

TOP 18

PROS & CONS

of testamentary trusts

Contents

Before you get started	2
Letter from the Wealth Adviser Library	3
Introduction	4
How trusts work	4
Testamentary trusts	4
Advantages of a testamentary trust	5
Disadvantages of a testamentary trust	7
Conclusion	8
Take the next step	8
Glossary	9





Before you get started

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- Sentry Advice (AFSL 227748)
- Synchron Advice (AFSL 243313)
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Information in this handbook is no substitute for professional financial advice.

We encourage you to seek professional financial advice before making any investment or financial decisions. We would obviously love the opportunity to have that conversation with you, and at the rear of this handbook you will find information about our authorised representative and how to go about booking an appointment.

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Letter from the Wealth Adviser Library

Dear Reader

Welcome to the Wealth Adviser Library

This library was built specifically to facilitate the provision of sound financial information to everyday Australians.

Our mission is to build an accessible, comprehensively supported team of members who share our vision and commitment to providing tailored financial advice and a new foundation of financial understanding and security for everyone.

With a national network of likeminded experts, we have the potential to provide the financial building blocks for future generations.

Knowledge gives you a huge advantage

We believe that knowledge gives you a huge advantage in creating and effectively managing wealth; in planning to reach your goals; and in being prepared for whatever unexpected twists and turns life may present.

That's why our team of experts has created this series of digital handbooks and manuals that seek to inform you of not only the benefits but also the potential risks and pitfalls of various strategies and investments.

We trust you enjoy this publication and find it informative and professionally presented. Of course, your feedback is always welcome as we strive to continually offer content in a format that is relevant to you.

Take the next step

Wealth Adviser (a division of WT Financial Group Limited) supports more than 400 privately owned and operated advice practices around the country. We invite you to engage with one of our advisers to discuss what it was you were hoping to achieve when you obtained this handbook, and to establish if they can help you achieve your goals and objectives.

At the rear of this handbook you will find details on how to book an appointment.

Wealth Adviser Library

Introduction

This eBook will provide you with useful information on Testamentary Trusts, outlining both the advantages and disadvantages of this financial instrument. In consultation with your professional financial adviser, this knowledge will enable you to make an informed decision about whether a Testamentary Trust is suitable for your financial planning needs.

Everything you need to know will be explained in layman's terms, including any financial and legal jargon. For convenience, we've also included a Glossary at the back of this eBook that provides a definition of the most common terminology you'll encounter with Testamentary Trusts.

How trusts work

Before we look at testamentary trusts specifically, we'll review the basics of how trusts actually work. A trust is a legal relationship where a person, people or entity (the trustee) holds and distributes assets (such as income and capital) for the benefit of others (the beneficiaries, which can include people or entities). The trustee performs this task on behalf of a settlor (the person who creates the trust by "settling" assets to be held in trust for the beneficiaries). To create the trust, the settlor enters into a legal agreement with the trustee, via a trust deed which outlines the obligations of all parties. Because the trustee has the effective control of the trust, it is obviously important that the settlor knows and/or fully trusts the trustee to act in both their and the beneficiaries' best interests.

The trustee is the manager of the trust's assets and is responsible for the trust's day-to-day administration. If the trustee is a company, that company's directors are responsible for the trustee function. The trust deed determines the proportion of the trust's income and capital that will be distributed to the trust's beneficiaries, and the degree of discretion the trustee has in carrying out its duties. based on considerations such as their respective needs and the tax effectiveness of the

distribution.

Beneficiaries are not guaranteed income or capital distribution from a discretionary trust, only the right to be considered by the trustee. Because of the discretionary nature of discretionary trust distributions, trusts are widely considered to be a tax-effective asset.

However, because tax laws change over time, it is very important that trust deeds are regularly reviewed to ensure they are delivering the most tax-effective outcomes for beneficiaries.

In addition to a trustee, some trusts also have a principal. The principal has ultimate control over the trust, and has the power to appoint or remove the trustee at any time. This principal role is also referred to as an appointor, guardian, or nominator in some trust deeds, and can be a person or an entity.

Testamentary trusts

A testamentary trust is a trust established in accordance with a will (with the person who has prepared the will being known as a testator). It is therefore an estate planning tool. A testamentary trust may deal with either all or only a portion of a testator's estate (their net worth at the time of their death). A testamentary trust may be especially suitable for people who will have a significant windfall upon their death, such as the proceeds from a life insurance policy. They are also relatively inexpensive to establish.

A testamentary trust can remain in existence for up to 80 years if necessary, or any shorter time period if specified in the will, or if the trustee is permitted to select an earlier vesting date (the date that the trust will end). There may also be more than one testamentary trust associated with a will, if the testator (who in terms of the trust is also the settlor) has prepared more than one for the purpose of achieving different objectives (for example, for different children).

Upon a testator's death, their estate is administered by an executor (either a person or entity) nominated by the testator

or by a probate court (a court that specialises in the administration of estates). The testator's (settlor's) net assets (i.e. gross assets at their time of death less any outstanding debts or otherwise specified Will distributions) are placed in the testamentary trust in accordance with their wishes, to be held by the trustee (who may also be the executor, but may not necessarily be). Beneficiaries of a testamentary trust typically include relatives of the settlor, and perhaps company entities in which the settlor has an interest. Where the principal role exists for a testamentary trust, the executor is often chosen for this role, and as mentioned earlier, has the power to remove or appoint the trustee.

Advantages of a testamentary trust

The range of potential benefits of a well-drafted Testamentary Trust can be broadly classified into three main categories:

- Control over Wealth Distribution
- Asset Protection
- Tax Benefits

We will now look at each of these three categories in turn:

Control over Wealth Distribution

A well-drafted Testamentary Trust can:

1. Ensure that a Settlor's children (and grandchildren etc.) are provided for long-term. Although many people simply leave all of their assets to their surviving spouse, there is no guarantee that the settlor's children will eventually receive the inheritance, particularly if their surviving spouse remarries and has further children. A testamentary trust on the other hand allows a settlor to avoid this potential scenario.

They also enable the opportunity for wealth provision for grandchildren and future generations, rather than solely providing for the current generation.

2. Enable a settlor to stagger the timing of beneficiary entitlements. It can potentially be dangerous leaving beneficiaries with a single, significant inheritance entitlements, especially in the case of young adults. However, smaller, regular payments to be distributed to beneficiaries over the longer term can be achieved via a testamentary trust. The settlor can also stipulate that distributions are dependent on certain events, such as the beneficiary achieving certain milestones, or that the proceeds are to be used for specific purposes, such as the deposit on a house or for their grandchildren's education. This avoids the potential for the settlor's accumulated wealth (i.e. the beneficiaries' windfall) to be quickly squandered.
3. Provide flexibility, with distribution by the trustee being based on future needs rather than current circumstances. People's circumstances invariably change over time. A testamentary trust provides a structure whereby a trustee can take this into account in terms of the trust's future beneficiary distributions.

Asset Protection

In addition to providing control over the settlor's wealth distribution described above, a well-drafted testamentary trust can:

1. Help protect beneficiary inheritances from challenge in the family court in the event of a marriage or relationship breakdown. If the settlor wishes to ensure that only their direct lineal descendants (i.e. children, grandchildren, great grandchildren etc.) will benefit from the future distribution of trust proceeds. A properly drafted testamentary trust may exclude linear descendants' spouses from any entitlement to trust distributions. Such a trust would ensure that any inheritance intended

for the benefit of the settlor's lineal descendant via the trust is not compromised by any future marriage or relationship breakdown, therefore avoiding the need for a family court ruling on the trust's proceeds.

2. Help protect beneficiary inheritances from creditors, bankruptcy and other financial hardship provisions. Many business-owners and company executives put asset protection strategies in place to protect themselves from the potential risks of future financial hardship and/or bankruptcy. Accordingly, such people may prefer not to receive inheritances in their own name. A testamentary trust can facilitate this wish. Assets held in the trust cannot be claimed by creditors, unless the debt relating to the creditor is a trust debt. Where an individual beneficiary has separate debts to the testamentary trust, their trust proceeds are protected from such creditors.
3. Reduce the likelihood of claims on an estate by disgruntled beneficiaries. A testamentary trust has a range of beneficiaries, rather than just a single beneficiary. A testamentary trust also has its proceeds distributed over time. These facts make it comparatively less likely that a disgruntled beneficiary will make a claim against an estate, than if the entire proceeds of the estate were distributed only at one single point in time.

Tax Benefits

Like all trust vehicles, testamentary trusts have the potential to provide tax benefits to beneficiaries. In addition, some tax benefits are either unique or more advantageous with testamentary trusts. A well-drafted testamentary trust can:

1. Enable beneficiaries to maximise the tax-effectiveness of their trust income proceeds. As with all trusts, the trustee for a testamentary trust has the discretion to be flexible with

income distribution to beneficiaries from year to year, influencing the potential tax obligation of each beneficiary. Good communication between a beneficiary and a trustee can minimise this obligation by adjusting the distribution from year to year to suit the personal circumstances and marginal tax rate of the beneficiary as this changes over time. A testamentary trust can also be structured and administered to help a beneficiary avoid the loss of a government benefit.

In the absence of a testamentary trust, a beneficiary receives the entire proceeds of an inheritance in a lump sum, along with the entire tax burden of the asset at the same time, potentially creating financial issues.

2. Facilitate income splitting among beneficiaries to minimise tax obligations. Income distributions to individual trust beneficiaries are taxed at each individual's marginal tax rate. Due to their discretionary power, a trustee can direct more of the trust's distribution to lower earning beneficiaries in order to minimise tax obligations. For example, this could significantly benefit married couple beneficiaries where one spouse earns significantly more than the other.
3. Facilitate income streaming among beneficiaries. Different classes of assets (for example share dividends and interest) can be allocated by the trustee to different beneficiaries, depending on factors such as needs and tax considerations.
4. Tax-effectively provide for minors (i.e. infants and children). In terms of minor beneficiaries, testamentary trusts have a significant tax advantage over trusts created during a person's lifetime (which are known as inter vivos trusts). For example, testamentary trust distributions to a minor can be included in the minor's tax-free

threshold up to the maximum annual limit permitted (currently up to \$18,200 for the 2019/20 financial year), with the balance taxed at marginal rates, which start at 19% after the first \$18,200 earned. By comparison, only the first \$416 of a minor's proceeds from a family trust is tax-free, with the remainder currently taxed at the below rates:

Family Trust income of a minor	Tax Rate	Testamentary Trust income of a minor	Tax Rate
\$0 - \$416	Nil	Up to the \$18,200 tax free threshold*	Nil
\$417 - \$1,307	66%	Standard individual tax rates apply after \$18,200	
Over \$1,307	45%		

*Any other income earned by a minor would also be counted toward the tax-free threshold, in addition to testamentary trust income.

The more favourable taxation treatment of testamentary trusts will potentially save minors from paying a significant amount of tax over time. In addition, the ownership of any assets left to minors via a testamentary trust must eventually transfer to them.

5. Enable capital gains tax and stamp duty flexibility for beneficiaries on asset transfers. In the absence of a testamentary trust, upon death a person's assets pass to the beneficiaries nominated in their will. In the case of property or the sale of a business for example, this can trigger potential capital gains tax and stamp duty obligations. However, with a testamentary trust, such assets pass into the trust for subsequent distribution by the trustee. This allows time for effective tax minimisation strategies to be investigated, and distribution decision to be made accordingly that are in the best interests of the beneficiaries from a taxation

perspective.

6. Reduce the tax payable on the settlor's superannuation and/or life insurance proceeds. Arranging for these proceeds to be paid into a testamentary trust can enable tax to be minimised.

Disadvantages of a testamentary trust

While there are potential advantages of using testamentary trusts, there are also potential disadvantages to consider, such as:

1. The risk of giving responsibility for the distribution of your assets to a trustee. There is no guarantee that the person a settlor chooses will have the competence (or even honesty) to effectively perform this role in the best interests of the beneficiaries. As mentioned earlier, careful consideration must be given by the settlor in nominating a suitable trustee.
2. Legal liability and time commitment required of the trustee. The trustee may be required to meet with a probate court to verify that the trust is being administered in accordance with its provisions. In addition, there can be a significant time commitment required of the trustee in dealing with both the beneficiaries and the assets of the trust. This is likely to be the case where there are multiple potential beneficiaries and circumstances to consider. If the assets of the trust are large or complex, the trustee may need to engage the services of professional advisors and liaise regularly accordingly. The on-going time commitment required of the trustee needs to be considered and discussed prior to the settlor nominating a suitable trustee for their

testamentary trust.

3. No guarantee that the settlor's nominated trustee will accept the appointment. Because a testamentary trust is set up after the death of the settlor, there is no guarantee that the trustee will actually accept their appointment to the role, even though this may have been discussed and agreed in good faith during the settlor's lifetime. The desired trustee's circumstances may have changed and if they decline the role, the probate court will determine the trustee.
4. The settlor needs to consider whether the future income generated by the testamentary trust would warrant any or all of these potential expenses.
5. Reduced beneficiary power/influence. While this may be desirable in some cases, a testamentary trust vests control in the trustee. It can be difficult and expensive for beneficiaries to take any legal action against a trustee should they ever need to do so. As mentioned earlier, the choice of the trustee by the settlor is a crucial decision.
6. The potential issues created in the event of the primary beneficiary's death during the life of the trust. Because a trust can be ongoing for a period of up to 80 years from the settlor's death unless otherwise specified by the settlor, consideration needs to be given about what will happen in the event of the death of beneficiaries, and in particular, the primary beneficiary.

Conclusion

This eBook has introduced you to the fundamental aspects of testamentary trusts, outlining the key advantages and disadvantages of this financial instrument. The information provided is intended to be a general guide. You should always seek specialist advice from your financial advisor about whether a testamentary trust is appropriate for you to consider in relation to your specific estate planning needs and circumstances.

The glossary that follows provides a convenient and concise layman's explanation of the key jargon and terminology you will likely encounter in discussing or further researching testamentary trusts.

Take the next step

We trust you enjoyed this publication and found it informative and professionally presented. Of course, your feedback is always welcome as we strive to continually offer content in a format that is relevant to you.

We now invite you to take the next step and meet with an adviser to discuss what it was you were hoping to achieve when you downloaded this handbook and to establish if we can help you achieve your goals and objectives.

Next you will find details on how to book an appointment with an adviser.

We look forward to meeting you soon.

Glossary

Appointor –see principal.

Beneficiaries –people or entities that are intended to benefit from a trust.

Discretionary testamentary trust –a type of testamentary trust where the trustee has full discretion over both which beneficiaries benefit from the trust, and the extent to which they benefit.

Estate –an individual's net worth in terms of assets at the time of their death.

Executor –a person or entity who administers an individual's estate. If an executor is not nominated in the deceased individual's will, an executor may be appointed by a probate court.

Family trust –a discretionary trust established to hold a family's assets or conduct a family business, with both assets managed and distributions made by a trustee.

Guardian –see principal.

Inter vivos trust –a trust that is made and which exists during a person's lifetime. It is the opposite of a testamentary trust, which only comes into existence upon a person's death if they have made provisions for such a trust to be established as part of their will.

Lineal descendant trust –a form of testamentary trust that ensures only the lineal descendants (i.e. children, grandchildren etc.) of the settlor will benefit from the trust. Spouses of lineal descendants are excluded from any of the proceeds of a lineal descendant trust.

Nominator –see principal.

Primary beneficiary –the first in line to receive a benefit.

Principal –a role that is included in some trusts. A principal can be a person or entity and has the power to both appoint and remove a trustee. Also referred to as an appointor, guardian, or nominator in some trust deeds.

Probate court –a Court that hears and rules on matters relating to wills and estates, including testamentary trusts where

necessary.

Protective discretionary trust –a type of testamentary trust that has more limited options for beneficiaries. A protective discretionary trust is appropriate for situations where some of the trust's beneficiaries are unlikely to be able to effectively manage their inheritance, due to factors such as age or disability.

Settlor –a person who settles their assets in a trust. In relation to a testamentary trust, the settlor is also the testator (the person who drafted the will).

Testamentary trust –a trust established in accordance with a will. It is the opposite of an inter vivos trust, which is established during a person's lifetime.

Testator –a person who has drafted a will. In terms of the testamentary trust, the testator is also the settlor.

Trust –a legal relationship where a trustee holds and distributes assets (such as income and capital) for the benefit of others.

Trust deed –a document that establishes and sets out the terms and conditions of a trust, including the legal obligations of all parties.

Trustee –a person, people or entity legally responsible for administering a trust according to its purpose.

Vesting date –the trust termination date, specified in the trust deed.

Will –a legal declaration by a person (the testator) outlining the desired distribution of their assets upon their death.

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Appointments are available Monday-to-Friday.

Please nominate your preferred day, date and time to meet with us. One of our client services representatives will call you to confirm your appointment.

Our services

Preferred appointment day and time

Day

Date

Time am/pm

Contact details

If you would like us to contact you via email to confirm your appointment or to answer any questions you have, please provide a valid email address for our records.

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Reader Notes



Reader Notes



Wealth Adviser

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