiary
Prospective Beneficiary - Defeasible or Fixed	Primary Beneficiary yet to reach required age (ie at least 18 years)
Beneficiary Controlled - Fully Discretionary (Single or Staggered Release)	Subject to options for the primary beneficiary to choose that are set out in the Will, a separate trust is established for each primary beneficiary, eg partner or children sharing the estate. If single release, an age or date is set in the Will for the transfer of control of funds from the executor to the BCTT trustee. If staggered release, 2 or more ages or dates (plus percentages) are set for the transfer of control of funds to the BCTT trustee.
Beneficiary Controlled - Parallel trusts	Parallel trusts are an option provided for in the Will, in the event that a primary beneficiary wants to utilise a separate trusts, eg one trust with retained profits and a company beneficiary, unrealised capital gains, subject to a family trust election or with a controller that meets/falls outside the small business CGT concessions control test
Beneficiary Controlled - Capital Reserved	An alternative or additional option to the default option of a fully discretionary beneficiary controlled testamentary trust - capital forms part of the estate of the primary beneficiary or of the children of the primary beneficiary - often established with the possibility or probability of a new domestic relationship in mind. This trust operates in the same way as the executor controlled capital protected testamentary trust (see separate pocket summary), but with the primary beneficiary acting as or choosing the trustee.
Superannuation Death Benefits - Fixed, Non-fixed or Capital Reserved	Surviving spouse with dependant children who is not receiving superannuation pensions or annuities - the spouse may be able to borrow from the trust free of interest and may or may not be an income and/or capital beneficiary

Type	Probable Beneficiary
Crisis Protective - Loss of Capacity	Primary beneficiary who is or becomes bankrupt or has lost or loses capacity

The above trusts vary from optional (usually beneficiary controlled) trusts to usually executor controlled trusts that are mandatory in defined circumstances:

- Optional testamentary trusts (eg estate, beneficiary and superannuation death benefits trusts) are likely to be used for as long as there are asset protection considerations or there are children, grandchildren or other relatives of a primary beneficiary under 18 years.
- Mandatory testamentary trusts (eg prospective beneficiary and crisis protective trusts) in a Will that has not been designed to enable “ruling from the grave” tend to operate in two main circumstances:
 - Operate if a primary beneficiary is yet to achieve a required minimum age, ie at least 18 years; or
 - Spring into being if a primary beneficiary becomes bankrupt, loses capacity or (in some Wills) suffers a breakdown of marriage or de facto relationship.

“Ruling from the Grave” or “Bloodline” Testamentary Trusts

Some Willmakers are faced with circumstances of their intended beneficiaries that necessitate the use of other types of mandatory testamentary trusts, usually controlled by the executor of the estate or a non-beneficiary trustee:

It is important to note that rights of occupation enabling a surviving spouse to live in the Willmaker’s main residence qualify for exemption from capital gains tax under section 118-95 of the ITAA 1997.

Trusts Benefiting Disabled Minors and Post Death Trusts

Testamentary trusts are not the only fixed and non-fixed trusts that generate concessional tax exempted income. Among the limited number of other possibilities are:

- any fixed or non-fixed trust (including standard family trusts) distributing income to a person under 18 whose physical or intellectual disability or illness is severe enough to qualify the minor for concessional treatment under section 102AC of the ITAA 1936;
- superannuation death benefits trusts - satisfying the requirements of subparagraph 102AG(2)(c)(v) and subsection 102AG(2A) of the ITAA 1936;
- insurance proceeds trusts - satisfying the requirements of subparagraph 102AG(2)(c)(iv) and subsection 102AG(2A) - these trusts are often fixed declarations of trusts or specially drafted fixed capital subtrusts within family trusts; and

- estate proceeds trusts - satisfying the requirements of subparagraph 102AG(2)(d)(ii), subsection 102AG(2A) and subsection 102AG(7) - these trusts can hold up to that share of an estate that a child under 18 would have received had their deceased parent not willed assets to another relative, eg the surviving parent.

All of the paragraph 102AG(2)(c) and (d) trusts must have fixed ultimate capital beneficiaries if they are to qualify for excepted income concessions - see subsection 102AG(2A) and, like testamentary trusts, only qualify for income tax concessions in respect of non-arm's length sources if that income is not in excess of arm's length rates of return.

Type	Probable Use
Education	Child/grandchild yet to finish education on completion of education the trust capital usually forms part of the residual estate
Absolute Capital Protected	Spouse or children who are not to receive control of capital but who are free to do as they please with the income. Remainder beneficiaries receive all capital either as "absolute" or surviving beneficiaries
Residual Capital Reserved	Spouse or children who are not to receive control of capital but who are free to do as they please with the income and can receive part of the capital at the discretion of the executor. Remainder beneficiaries receive the residual capital either as absolute or surviving beneficiaries
Protective - Special Disability	Vulnerable beneficiary with a severe disability, in need of financial support for care and accommodation (other expenditure is not permitted), but is not to be given control. Capital is reserved for remainder beneficiaries after vulnerable beneficiary dies. (This trust is exempt up to \$500,000 from Centrelink means testing for both the donor to the trust and the lifetime beneficiary)
Protective - All Needs	Vulnerable beneficiary, in need of financial support, but is not to be given control. Both income and capital available to meet the needs of the vulnerable beneficiary. Balance of capital is reserved for remainder beneficiaries after vulnerable beneficiary dies. No Centrelink concessions.
Right of Occupation	Surviving first or subsequent spouse or other beneficiary who is to have right of residence for a defined maximum period, eg a stipulated number of years or the remainder of their lifetime. The remainder interest in the residence may pass to the Willmaker's children or other relatives
Fixed Life Interest	Surviving first or subsequent spouse who is to receive an income stream
Flexible Life Interest	Surviving first or subsequent spouse who can also consent to (often excepted income) distributions to children or grandchildren and/or may possibly benefit on a needs basis from the capital)

Type	Probable Use
Remainder Interest (Fixed or Defeasible)	Receives capital when right of occupation or life interest ceases
Remainder Interest (Non-fixed)	Receives balance of capital when right of occupation or life or term interest ceases
Crisis Protective - Bankruptcy	Primary beneficiary when and if bankrupt

Flexibility and Tax

Testamentary trusts are only worth considering including in a Will when a person’s “estate” assets are likely to be sufficiently large for the savings associated with the trust to outweigh the cost of administering each trust.

With the possible advent of taxation restrictions for particular types of non-fixed trusts, eg possibly those with unrealised capital gains, it may prove advantageous for the Will to provide for the possibility of more than one beneficiary testamentary trust for a primary beneficiary. For example a primary beneficiary could utilise two trusts:

- One that holds an “active” asset and is structured in terms of distribution of income and capital to meet the requirements of Division 152 of the ITAA 1997; and
- One that holds other assets to which Division 152 does not apply, may have a different pattern of income and capital distribution and/or may be protecting those assets from the risk of litigation.

Avoiding Pitfalls of Testamentary Trusts

If testamentary trusts are going to be a viable option for a Willmaker and the estate beneficiaries, there are important issues to address:

1. Unwanted testamentary trusts

An unwanted and inappropriate testamentary trust may come into existence if a primary beneficiary:

- does not have a use for a testamentary trust and is given a mandatory testamentary trust; or
- has reached or is nearing retirement age and would prefer to receive tax free superannuation pension income in retirement, rather than taxable testamentary trust income.

It is important that the executor be given the discretion to avoid transferring assets into the trust. (If the primary beneficiary has to shut down the unwanted trust, unnecessary capital gains or other tax liabilities may be triggered.) It is also important to recognise that changes

might occur between the date of the Will and the date of death, eg changes to the beneficiary's circumstances or to taxation laws, and it may not be possible to redo the Will prior to the Willmaker's death.

Examples of recent tax law changes impacting on testamentary trusts include:

- the family trust election rules (that treat ongoing deceased estates and testamentary trusts less leniently than deceased estates during their initial period of administration); and
- the capital gains tax concessions for "active" assets for small businesses that impact on the choice of beneficiaries that might receive income and capital during the course of the testamentary trust's administration.

2. Lack of Flexibility to Deal with Future Tax and Other Changes

Non-fixed trusts (testamentary and otherwise) already face certain adverse taxation and means tested pension eligibility rules.

It is therefore important that Wills be drafted with as much flexibility as possible to enable the asset protection and income tax advantages of testamentary trusts to be maximised and the possible capital gains and income tax disadvantages minimised.

3. Main Residence Exemption and Right of Occupation

Fixed and non-fixed trusts both qualify for the same 50% capital gains tax discount under Division 115 of ITAA 1997 that applies to individuals, but not to companies. Family discretionary and other non-fixed trusts (established by Deed) and fixed or non-fixed unit trusts, however, do not qualify for the main residence exemption under Subdivision 118-B. Discretionary testamentary trusts (such as beneficiary testamentary trusts) only qualify for an extension of the main residence exemption in Item 2(c) of subsection 118-195(1) of ITAA 1997 for as long as a beneficiary who is given an express right of occupation of the Willmaker's main residence continues to exercise that right.

4. Principal Residence Exemption and Land Tax

The principal residence exemptions from land tax in the various Australian States and Territories are also an issue and may cause a primary beneficiary to prefer to avoid a testamentary trust in respect of the residence or to be given an equitable interest in the residence. An equitable interest that provides the beneficiary with an interest greater than a mere right of occupation is an asset for bankruptcy purposes.

In 4 Australian States and Territories, namely New South Wales, Victoria, Queensland and ACT, higher rates of land tax apply to other non-primary production land owned by non-fixed trusts as well (in the case of the ACT the higher rates only apply to non-income generating residential properties).

5. Need for fixed or more restricted trusts

There are times when a fixed or very restricted testamentary trust is more appropriate. For example, there is usually no need for a beneficiary testamentary trust to be established until

the prospective primary beneficiary turns at least 18 years and decides at that time whether or not a beneficiary testamentary trust is appropriate. In the meantime the executor can administer a prospective beneficiary testamentary trust solely for the benefit of the prospective primary beneficiary. (Tax concessions apply to minor beneficiaries receiving income from their prospective share of an estate.)

6. Inflexible testamentary trusts

An executor's discretion clause may also be important to enable none or only some of the estate assets to be distributed to a testamentary trust. For example, it might be desirable that ownership of a residence pass to a primary beneficiary personally if the primary beneficiary is going to live in the residence and claim the main residence exemption under section 118-110 of the 1997 Act. This exemption does not apply to residences owned by companies, superannuation funds or trusts other than "absolute entitlement" trusts, ie trusts with individual beneficiaries who have absolute entitlements to the trust and satisfy the requirements of section 106-50 of the 1997 Act.

The executor, rather than the trustee, is usually given the discretion to avoid a testamentary trust (but usually needs the prior consent of the primary beneficiary before the discretion can be exercised). This means that if bankruptcy or means tested pension eligibility rules are further tightened, the primary beneficiary cannot be said to have the power to exercise that discretion.

7. Need for Adequate Funding

Whether there is sufficient funding for testamentary trusts will depend on the size of the estate, the number of primary beneficiaries and whether assets such as inheritances, insurance and superannuation death benefits will be paid into the estate. For tax, retirement planning and asset protection planning reasons, many people can hold a significant proportion of their assets outside their personal names.

8. Unnecessary tax liabilities

Too often Wills are drafted without input from a Willmaker's financial planner or accountant. This can mean that tax and other practical issues are ignored and unnecessary tax liabilities are generated as a result, eg unnecessary capital gains tax being paid or an unnecessary taxable death benefit eligible termination payment of superannuation death benefits.

It is also important that Willmakers (and their lawyers and other professional advisors) appreciate the significance of the current and future ownership of assets such as insurance policies, superannuation death benefits, account based pensions, loans to companies and trusts, unallocated net family trust assets and inheritances.

9. Means Tested Pensions and Testamentary Trusts

These days the means testing rules for determining pension eligibility (with some exceptions, eg special disability trusts for people with severe disabilities), take into account assets that a pensioner may be said to:

- control (eg a testamentary trust of which the pensioner is a potential beneficiary or is the trustee or appointor);

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- have given away, eg by disclaiming an inheritance from a deceased estate.

This means that careful consideration needs to be given to:

- the drafting of Wills (including giving the trustee of a testamentary trust the power, usually only exercised with the consent of the appointor, to permanently exclude a beneficiary);
- the nomination (whether binding or merely advisory) of preferred beneficiaries for superannuation or account based pension death benefit beneficiaries;
- ownership of life insurance policies; and
- other estate planning documents.

While non-fixed testamentary trusts may still achieve pension eligibility if carefully drafted, it is possible that the wrong person, eg unscrupulous children, might be given control of the trust and abuse that control for their personal benefit.

10. Family Trust and other Tax Elections

Given that (like ongoing deceased estates) testamentary trusts may have to make family trust or interposed entity elections down the track, it is important to recognise that for practical purposes the class of potential beneficiaries may be effectively narrowed as a consequence of such an election. Family trust elections pose particular difficulties when the key beneficiaries of a testamentary trust (other than a fixed life interest) cannot come within the same family group.

11. Lack of Long Term Planning

Like family trusts established by Deed, many testamentary trusts fail to address how control is to be shared if the trust continues past the primary beneficiary's death. It is strongly recommended that dispute resolution formulas be included as standard features in the terms of the various testamentary trusts to cover this "second generation" situation.

Providing the above pitfalls are avoided or their impact is more than offset by the advantages, testamentary trusts are an important estate planning tool in assisting Willmakers to achieve their estate planning objectives.

Note: Statement of Advice: The above material is for general information only & should not be relied on as (or in substitution for) legal, personal financial or other professional advice. See our website for the latest version and cross references.