RICHARDS FINANCIAL SERVICES

2019 Testamentary Trusts- Benefits and Disadvantages

A testamentary trust is commonly used by estate planning lawyers to protect the assets of the family from creditors, family law actions and, at the same time, provide flexibility in relation to the distribution of the estate. In essence, a testamentary trust is a trust that arises from the estate of the deceased and provision for it is contained in the deceased's will. As such, the terms and conditions of the trust, including the appointer, income and capital beneficiaries, Trustee and so on, are to be designated in the will of the deceased.

The benefits and limitations are discussed below.

Advantages

1. Control is held by the Trustee of the testamentary trust and obviously the person who has the power to appoint and remove the Trustee — the appointor of the trust.
2. It is built for the purpose of looking after the family and others on the death of a family member, with income and capital distributed by the Trustee to a group of family or non-family beneficiaries. The testamentary trust will require the Trustee to look after family members in a specified way, rather than provide the Trustee with complete discretion.
3. It is possible to create income streams from the testamentary trust — although with difficulty and certainly not the tax certainty of a pension in a SMSF.
4. The Trustee is able to look after capital and income beneficiaries differently. The Trustee may distribute a capital gain to one beneficiary, a dividend to another, while a third may receive property income, depending on the terms of the testamentary trust deed.
5. A capital gains tax discount of 50% applies to any assets disposed of by the Trustee, provided the Trustee has held them for more than 12 months. Although the Trustee claims the discount, they distribute the pre-tax capital gain to the beneficiary. This enables the beneficiary to claim the discount in their own hands and, more importantly, offset the capital gain with any capital loss that they may have from the disposal of assets in the current or prior years.
6. Assets are protected from creditors. Any assets in the testamentary trust may be protected from creditors of the potential family beneficiaries.
7. Minor beneficiaries are not subject to penalty taxes and are taxed just like any other ordinary taxpayer.

Please Note: Many of the comments in this publication are general in nature and anyone intending to apply the information to practical circumstances should seek professional advice to independently verify their interpretation and the information's applicability to their particular circumstances.

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8. In terms of divorce and family break-ups, testamentary and other trusts have proved their effectiveness in sheltering assets from the Family Court and courts in general, although this is becoming more difficult.

9. Some part of the testamentary trust can be used to house a deceased's superannuation benefits. If these benefits are held solely for the use of dependants of the deceased, then no tax is payable on receipt by the executor of the deceased's estate on these amounts. If the benefits are to be applied for the benefit of non-dependants, then the tax on the lump sums received is 17%. Any income or gains earned in the testamentary trust on these partitioned superannuation proceeds are taxed as ordinary trust income.

Disadvantages

1. Testamentary trusts are hard to administer and account for. By their very nature, trusts are complex structures, particularly when different types of income and capital are distributed among beneficiaries under a wide-ranging trust deed. This means costs of running a testamentary trust may be substantial.

2. Where specific requirements are built within the trust deed (eg each child to receive a set amount of income each year), the drafting of the legal document can become quite complex, costly and hard to implement.

3. All income and capital gains must be distributed annually or the testamentary Trustee pays tax on the income at the top marginal tax rate of 47%. In the case of a trust with different income and capital beneficiaries, this means that, in terms of capital gains made by the trust, it must choose one of the following options and still balance between both types of beneficiaries:

    - distribute capital gains to capital beneficiaries whenever made which reduces the asset base for the income beneficiary;

    - distribute capital gains as part of the income of the trust to the income beneficiary if the income of the trust includes assessable capital gains;

    - keep it in the trust with the Trustee paying tax at 47%, and

    - keep it in the trust with the capital beneficiary paying tax with distributions recapitalised.

4. Income distributed from the trust is subject to tax at the beneficiaries' marginal tax rate, although imputation credits on dividends received and passed through to a beneficiary will shelter some of the tax payable. There are no tax concessions provided to beneficiaries of a testamentary trust except that minors are taxed as ordinary taxpayers.

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5. Testamentary trusts are subject to the “rule against perpetuities” unless using a LightYear Docs Perpetual Testamentary Trust and must be wound up no later than 80 years from the date of establishment. This may impact estates seeking to pay long term income benefits to a family line including children and grandchildren.

Warning: A Testamentary Trust flows out of the deceased’s Will and before it can be implemented the Executor may have to deal with any Family Provisions challenge, rendering the Testamentary Trust inoperable if there is no estate assets.

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