

PRINCIPLES OF TESTAMENTARY DISCRETIONARY TRUSTS



By Michael Klatt, Partner

1. The Basics

- 1.1. A Testamentary Discretionary Trust (TDT) is simply a discretionary trust created by a Will.
- 1.2. Sometimes TDTs are called "testamentary trusts". However, a testamentary trust is any trust established under a Will which may be a fixed trust rather than a discretionary trust.
- 1.3. Most TDTs would be wholly discretionary allowing the trustee of trust a discretion in relation to the application of the income and capital of the trust. There is no reason, however, why, if the testator so desires, the trust terms could not provide for income to be applied partly or wholly for certain beneficiaries with the application of capital to be at the discretion of the trustee. Taking away the discretionary aspects, however, reduces the flexibility normally given to the trustee.
- 1.4. The Trust does commence until the date of death of the testator and can continue for a maximum of 80 years. Generally, however, there would be a power in the trust terms allowing the trustee to terminate the trust at an earlier date.
- 1.5. A Will may contain a number of TDTs with each of the TDTs set up to benefit a different beneficiary.

2. TDTs – How They Work

- 2.1. A standard Will made by a husband and wife who have children would appoint the surviving spouse as executor and the whole of the testator's estate would pass to the surviving spouse. The Will would provide further that, in the event the spouse does not survive, the whole of the estate would be divided equally between the surviving children. The children may or may not be executors in this case depending on their age and whether the testator believes the estate can be administered by the children without any arguments.
- 2.2. When property is left absolutely to a spouse or children, those assets will be transmitted into the beneficiaries name or converted to cash which is distributed to the beneficiaries. These newly acquired assets, in the hands of the beneficiaries, are then exposed to possible creditors, the trustee in bankruptcy and claims by a future spouse of the surviving spouse or where children are beneficiaries, claims by the children's spouses.
- 2.3. The newly acquired assets of the beneficiary may also generate income upon which the beneficiary will have to be pay tax. The beneficiary may already be earning significant income and, accordingly, any additional income earned from investment of the inheritance may be taxed at one of the higher marginal rates.
- 2.4. In the case where the testator has provided a TDT in their Will, their assets will still pass into their estate, but the balance of the estate (after payment of debts and testamentary expenses) or part of the estate or specific assets may pass to the TDT rather than the beneficiaries absolutely.
- 2.5. The testator would identify the beneficiary or beneficiaries for whom the TDT is being established. I refer to these beneficiaries as the primary beneficiaries. The trust terms will also provide who are discretionary beneficiaries. These may be named beneficiaries or classes of beneficiaries. Who may be in those classes will be discussed further in this paper.



- 2.6. The terms of the trust would nominate a trustee. This may or may not be the executor and may also provide for an appointor who has the power to appoint and remove trustees of the trust similar to the power of appointment contained in family discretionary trusts (also known as family trusts).

3. Advantages of TDTs

Asset Protection - Creditors

- 3.1. The primary reason for setting up a TDT is asset protection. Where the TDT provides the trustee with a discretion in relation to both income and capital, none of the beneficiaries have a fixed entitlement. They merely have the right to be considered for a distribution. Accordingly, they have no vested interest until the trustee appropriates the income or capital. Obviously, if a particular beneficiary is in financial difficulty or bankrupt, the trustee would elect not to make distributions to this beneficiary. The trustee may, however, elect to make distributions to that beneficiary's family if, indeed, they are also beneficiaries of the TDT.
- 3.2. The trustee in bankruptcy will not be able to attack the assets of the trust. The trustee would only have a right to claim on assets appointed by the trustee for the benefit of the bankrupt beneficiary, but not yet transferred to that beneficiary. Further, the trustee in bankruptcy would have no claim to income of the trust unless it was already appointed for the benefit of the bankrupt beneficiary, but not paid and only amounts of income over the threshold amount.

Asset Protection – Family Law Claims

- 3.3. With the high number of relationships and marriages ending and the increase in wealth available to pass on to their children, many testators are looking for ways to ensure that the inheritance their children receive is in some way protected.
- 3.4. Both the Family Court under the Family Law Act and the State Courts under Part 19 of the Property Law Act consider the contributions of each party to the relationship and also, to a degree, the needs of the parties when ordering a division of property. The fact that a party to the relationship which has broken down has received an inheritance from their parent will obviously count as a contribution made on behalf of the child of the testator. However, it is generally accepted that the longer the period between when the contribution was made and the separation, the less significance is placed on the contribution to an extent where, if that period is in excess of 10 years, the contribution may have little significance at all.
- 3.5. If, however, the assets are held in a TDT with a party to the relationship being the primary beneficiary, there is generally a good argument that the assets of that trust should not form part of the matrimonial property. Before a Court would consider trust assets as matrimonial assets, the Court would need to be convinced that the trust was being operated by a party to the marriage in such a way that the party was treating the assets as their own.
- 3.6. It must be remembered, however, that even though the discretionary beneficiaries have no vested interest in the trust, they still have the right to be considered and, in fact, if the trust was being operated in a way so that distributions were being made not only to the party in question, but to others, it would seem hard to imagine that the Family Court would make orders forcing the party to make a distribution from the trust to the other party to the relationship.
- 3.7. The decision of the High Court in *Ascot Investments Pty Ltd –v- Harper* (1981) 55 ALJR 233 still appears to be good law in relation to the Court's attitude to considering trust structures. The High Court found in that decision that the Family Court did not have power to deprive third parties of an existing right or to impose a duty that would it



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not otherwise be liable to perform except where the alleged rights of the third party are only a sham. The Court also considered that the Family Court could make orders in relation to a company where the company is completely controlled by one party to the marriage. The Court otherwise found that "the Family Court must take the property of a party to the marriage as he finds it".

- 3.8. The *Family Law Act* was amended by the insertion of Part VIII A which commenced on 17 December 2004. This part allows the Court to make orders binding third parties, but only in certain circumstances. The writer does not consider that these new provisions change the position in relation to how the Family Court will deal with parties who are discretionary beneficiaries of TDT.
- 3.9. It should, however, be remembered that although the Family Court may not make an order in relation to the assets held in the TDT, the Court can consider the "rights" which a discretionary beneficiary may have or the possible distributions the discretionary beneficiary may obtain as a financial resource and adjust property rights held by the parties in other matrimonial property accordingly.
- 3.10. The writer is not aware of any Family Court decisions where the Court has ordered a party to marriage to do all things necessary to cause property from a TDT to be distributed to the other party to the marriage.
- 3.11. Obviously, the selection of the trustee of the TDT and appointor may be of some relevance. If the party to the marriage is not only a discretionary beneficiary, but also the sole trustee and appointor of the trust, there would be a higher likelihood that the Court may find that the assets held in the TDT are really assets of the party to the marriage.

Flexibility

- 3.12. Another advantage of a TDT is flexibility. The trust can continue for a period of up to 80 years. During this time, the trustee will at least yearly consider what distributions of income should be made to beneficiaries and, from time to time, what distributions of capital may be made. Obviously, the needs of different beneficiaries may vary significantly and, accordingly, distributions can be made to meet these needs. Having said that, if TDTs were desired and there are a number of adult beneficiaries, separate TDTs would generally be established for each of the adult beneficiaries primarily for the benefit of each of their immediate family.

Tax savings

- 3.13. The other major advantage with TDTs is the tax savings that can be made. With a standard Will, any assets acquired by a beneficiary absolutely which generate income will obviously effect the tax position of the beneficiary. Further, if the assets acquired by the beneficiary have an unrealised capital gain, the beneficiary will ultimately pay capital gains tax when the asset is sold. The beneficiary acquires the deceased's cost base as there is effectively a roll over unless the beneficiary is a charity which is tax exempt. In that case the capital gains tax is payable on the death of the deceased.
- 3.14. If, however, the estate assets pass to a TDT, there is also a roll over of any unrealised capital gain. Further, the transfer of the property to the TDT does not attract stamp duty. Provided that the trustee appropriates income to beneficiaries of the TDT, the income will be taxed in the hands of the beneficiary and not the trustee. The beneficiaries who take a distribution may well be adults with little other income. Accordingly, they can receive income of \$18,200.00 from their employment and/or the Trust tax free and the benefit of the adult marginal rates. Further, beneficiaries under the age of 18 may also receive distributions of \$18,200.00 tax free and have the benefit of the adult marginal tax rates. This relief is found in s.102AG2(d)(i) of the *Income Tax Assessment Act 1936*.



- 3.15. A TDT differs from a family discretionary trust in that distributions to beneficiaries under the age of 18 under a family discretionary trust are tax free only on the first \$400.00 (approximately). Distributions over that are taxed at the highest adult marginal rates.

4. Disadvantages

Administration

- 4.1. With any trust, there is a degree of control and administration required and the associated cost that goes along with that. Accordingly, if the primary reason for using a TDT is tax savings, the cost of running the trust would need to be weighed against the potential tax savings.

Family Provision Claims

- 4.2. Depending on who controls the TDT, a beneficiary may not have certainty as to what they will receive from the estate. This could give rise to a consideration by the beneficiary to making a Family Provision Application and it must be remembered that the testator's assets pass into the estate and do not pass to the TDT until the administration of the estate is complete.
- 4.3. The assets need to form part of the estate to then pass into the TDT. This may expose the asset to a possible Family Provision Application when the assets could well have passed to a beneficiary directly and not through the estate. An example of this would be where a life policy is taken out on the life of the testator and a particular beneficiary is the owner or beneficiary of the policy rather than the testator. The proceeds of that life policy, had they passed directly to the beneficiary, would not have formed part of the estate and, accordingly, not have been exposed to a potential Family Provision Application.

5. Who Should Use a TDT

- 5.1. Testators with beneficiaries:

- in high risk professions or businesses;
- that are bankrupt already or on the verge of bankruptcy;
- who are at risk of relationship breakdowns

may wish to consider a TDT to provide some protection to beneficiaries and attempt to protect the wealth that has been accumulated by the testator during their lifetime for the benefit of their descendants.

- 5.2. Of course, at a time that a testator considers making a Will, the testator's children might be young or, if they are married, they may well be happily married leading a testator to think that the inclusion of a TDT is of no real benefit to his or her family. The problem is no-one has a crystal ball and things may well change after the death of the testator. If the TDT has been set up, it will prove extremely useful in the case of problems arising. From the writer's experience, however, clients take little convincing that the inclusion of a TDT is a useful tool which may be used by their descendants.
- 5.3. Testator's with a high net worth who wish to give their beneficiaries with young families an opportunity to save tax will also benefit from inclusion of a TDT in their Will.
- 5.4. If tax savings are the main motivator of the testator, the writer's view is that capital which would otherwise have passed to the beneficiary should be at least \$500,000.00.

6. Specific Issues



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- 6.1. With an increase in wealth generally in society, TDTs should always be discussed with clients so that at least the client knows what they are and has had the opportunity to consider whether they wish to include a TDT in their Will.
- 6.2. A careful review of a client's affairs is needed at the time that the client is providing instructions for the preparation of a Will. To properly identify what assets will form part of the estate, clients need to understand that non-estate assets may not end up in the estate and therefore cannot pass to a TDT. Family trust assets are a prime example of this.
- 6.3. Although non-estate assets can be gifted to a TDT after its commencement, income earned on those assets does not have the tax advantages under s.102AG(2)(d)(i). That section only applies to income earned on assets passing from the estate or any assets that can be traced from estate assets.

Beneficiaries

- 6.4. It is important to identify what assets should pass to a TDT. In some cases, it may be a disadvantage for assets to pass into a TDT, for example where a testator's wishes for their main residence to pass to a particular beneficiary and that beneficiary intends to also use the home as their main residence. If the assets passes to a TDT, it will lose the capital gains tax exemption which would otherwise apply. Accordingly, it is sometimes necessary to balance asset protection issues against the cost in increased tax costs.
- 6.5. It is necessary to properly consider who should be beneficiaries of the TDT. Generally, there will be a primary beneficiary who the testator may well have otherwise have left the property to absolutely. Then there will be secondary beneficiaries who the testator would expect to take the benefit of the trust after the death of the primary beneficiary, for example, a testator's spouse may be the primary beneficiary and then the children equally, the secondary beneficiaries. Then it is necessary to look at listing individual discretionary beneficiaries or classes of discretionary beneficiaries. This may well include children and grandchildren of the primary beneficiary, perhaps even parents, brothers and sisters, uncles and aunts. It is also possible to include companies and other trusts of which beneficiaries are shareholders or beneficiaries in. One of the most difficult decisions is whether spouses of beneficiaries should also be included as discretionary beneficiaries of the TDT. Of course, spouses will only be entitled to income or capital if the trustee decides to distribute to the spouse, but there could be a good reason for including a spouse. For instance, if a son was nominated as the primary beneficiary, his wife may not be working and a distribution of \$18,200.00 tax free and further income which would attract tax on the lower adult marginal rates could be made. Many testators, however, are strongly opposed to spouses being included as a beneficiary in any capacity.

Trustees

- 6.6. The appointment of a trustee or trustees of the TDT is also an extremely important decision. It may be that the testator appoints the executor or executors as trustees, but that does not need to be the case. The testator may consider appointing the primary beneficiary the trustee or one of the trustees. The advantage with this is that the primary beneficiary can then have full control of the distributions of income and capital. The disadvantage with this is that in any Family Court property settlement proceedings, the Court may be more likely to take the view that really the trust is an alter ego of the beneficiary. It may be wise to appoint another trustee with the primary beneficiary and it would be prudent to include a clause providing for the removal of the trustee in the case that the trustee becomes bankrupt. Alternatively, many of our clients appoint an independent appointor or principal of the trust such as a law firm or



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accounting firm which, in the writer's view, gives further protection in matrimonial property proceedings.

- 6.7. The succession of trustees. The power to appoint new trustees lies with the appointor or principal. The testator may consider appointing the primary beneficiary as the appointor of the trust who would have the ability to remove and appoint trustees. However, in the writer's view, this does not give the same level of protection as having an independent appointor. There needs, however, to be succession planning for this power of appointment also. The testator may consider appointing the secondary beneficiaries as successors to this power. This may well be the children of a spouse so that when the spouse who is the primary beneficiary dies, the children then effectively control the TDT.

Consent to Distributions of Capital

- 6.8. The testator may consider including a clause in the trust terms which necessitates the trustee obtaining the consent of the primary beneficiary or secondary beneficiaries if the primary beneficiary has died to distributions of capital.
- 6.9. In some cases, the testator may not want the primary beneficiary to have any control at all. For example, if the primary beneficiary has some sort of mental disability, it would not be prudent that they have any control.

Superannuation Proceeds Trust

- 6.10. Care should be taken in specifically identifying what happens to a testator's death benefits payable by a superannuation fund. If death benefits are to be paid to the estate, the testator may consider making provision in the Will for a superannuation proceeds trust which has the same terms as a TDT, but the beneficiaries are restricted to persons who fall within the definition of a dependent for the purposes of the superannuation and tax legislation. This way distributions made to the superannuation proceeds trust may be tax free up to the reasonable benefits limit.

Loans to Beneficiaries

- 6.11. A testator may wish to include a clause in the trust terms allowing the trustee of the trust to make loans to beneficiaries with or without security. Obviously, the benefit of this is that money could be loaned to a child to acquire a home and security taken over the home and, if the child gets into either marital difficulties or financial difficulties, the loan could be called up.