Will Testamentary Trusts

Do you want to secure your assets and provide a means of tax minimisation for your beneficiaries?

If so, perhaps you should consider transferring your inheritance into a testamentary trust.

Most wills are inflexible and transfer the deceased's assets directly to beneficiaries without an opportunity to nominate a structure for the inheritance. However, a testamentary trust gives the beneficiary the option to inherit all or part of their share either directly to them or by way of a trust. While the decision of the beneficiary on whether to use the testamentary trust or not will depend largely upon their particular financial circumstances at the time, by giving the beneficiary the option, you are providing them with a means to control their financial future.

What are the benefits of using a testamentary trust?

The major benefits of using a testamentary trust are:

- it may allow the beneficiaries to pay the least possible income tax and capital gains derived from inherited assets
- testamentary trusts may encourage beneficiaries to use any surplus income for the benefit of young children and grandchildren
- placing assets in a trust may protect beneficiaries involved in legal proceedings such as bankruptcy or divorce
- trusts may be able to protect assets to ensure they benefit the beneficiaries for as long as possible. This is particularly important in circumstances where the beneficiary is incapable of properly managing money
- a testamentary trust may assist in allowing particular assets to remain in the 'family' rather than being lost to married relatives

So what is a testamentary trust?

A trust arises where a person transfers assets or money to another person, known as a trustee, who holds the assets or money for the beneficiaries.

A testamentary trust is created pursuant to a person's last will and testament. As such, a testamentary trust is not created until that person dies.

The trustee of a testamentary trust must act in accordance with the terms of the trust set out in the deceased's will. The trustee is responsible for investing money and distributing any income or capital in accordance with those terms.

The majority of trusts are discretionary trusts, this means the trustee has complete discretion as to how any income or capital gain is distributed among the beneficiaries. A beneficiary of a discretionary testamentary trust has no rights to income or assets of the trust until the trustee exercises his or her discretion in the beneficiary's favour.

Under the Income Tax Act, if gains derived by a trust are allocated to one or more beneficiaries, they are liable to pay tax on their share of the gains at their normal marginal tax rates. Hence, in practice, the trustee usually distributes any gains derived by the trust to those beneficiaries who in that year have the lowest marginal tax rates.

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How does a testamentary trust work?

The trustee owns all assets of the trust and earns all income and capital gains from investments. The trustee opens a separate bank account in the name of the trust and is responsible for the lodgement of the income tax returns of the trust.

Provided the trust allocates all income and capital gains to the beneficiaries each year, it will not be liable for tax. This is evidenced by an annual resolution signed by the trustee.

Beneficiaries who have been allocated trust income are required to include the trust income in their personal tax returns and to pay tax on it.

Possible tax benefits and asset protection

Under normal circumstances, if a beneficiary is under 18, the trust income distributed to him or her is taxed at penalty interest rates. Under these rates, the child has a limited tax free threshold. However, if the income is derived from a deceased estate, the child will be taxed at normal adult tax rates and the child will have a higher tax free threshold in relation to any trust income applied for his or her benefit.

The other advantage is that because assets are held on behalf of beneficiaries, they can not be treated as an asset of the beneficiary should that beneficiary be a party to a legal proceeding such as bankruptcy. If a beneficiary inherits assets in their own name and a business they are running fails, the inherited assets may be lost to creditors.

The assets would however be protected if they were held in a testamentary trust because a beneficiary has no rights in relation to assets which are owned by the trust and not the individual.

It should be noted that testamentary trusts do not provide complete protection, but do offer significantly more protection to beneficiaries than direct inheritance.

In summary

We recommend that individuals should give beneficiaries the option to inherit their share of an estate by way of testamentary trust so as to provide each beneficiary with the ability to control and protect their inheritance. While it is conceivable that in the future the effectiveness of such a trust may be reduced, by making provision for a testamentary trust in your will you are not forcing the beneficiary to use the trust but providing a means by which the beneficiary may make full use of all of the possible benefits on offer to them.