modern estate planning

why your will should contain testamentary trusts

These notes are general information only and are <u>not</u> a substitute for professional advice. You should not rely on any part of these notes without first obtaining advice from a qualified professional person.

If you have any question concerning the matters covered in these notes, please contact us for further explanation.

about PricewaterhouseCoopers estate planning lawyers

PricewaterhouseCoopers Estate Planning Lawyers is a unique legal practice that specialises exclusively in the area of sophisticated succession and estate planning advice for high net worth individuals and/or individuals with complex situations.

Most lawyers have little, if any, training in Will drafting or understanding of the value of specialised discretionary testamentary trusts. Moreover, equity and trusts, taxation and superannuation are usually elective university subjects avoided by many lawyers. As assets of clients are often held in various entities (and for good reason), creative solutions are required to meet the needs of clients in the area of effective estate planning, and those solutions must integrate the associated issues of control of entities, taxation (particularly Capital Gains Tax) and superannuation.

Our estate planning lawyers have additional qualifications and experience in taxation, superannuation and financial planning. Ours specialist lawyers work in close collaboration with the financial advisers and accountants of our referred clients to ensure that tax effective and asset protective solutions are employed.

In particular, advisers and their clients greatly value our ability to provide *sophisticated and highly innovative estate planning advice, strategies and solutions* to address their clients' often complex and unique needs and concerns.

For comprehensive estate planning advice and to organise an initial meeting with an experienced Estate Planning Lawyer please contact PwC Estate Planning on 02 8266 9521.

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What is a Testamentary Trust?

A testamentary trust is a trust established by a Will. A "Beneficiary Testamentary Trust" can be **optional** (the beneficiary can choose not to use it), **discretionary** (the beneficiary decides who will benefit) or a **fixed** trust or a combination of these.

Optional, discretionary, testamentary trusts are widely recommended for use in modern Wills because of the taxation and asset protection advantages that they offer when compared to a 'standard' Will.

A standard Will offers little assistance to a beneficiary of an inheritance in relation to issues of tax efficiency and asset protection.

Why use a Testamentary Trust?

Establishing testamentary trusts in your Will provides your beneficiaries with maximum flexibility in dealing with their inheritance. The usefulness of a discretionary Will trust to a beneficiary will depend upon the beneficiary's specific needs and circumstances at the time of your death, so it is important that the terms of the testamentary trust are sufficiently wide to offer the beneficiary as many options as possible so as to provide freedom and flexibility.

What if a Testamentary Trust turns out not to be useful to my beneficiaries?

Your Will should be drafted so that the primary beneficiary has the power to decide to:

1. use the trust for all, part or none of the beneficiary's inheritance;
2. wind up the trust at any time; or
3. pass the control of the trust in accordance with the primary beneficiary's Will.

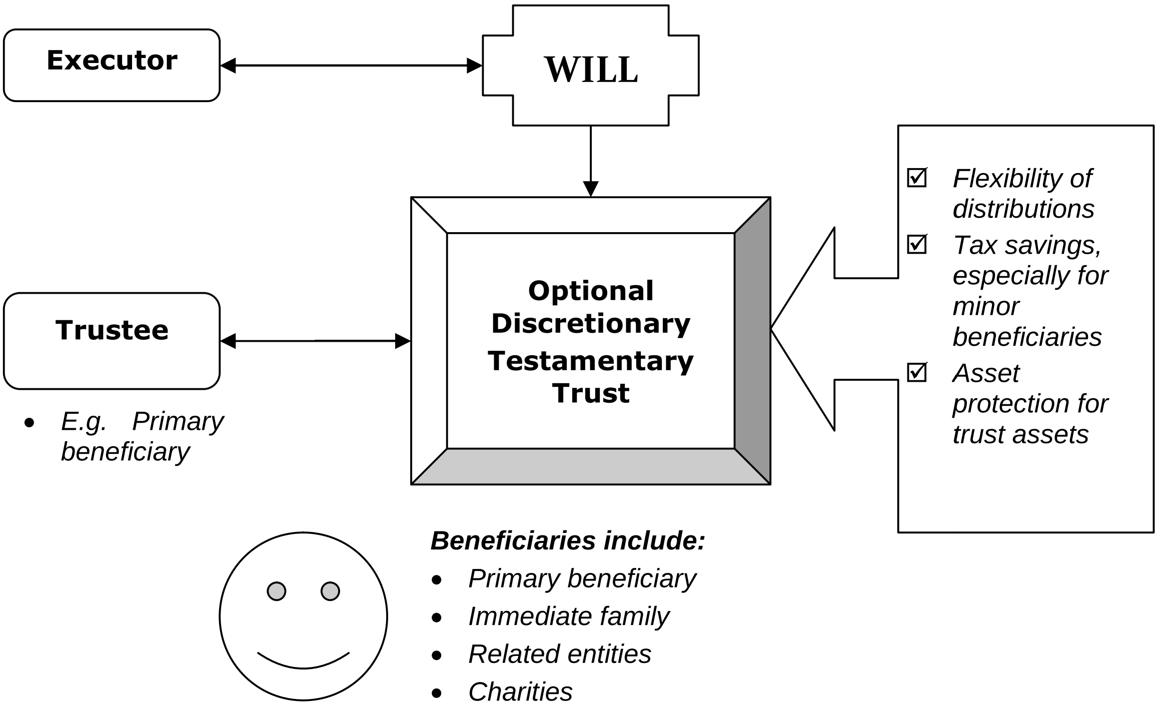
Because a testamentary trust can live for up to 80 years from your death, it can provide flexibility, asset protection and taxation advantages for many generations of your family.

What does a Testamentary Trust "look like?"

The diagram on the next page depicts how a testamentary trust may be structured.

Simply put, instead of leaving an inheritance directly to a nominated beneficiary, you appoint your nominated beneficiary as the primary beneficiary of a discretionary trust, with wide discretionary powers, in respect of the inheritance.

Diagram - Beneficiary Testamentary Trust



What Assets can be put into a Testamentary Trust?

Any assets belonging to you can be left to your beneficiaries via a testamentary trust on your death. Additionally, payments made to your estate as a result of your death, i.e. superannuation death benefits or the proceeds of life insurance, can also be directed to be held within a testamentary trust.

To provide maximum flexibility to your beneficiaries, your Will should be drafted to allow your executors to choose which assets belonging to you should be held within a testamentary trust.

How will my beneficiaries potentially benefit from a Testamentary Trust?

Your beneficiaries may potentially derive the following benefits:

- ***Significant income tax savings for beneficiaries***

  Well-drafted Testamentary Trusts can give a beneficiary the option to reduce personal income tax by splitting income from the investment of their inheritance between a range of family members on lower tax rates.

  The trustee of the testamentary trust (normally the primary beneficiary) has complete discretion to determine who receives the income of the trust. Tax is paid on the income of the trust at the marginal tax rate of the beneficiaries who receive it. Therefore, by selecting beneficiaries on low marginal tax rates, the trustee can minimise the overall taxation liability on the trust income. The trustee can choose to distribute income to minor beneficiaries of the trust with each beneficiary being able to receive up to $16,000 of income per year tax-free (for the 2010-11 financial year with the benefit of the Low Income Tax Offset of $1,500).

  The trustee can also distribute income from the trust to charitable and religious beneficiaries. As many such beneficiaries have tax deductibility status or are tax exempt, no tax is paid on income allocations to such organisations.

- ***Beneficiaries under 18 attract special tax concessions***

  Normally "penalty rates" of tax apply to income derived from trusts which is paid to children under age 18. However, the Tax Act allows children under age 18 who receive income from a testamentary trust to be treated as adults for tax purposes. This could mean significant tax savings for beneficiaries who can "split income" with minor children.

- ***Significant capital gains tax savings for beneficiaries***

  A well-drafted discretionary testamentary trust can also provide the opportunity for your beneficiaries to minimise Capital Gains Tax which arises from the sale of your assets.

  Capital Gains Tax is not triggered when an asset belonging to you passes via your Will to your executor or the trustee of a testamentary trust. Also there is no Capital Gains Tax when your assets are transferred from the trustee of a testamentary trust to a beneficiary (except where assets pass to a tax-advantaged entity) – see *ATO Practice Statement LA 2003/12*. The Federal Government has proposed that it will legislate to support this practice statement.

  As with the income of the trust, the trustee can select which of the beneficiaries of the testamentary trust should take a capital gain. By choosing to distribute a capital gain to a beneficiary on a low or nil income, the capital gains tax liability can be significantly reduced.

  Holding the assets of an estate within a trust offers the beneficiaries an opportunity to defer the need for the sale of assets (and therefore payment of capital gains tax) until later when more numerous beneficiaries come into existence. As they say, *"Tax deferred is tax saved"*.

- ***Preservation of CGT Principal Place of Residence Exemption***

  A testamentary trust can be used to preserve the capital gains tax exemption for the principal place of residence of the deceased if the terms of the testamentary trust provide for a *right to occupy* the relevant dwelling to be able to be granted. The terms of the exemption need to be strictly followed – see *ATO Interpretative Decision ID 2006/34*.

- ***Beneficiary's inheritance can be protected from bankruptcy***

  A testamentary trust can provide significant protection to your beneficiaries from the repercussions of bankruptcy.

  Assets that pass to a discretionary testamentary trust from an estate are held for the beneficiaries until the trustee elects to distribute such assets. At law, the assets are not owned personally by a discretionary beneficiary and therefore do not form part of the beneficiary's personal estate. Therefore, a creditor or other person claiming against the beneficiary cannot obtain the assets held in the trust.

- ***Beneficiary's inheritance can be protected from Family Law claims***

  A discretionary testamentary trust may also provide some protection for a beneficiary who is experiencing family law difficulties.

  By providing for a beneficiary's entitlement to be held in a discretionary testamentary trust, the primary beneficiary can isolate estate entitlements from personal assets. This may help protect his/her estate entitlements from family law property proceedings.

- ***Beneficiary's inheritance can be kept in the family***

  A modern, well-drafted discretionary testamentary trust may also help your beneficiaries keep their inheritance from passing to non-family members; for example, by providing that on their death the control of the testamentary trust passes to their children (rather than to a spouse).

Summary

By incorporating discretionary Testamentary Trusts in your Will, your beneficiaries will be able to access numerous options which may help them protect their inheritance from loss through family law dispute or bankruptcy, as well as providing strategies which can help them reduce/minimise the incidence of income and Capital Gains Taxes.

Properly drafted, the use of discretionary Testamentary Trusts within your Will offers your beneficiaries flexibility and options not available with standard Wills, which could result in significant advantages to your beneficiaries.

Further Questions?

If you want to talk to experts in preparing modern Wills containing Testamentary Trusts, please feel free to contact us, or if you wish to update or amend your Will. Call PricewaterhouseCoopers Estate Planning Lawyers on 02 8266 9521 or email: marilyn.paul@au.pwc.com