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Explanatory Memorandum

Testamentary Trusts

A testamentary trust is a trust created under a Will that comes into effect upon the death of the Will Maker. Typically a testamentary trust takes the form of a discretionary trust, which allows the trustee a broad discretion to distribute the income and capital of the trust amongst a wide class of beneficiaries. However they are drawn to meet the individual's needs, so can be fixed, or limited (for example to direct descendants).

A Will may make provision for the creation of 1 or more testamentary trusts.

Testamentary Trust Wills are commonly put in place to protect an inheritance for "at risk" beneficiaries. This could be such things as beneficiaries who are children, creditors of beneficiaries, beneficiaries who are likely to mismanage an inheritance or beneficiaries who may be subject to Family Court proceedings (eg: a property settlement). If the Will Maker is concerned about one of these scenarios, by creating a testamentary trust Will, the Will Maker can still make provision for a beneficiary while entrusting control over the inheritance to a third party.

Benefits

1. Young Children

   A testamentary trust structure provides greater flexibility to those people who you nominate to look after your children's inheritance. It allows greater powers of investment and tax effective distribution strategies so as to ensure an inheritance is appropriately looked after until your children become an age where they can take over management of the trust.

2. An inheritance may be protected against creditors in the event of a beneficiary's bankruptcy

   For asset protection a beneficiary may not want assets in their name. Or if a beneficiary is bankrupt or facing bankruptcy, their inheritance may be directed into a testamentary trust, which will protect these assets from their current or future creditors.

   As the testamentary trust takes the form of a discretionary trust, the beneficiary generally does not have a right to receive distributions of income capital from the trust until the trustee determines otherwise. Accordingly, the beneficiary does not ordinarily have a right to the trust's assets, and neither does the creditor.

3. In the event the beneficiary becomes part of divorce proceedings, an inheritance is unlikely to be distributed pursuant to a Family Court order in property settlement proceedings.

   If a beneficiary is party to a divorce and/or property settlement, then a testamentary trust may protect the trust assets from the reach of the Family Court. By using a testamentary trust, your estate may be directed to your bloodline, rather than being divided between unrelated parties.

   Depending on the circumstances of the beneficiary's property settlement, the Family Court may determine that the trust assets are a financial resource of that beneficiary and this will be taken into account in determining how the assets of the relationship are to be divided.

4. Families can ensure adequate funds are provided for a beneficiary and at the same time protect the funds by keeping them out of the beneficiary's control

If the Will Maker has concerns about a beneficiary, spending habits or money management skills, then an inheritance can be protected by establishing a testamentary trust controlled by a trusted third party (e.g. family friend, accountant).

This will allow the trust assets to be applied to the benefit of the beneficiary, and their immediate family (such as the payment of children's school fees), without concerns that the inheritance would be squandered in a short period of time.

5. Considerable tax savings can arise.

Section 102AG of the *Income Tax Assessment Act 1936* (Cth) provides certain mechanisms which allow children under the age of 18 years to be taxed on income distributed from a testamentary trust as an adult, thereby enjoying the benefit of the tax-free threshold and normal marginal tax rates.

Other tax savings may include:

(a) The ability to stream and distribute different categories of income to different beneficiaries. For example, all of the income received as interest on a particular trust asset which has been invested can be applied to one beneficiary, potentially allowing the beneficiary to obtain a better individual tax position;

(b) The ability to distribute to tax exempt entities (typically charitable entities). Tax exempt entities are beneficiaries of standard testamentary trusts. If a trustee decides that it would like to make a donation to a tax exempt entity then it can do so directly from the testamentary trust.

(c) The ability to make greater distributions of trust income to beneficiaries who are taxed at lower marginal rates. This provides the trustee with flexibility in making its trust distributions each year. For example, a trustee can make a larger distribution of trust income to the spouse of a primary beneficiary who is not working, therefore taking advantage of the spouse's lower marginal tax rate.

What assets are included in testamentary trusts

1. Only assets that are held in the deceased person's name at the time of his or her death are included in the trust. Therefore it is important that insurance policies and the ownership of jointly owned property are reviewed by us to ensure that they will form part of the trust.

2. Sometimes it is preferable that superannuation moneys be received by surviving spouses or children rather than being paid into the trust. Accordingly, it is appropriate to have options in your Will to enable superannuation moneys to be paid either to the trust or to individuals.

Other issues to consider

1. The Trustees of the testamentary trust do not have to be the executors of your estate.

2. The guardian of your infant children will need to work with the Trustees, so choose people for these roles who don't have obvious conflicts of interest.

3. You don't have to put the whole of your estate into a testamentary trust. You can put specific assets, or sum of money into the trust and the balance of your estate can be gifted directly to your beneficiaries. Alternatively, you can make specific gifts of property to beneficiaries before the balance of your estate goes into the testamentary trust.

4. Your creditors will be paid out of the estate before any assets go into the testamentary trust.

5. A testamentary trust offers no protection against a Family Provision application and like all provisions of a Will, may be vulnerable in such an application.

6. It is possible to limit the amount of income and capital a beneficiary can receive so as to not disrupt a beneficiary's entitlements to pensions or similar.

7. The trust has total flexibility, enabling the trustee to invest in whatever property or assets they wish. They can also draw on capital and income from time to time for particular needs.