Australian Executor Trustees

Estate planning client guide

Why should you consider a testamentary discretionary trust?

A trust created within your Will can provide significant flexibility, as well as tax minimisation and asset protection, for those who will benefit from your estate.

What is a testamentary trust?

In general, a trust describes an ownership structure where the assets of the trust are owned by one person or organisation (the trustee) but held for the benefit of other individuals or organisations (the beneficiaries).

A testamentary trust is a trust that is created within and by your Will but does not take effect until your death. It differs from a family trust (also known as an inter vivos trust) as a family trust is created by deed and commences during your lifetime.

A testamentary trust may be created using specified assets, a designated portion of your estate or the entire remaining balance of your estate. Multiple trusts may be created by the one Will and it's possible to have trusts with different provisions which can be tailored to the needs of the beneficiaries.

While the trustee of the trust is usually nominated by the willmaker, the willmaker can also give the primary beneficiary of the trust the power to appoint the trustee.

What is a testamentary discretionary trust?

A testamentary discretionary trust is one where the trustee has the discretion to distribute capital and income in the same or differing proportions between a group of beneficiaries nominated in your Will. The trustee may also have the ability to wind up the trust at any time.

What are the advantages of a testamentary discretionary trust?

Flexibility for your beneficiaries

The trustee may distribute capital and income to any nominated beneficiary at any time and in any proportion. The trust can be wound up at any time or kept open for an extended period of time (up to 80 years in most States). So, a testamentary discretionary trust gives the beneficiaries both flexibility and control over when and how they take their inheritance.

Protection of assets

Before the assets can be taken out of the trust, the trustee must first determine distribution to the beneficiaries. As the assets are not legally owned by the beneficiaries, they have a far greater level of protection from legal proceedings, such as marriage or relationship breakdown or bankruptcy (however, it's beneficial to have an independent trustee in place in case this does occur). A trust legally separates the inherited assets from the personal assets of the beneficiaries.

Taxation advantages

The discretionary powers given to the trustee in the Will make the testamentary discretionary trust a flexible tax planning vehicle. Taxable income generated by the trust can be allocated to the beneficiaries of the trust in a tax-effective manner.

The beneficiaries pay income tax on their share of income according to their marginal tax rates. Unlike tax on income from a family trust, beneficiaries under 18 years of age are taxed at normal adult rates rather than at penalty tax rates. The potential for tax savings when trust income is allocated to children, therefore, may be substantial. In fact, from 1 July 2012 a person under 18 years can receive $20,542 tax-free if they have no other income.

Case study

John and his wife, Mary, both have incomes that attract the top marginal tax rate of 46.5%. They have three children under 18, none of whom have any personal income.

John is about to inherit $400,000 in a combination of shares and fixed interest securities. The anticipated annual investment returns from the inheritance are:

Interest	$10,000
Dividends	$10,000
Imputation credits	$3,000
Discounted capital gain (reinvested)	$7,000
Taxable income	$30,000

From this income, the cash received will be $20,000.

John compares how much disposable cash his family will have each year if the $400,000 is inherited directly by him or through a testamentary discretionary trust.

Scenario 1: John inherits in his own name

Tax on $30,000 (46.5% tax rate)	$13,950
Less imputation credits	$3,000
Tax payable	$10,950
Cash received	$20,000
Less tax	$10,950
Disposable cash	$9,050

Scenario 2: John inherits as trustee of a testamentary discretionary trust

John can allocate the trust's income to the three children in equal shares. The taxable income for each child is $10,000.

Tax on $10,000	$nil
Less imputation credits	$1,000
Tax refund for each child	$1,000
Cash received	$20,000
Add tax refund for all three children	$3,000
Disposable cash	$23,000

In summary, the disposable annual cash return is:

Direct inheritance by John (Scenario 1)	$9,050
Testamentary discretionary trust (Scenario 2)	$23,000

The difference is $13,950 which is the after-tax cash saving of using the testamentary discretionary trust. If John's inheritance can be taken in the form of a testamentary discretionary trust, John and his family will have an additional after-tax income of $13,950 each year.

For further information please contact your AET estate planning specialist on **1800 882 218**.

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