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TESTAMENTARY TRUSTS EXPLAINED

1. General Overview

A testamentary trust is simply a trust that is created by a taxpayer's will which does not come into effect until the taxpayer dies. A testamentary trust is like any other ordinary "inter vivos" trust, the only difference being that it is created under a will rather than by a living person. The terms of a testamentary trust are set out in the will.

Whilst a testamentary trust can take many different forms (E.g. fixed trust, a trust for specific purposes etc) generally, for estate planning purposes, a testamentary trust is a discretionary trust and accordingly its terms are similar to those found in an ordinary family discretionary trust deed.

When the taxpayer dies, the terms of the taxpayer's will causes the testamentary trust to be created and during the course of the administration of the estate the taxpayer's assets will be transferred to the testamentary trust in accordance with the terms of the will[1]. Once in the testamentary trust, like any other family discretionary trust, the trustee has full discretion regarding distributions and income and capital.

2. General Advantages

The main advantages of a testamentary trust are as follows:

2.1 Protection of assets against creditors and bankruptcy of beneficiaries

If, when a taxpayer dies, one of their beneficiaries is bankrupt or in serious financial trouble, and assets received by that beneficiary under the taxpayer's will are not protected and will be used to satisfy the beneficiary's creditors. However, if on the deceased's death the assets were held in a testamentary trust, then as those assets were not owned by the beneficiary they would not be exposed to the beneficiary's creditors.

2.2 Protection against spendthrift beneficiaries

A concern of many parents is that if they die while their children are young and those children inherit money and assets they may irresponsibly waste a large proportion of their inheritance.

[1] The transfer of the assets into the testamentary trust will not be subject to CGT under Division 128 of the Income Tax Assessment Act 1997

By having a testamentary trust a responsible person can be made trustee of the testamentary trust and distribute so much of the income and property form the trust as is needed by the children from time to time, for example, for eduction and living expenses. When the children are older and more responsible they can take control of the testamentary trust and their inheritance.

2.3 Protection against a relationship breakdown

If a beneficiary's marriage breaks down and the deceased's assets are held within a testamentary trust then it is less likely they can be the subject of the beneficiary's family court property settlement. If, on the other hand, the beneficiary had inherited the assets absolutely, those assets would most likely be taken into account by the family court when making orders regarding the division of the couple's property.

Although a testamentary trust offers some protection, depending on who controls the trust, the terms of the trust and who the beneficiaries are may be taken into account by the Family Court when considering the financial resources of the beneficiary.

2.4 Flexibility of distributions

From a tax perspective, just as with an inter vivos family discretionary trust, income can be steamed and distributed in a way to minimise tax by taking advantage of different beneficiary's marginal tax roles. [See also Taxation Advantages below].

3. General Disadvantages

The main disadvantages of a testamentary trust are as follows:

3.1 Cost and complexity

They may be costly to operate. Someone must act as trustee and run the testamentary trust. The Trustee may need legal and accounting assistance. The Trustee may have to prepare accounts and must lodge a trust tax return each year.

3.2 Build up of minor’s account

Although tax savings can be achieved by distributing income to a minor, if the distribution is not physically paid each year the outstanding present entitlement in favour of the minor will build up each year. When the minor reaches the age of majority they may demand payment of the amount owing to them at a time when the cash is not readily available. In some circumstances the minor may even be able to cause the trust to be vested. This problem is minimised in circumstances where money is paid or applied for the use or benefit of the minor.

3.3 May need to make family trust election

If shares are held in the testamentary trust then the Trustee may need to make a family trust election so that the beneficiaries can satisfy the 45 day holding period rule.

3.4 Trust losses

Unlike a deceased estate, a testamentary trust must comply with the trust losses rules[2] whereas a deceased estate gets a 5 year moratorium.

4. Taxation Advantages

In order for a testamentary trust's income to be "excepted trust income" the critical factor is that the testamentary trust must be created out of a deceased estate[3].

The income of the testamentary trust need not be derived from the deceased's assets owned at the time of death and will still be excepted trust income where the assets that passed to the testamentary trust from the deceased have been sold by the trustee and the proceeds reinvested.

Perhaps the most obvious advantage is that income devised by a testamentary trust may be distributed to a minor beneficiary who will attract the normal marginal rates of an adult, i.e. the first $6,000.00 income will be tax free[4].

However, care must be taken not to attract the anti-avoidance provisions in the Income Tax Assessment Act[5].

Under the anti avoidance provisions, income of testamentary trust will not be excepted trust income where:

a) the derivation of the income; or
b) any act or transaction directly or indirectly connected with the derivation of the income

was not at arm's length. In these circumstances only that amount of income that would have been derived had the parties been dealing at arm's length will be excepted trust income.

The Australia Taxation Office also provides some guidance about what it considers dealing at arm's length actually means[6].

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[2] Section 272 of Schedule 2F of the Income Tax Assessment Act 1936
[3] Section 102AG of the Income Tax Assessment Act 1986
[4] Normally a minor is a "prescribed person" under the Income Taxation Act 1936 and attracts tax at penalty rates
[5] S.102AG(3) and (4) of the Income Tax Assessment Act
[6] Paragraphs 52-54 of TR 2006/D1