Testamentary Trust – Saving tax and protecting assets

What is a Testamentary Trust?

A Testamentary Trust is, put simply, a trust created by a Will.

It is similar to a normal discretionary family trust but is established by a Will when a person dies.

What are the benefits of a Testamentary Trust?

It can provide asset protection and saves tax.

How does it save tax?

A testamentary trust allows the person who controls it to split the income generated by the trust between family members.

Importantly, children who receive income from a testamentary trust are taxed at adult tax rates, instead of penalty rates (up to 66%) which apply to other types of trusts. This also means that children can enjoy the 'tax free threshold' and receive up to $18,200 from the trust without paying any tax.

Case study

Melanie dies leaving her spouse John with three children, Sam, Mike and James.

Melanie's primary assets comprise the family home and a life insurance policy valued at $2,000,000.

John is a real estate agent. John earns $250,000 per annum so any further income received by him will be taxed at the highest marginal tax rate of 45% plus Medicare levy of 2%.

Without a Testamentary Trust

John receives the $2,000,000 left to him by Melanie.

John invests the $2,000,000 and generates $120,000 income annually.

That income forms part of John's taxable income and he pays tax (at 47%) of $56,400. After paying tax, John is left with $64,600.

With a Testamentary Trust

In this situation, Melanie's Will creates a Testamentary Trust which is controlled by John.

The $2,000,000 is placed into the Testamentary Trust.

The $2,000,000 is invested and produces the same return of $120,000 annually.

The income is distributed in accordance with the following table:

	Income distribution	Tax paid
Sam	$40,000	$4,547
Mike	$40,000	$4,547
James	$40,000	$4,547
Total tax paid		**$13,641**

After paying tax, the net amount John will have to spend is $106,359.

This simple case study illustrates that by using a Testamentary Trust, just in year one, John is able to save $41,759.

Over a five year period and ignoring the effects of compounding, the total savings will be over $210,000.

What to do with this money

Funds in a Testamentary Trust that are distributed to children do not need to be paid to those children and can be used for things such as the children's school fees, clothing, medical expenses, health care and all of the other needs for the children.

Level 4, 555 Lonsdale Street
Melbourne VIC 3000
T 03 8600 8888 **F** 03 8600 8899
kcllaw.com.au

We can discuss how this works in practice with you further.

Asset protection

The other major benefit of a Testamentary Trust is asset protection. Because the assets in the Testamentary Trust do not belong to the beneficiaries of the trust but are simply controlled by those beneficiaries, they are not subject to the risks associated with the beneficiaries such as litigation, creditors or bankruptcy.

Taking the example set out above, not only is John a real estate agent but he has recently undertaken a property development which has gone bad.

John is being sued by all of his business partners and the tax office.

The tax office and the partners know of the $2,000,000 life insurance policy over Melanie's life.

Unfortunately for the partners and the tax office, those proceeds do not belong to John and instead form part of the Testamentary Trust.

Therefore, the partners and the tax office are unable to access those funds and those funds will remain protected and in the family.

Protecting from divorce

Testamentary Trusts can also be used to provide some protection if any of the beneficiaries divorce.

By careful planning of the terms of the Testamentary Trust and ensuring the Testamentary Trust is established in the right way, it can be much more difficult for a disgruntled spouse to access funds left to a beneficiary via a Testamentary Trust.

Other advantages

Testamentary Trusts can also provide ongoing protection for young children, vulnerable or disabled beneficiaries. You can decide who will manage the Testamentary Trust on behalf of the beneficiary and if appropriate, at what age a beneficiary should take over control of the trust.

Do it properly

If you are going to establish a Testamentary Trust in your Will or have received an inheritance via a Testamentary Trust, make sure you obtain proper advice.

A Testamentary Trust can be a fantastic tool for wealth preservation, protection and financial planning. However, if implemented incorrectly or without thought, the benefits afforded by Testamentary Trusts can be missed and other unanticipated problems may arise.

To discuss how a Testamentary Trust can benefit you and your family, please contact our Estate Group on (03) 8600 8885.

Level 4, 555 Lonsdale Street
Melbourne VIC 3000
T 03 8600 8888 **F** 03 8600 8899
kcllaw.com.au