Testamentary Trust – Reduces tax and protects assets

What is a Testamentary Trust?

A Testamentary Trust is a trust created by a Will.

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

What are the benefits of a Testamentary Trust?

It can provide asset protection and reduce tax.

How does it reduce tax?

A testamentary trust allows the person who controls it to split the income generated by the trust between family members who are on lower tax rates.

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 utilise the 'tax free threshold' and receive up to $18,200 of income per year from the trust without paying any tax (based on resident tax rates for the year ending 30 June 2024).

Case study

Melanie dies leaving her spouse John with three children, Sam, Mike and James, who are all students.

Melanie's main assets in her name comprise an investment property and a life insurance policy with a total value of $2,000,000.

John is a property developer earning $200,000 per annum, so any further income received by him will be taxed at the highest marginal tax rate of 47% including the Medicare levy.

Without a Testamentary Trust

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

John invests the life insurance proceeds and leases the investment property to generate $120,000 income annually.

John pays tax (at 47%) of $56,400 on the income. After paying tax, John is left with **$64,600**.

With a Testamentary Trust

In this scenario, Melanie's Will creates a Testamentary Trust controlled by John.

The $2,000,000 of assets are transferred to the Testamentary Trust.

The assets produce the same return of $120,000 annually.

The income is allocated as follows:

	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, John is left with **$106,359**.

This simple case study illustrates that by using a Testamentary Trust, just in year one, John can save $41,759 in tax!

Over a five-year period, the tax savings are likely to be over $200,000.

What to do with this money

Funds in a Testamentary Trust that are allocated to children do not need to be paid to those children but can be applied instead for the benefit of their education, wellbeing and support.

We can discuss how this works in practice with you.

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Asset protection

- **Protecting from creditors**

As the assets of a Testamentary Trust are held for the beneficiaries and not held in the personal names of the beneficiaries, they are not subject to the risks associated with the beneficiaries such as litigation, creditors or bankruptcy.

Taking the example set out above, John has recently undertaken a property development which has gone bad.

His business partners, clients and the tax office are all seeking payment from John.

The assets from Melanie's estate 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 assets and they 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 face a divorce.

By careful planning of the terms of the Testamentary Trust and ensuring the Testamentary Trust is established and used 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.

- **Protecting vulnerable family members**

Trusts can also provide ongoing protection for young children or vulnerable beneficiaries, such as family members who are not financially responsible, have poor spending habits or have a severe intellectual disability.

You can decide who will manage the Testamentary Trust on behalf of the beneficiary and if appropriate, at what age a beneficiary will take over control of the trust.

Do it properly

If you are going to establish a Testamentary Trust in your Will, it is critical that you obtain proper legal and tax 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.

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