Sladen Legal drives results

Testamentary Trust Wills

Information on discretionary will trusts

Wills which incorporate discretionary trusts can provide various advantages. They are commonly referred to as testamentary trust wills. These notes discuss how these wills work and what advantages they provide.

What is a discretionary trust?

A trust arrangement is a relationship where one person, the trustee, is given assets to hold for the benefit of another person or group of persons, the beneficiaries.

In a discretionary trust there are two or more beneficiaries. In fact there is usually a large group of beneficiaries. It might be the members of a family, their partners and any descendants of those people and more distant relations. The trustee has discretion to select from the group of beneficiaries those who receive any payment of income or capital from the trust assets. This is a key feature of discretionary trusts. Significantly, no beneficiary of a discretionary trust has a right to demand any capital or income from the trust. The trustee is under no obligation to pay any money to any particular beneficiary.

As well as the trustee and beneficiaries, most discretionary trusts have an appointor. The appointor of a trust is the person who has the power to "hire and fire" the trustee. In this way the appointor is the ultimate controller. The appointor and the trustee can be the same person which means that the appointor can appoint an additional or alternative trustee.

Role of executor and trustee

When making a will, whether or not it incorporates a discretionary trust, you appoint someone to be your executor and trustee. The task of the executor is to gather in the assets and pay any debts. The task of a trustee is to hold monies on behalf of beneficiaries and make distributions to them at the appropriate time.

The tasks of an executor and a trustee are usually handled by the same person or persons. The words "my trustee" in a will usually mean the person who acts as executor and trustee of the estate. The role of the trustee may only last for one or two days pending distribution or it may last for many years, for example, where there are infant beneficiaries.

The trust created in a standard will is what is known as a fixed trust in that the trustee must hold specified assets or a share of the estate for a beneficiary as directed by the will. The trustee has no discretion to distribute the estate assets amongst beneficiaries as he or she chooses.

If a will creates a discretionary trust then it is usual to appoint a trustee of that trust in addition to the trustee of the estate.

The trustee of the discretionary trust will have different powers to the trustee of the estate although the same person could be appointed to both roles. The trustee of the discretionary trust, as stated above, will have power to distribute assets of another the trust and income from those assets amongst the trust's beneficiaries as he or she wishes.

A discretionary trust in a will

When you make a will, instead of giving a beneficiary your estate or a share thereof directly, you can give the estate or the share to a discretionary trust for the potential benefit of that beneficiary and his or her family and associates. This beneficiary is sometimes called the primary beneficiary of the trust.

When you include a discretionary trust in your will, the terms of the discretionary trust must be set out in the will. There is no law that stipulates what the terms of a discretionary trust must be and trust terms vary from one trust to another. The discretionary trust terms which Sladen Legal includes in its wills are similar to those which we include in our highly regarded discretionary trust deeds. They are sophisticated documents which are regularly updated to reflect the current state of the law and are recognised in the market place as being of the highest quality.

The main issues to address in preparing a discretionary trust will are the identity of the appointor, the trustee and the beneficiaries, determining when the trust must end and what happens to assets in the trust at that time, and stating what powers are given to the trustee and to the appointor and whether any limitations are placed on those powers.

Discretionary trust wills can take various forms. You might leave your estate to a single testamentary trust of which your spouse and children and others are all beneficiaries. Alternatively a separate trust could be established for the family of each child with your spouse a beneficiary of each trust.

Another option is to leave your estate to your spouse directly, with no testamentary trust, but if your spouse has died before you then to a single testamentary trust for the benefit of all children, their families, and others, or to a separate testamentary trust for each child's family and others.

These options and their consequences need to be carefully considered when preparing a will.

You might expect that if you wished to establish a discretionary trust for a particular son and his family, that son would be the sole appointor and trustee. However this arrangement will not provide the asset protection which would otherwise be available if the son shared the role of trustee and appointor with another person. This is discussed below. In some circumstances parents will elect to include a sibling of a primary beneficiary as a co-trustee and/or co-appointor with the primary beneficiary, or even to deliberately exclude the primary beneficiary from being a trustee or appointor at all. For instance if a child had a chronic gambling problem it would be advisable the share in the estate is to be controlled by someone else, perhaps a sibling, utilising a discretionary trust.

What are the advantages

There can be several advantages in using discretionary trusts in wills including protection of family assets from various risks and possible tax savings.

The following are some examples of the benefits of a discretionary trust will can assist:

- **Beneficiaries at commercial risk**

Accountants, doctors, auditors, company directors, and financial advisors, amongst others, face the risk of being sued for a mistake made by them or one of their business partners in the conduct of their work. There is no guarantee that insurance will always cover such a claim. These people often therefore avoid having assets in their own name.

Many couples make wills leaving all of their assets to their spouse, but if the spouse predeceases then to their children. If the spouse or any of the children are in the

types occupations there is a risk that the inheritance may finish up in the hands of creditors of that person. If a successful negligence claim was brought against the spouse or child who had inherited from the estate.

If on the other hand the assets otherwise passing to a spouse or child had been given to a discretionary trust controlled by the spouse or child and someone else, then the assets should not be available to a creditor of the spouse or child.

- **Spendthrifts and gamblers**

Occasionally a will maker will have a son or daughter who is a spendthrift or has a gambling habit.

A discretionary will trust can be used in these situations.The beneficiary is not then deprived of a benefit from the estate but does not have control of what would otherwise have been his or her share. If the beneficiary's share is given by will to a discretionary trust the trustee can be someone else in the family, or a trustee company, who can then control the inheritance and distribute to the beneficiary and his or her family as considered appropriate. Bear in mind however that excluding the beneficiary from control in this way may increase the risk of a claim being made against the estate by that beneficiary.

Some will makers exclude a son or daughter with gambling problems from any share in the estate. This raises the possibility of a claim against the estate by the son or daughter. Using a discretionary trust will may reduce the risk of such a claim as the beneficiary is not necessarily excluded from a benefit, but the benefit will be subject to the discretion of the trustee.

- **Beneficiaries in an unstable relationship**

Will makers are often concerned that when their estate passes to a son or daughter some of the estate will finish in the hands of the partner of that person if his or her marriage or relationship breaks down.

The Family Law Act applies to both married couples and couples who have been in a defacto relationship for more than two years or have a child born of that defacto relationship. A defacto relationship includes same sex couples.

Under the Family Law Act, money which is inherited by a partner may be excluded from the pool of matrimonial assets for distribution between the parties on a breakdown of the marriage. Often however the inheritance is "lost in the wash" with other assets. It might be received by the son or daughter of the will maker but then spent by that person and his or her spouse on mutual expenses. It then becomes difficult for the Family Court to give back to the son or daughter the money he or she inherited before the other assets of the couple are divided. The total asset pool of the couple might be such that if the inheritance is given back very little is available for distribution between the parties.

If a will maker intends that an inheritance would provide for more than just one child (and their future ex-spouse), for example there may be a desire to benefit grandchildren and further descendants also, instead of giving assets to a son or daughter a will maker gives those assets to a discretionary trust controlled by for example, an adult child and another person as trustees then the assets do not get mixed in with matrimonial assets. The Family Court can make orders affecting property in such a trust if a party to the relationship is the sole trustee and appointor or has effective control of the trust. If there is another trustee and appointor who is outside the marriage and who administers the trust in a proper manner, the Court is unlikely to make an order relating to the assets of the trust. Note that the Family Court is over time gaining more power in relation to discretionary trusts and there is no certainty that assets in such trusts will always remain out of the Court's reach even when the trust is run by people who are outside the relationship.

Taxation Issues

There can be tax advantages with a discretionary trust will.

If you leave assets directly to a beneficiary, be it a spouse or child, and that beneficiary invests the inheritance, tax must be paid on the income earned from the inheritance at the beneficiary's marginal tax rate.

The tax rates are as follows for the 2018-2019 year:

0 to $18,200	0%
$18,201 to $37,000	19%
$37,001 to $80,000	32.5%
$80,001 to $180,000	37%
$180,001 +	45%

Note:

- The Medicare Levy applies in addition to the above.
- The low income tax offset means that no tax is payable up to approximately $20,500 (subject to application of the Medicare Levy).

The rate stated applies only to the income within the range stated.

The increase in the tax free threshold from $6,000 to $18,200 from 1 July 2012 provided potentially greater tax savings where distributions can be made to children who are not earning any income or are only earning minimal income.

If a beneficiary is working then he or she will presumably be paying tax at 32.5% or more and any additional income from invested inheritance will be taxed at that rate or at a higher rate in the event of the income taking the beneficiary into the next tax bracket.

On the other hand, if the share of an estate which a beneficiary would have received is instead given to a discretionary trust and invested, then the income can be distributed amongst the beneficiary's family members on the most tax effective basis.

Most importantly in this situation, if any income can be distributed to children under 18 years, those children will be taxed at adult rates, that is the rates set out above. This is contrary to the situation where income is given to a child under 18 from a trust is established outside of a will. In that case any distribution of income to a minor is tax free up to $416 only and thereafter the top marginal tax rate applies. It is pointless for a beneficiary to establish a discretionary trust with inherited assets after the death of the will maker if the aim is to reduce tax by distributions to minors.

For example, Sarah is a well paid company executive. She pays tax at the top marginal rate. Her mother has recently died and her father died several years ago. She has one brother and her mother's estate is divided between her and her brother. She receives $800,000.00 and she invests this to earn $40,000.00 per annum in interest. She then must pay tax on the $40,000.00 being $18,000.00 (plus the Medicare Levy) every year.

Sarah has two children aged under eighteen who are at school.

If, instead of Sarah receiving $800,000.00 directly, her share in the estate had been given to a discretionary trust, the situation would have been much better from the tax point of view. The trust could invest the $800,000.00. The same income of

$40,000.00 would have been earned but could now be distributed amongst Sarah's two children, with each receiving

$20,000.00 per annum. No tax is payable by the children. Tax of $18,000.00 per annum plus the Medicare Levy has been saved.

The tax savings that can be made by utilising a discretionary trust can be very substantial and you must bear in mind that they can accrue year after year.

Of course because you do not know when you are going to die you cannot be certain about the extent of benefits which might be available from testamentary trusts. That will depend upon the primary beneficiary's personal and financial circumstances at the time.

Nonetheless as the asset protection benefits and tax savings can be substantial, a testamentary trust should be considered when making your will.

Taxation of trusts

There is a possibility that the laws governing taxation of trusts will change in the future. However based on the changes indicated to date the tax advantages discussed above will still be available.will still be available.

Disclaimer

This information is of a general nature only. It is not legal advice and should not be relied upon as such. You should seek specific legal advice about your circumstances before making any will.

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