Testamentary discretionary trusts

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A testamentary discretionary trust ("TDT") is one of the most powerful estate planning tools available. Things you need to know about TDTs:

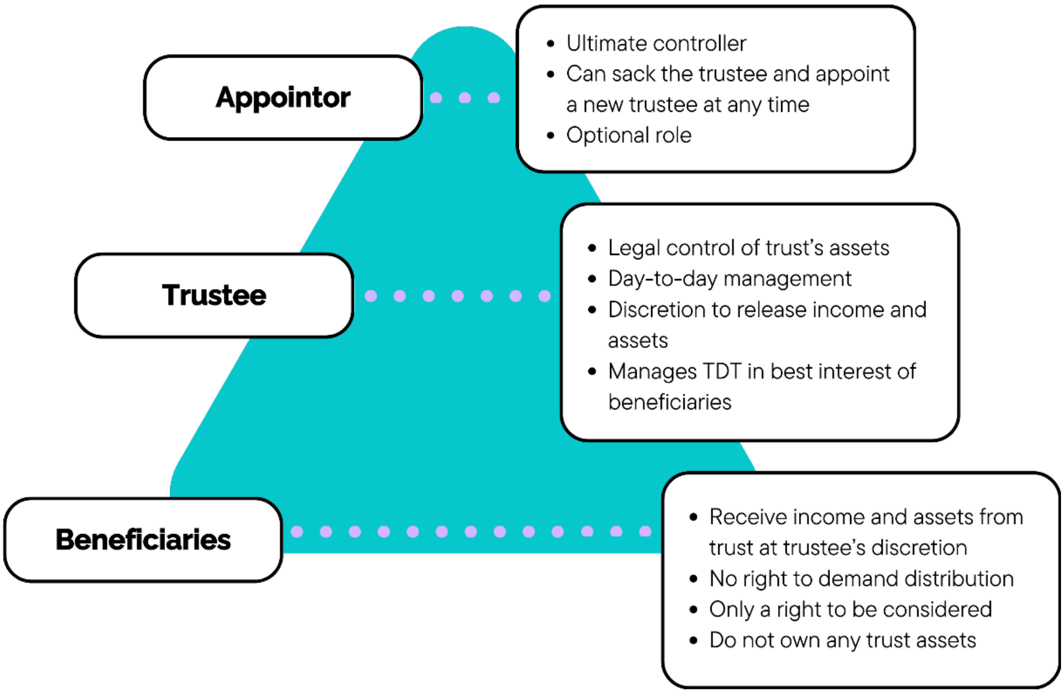
- ☐ Testamentary discretionary trusts may save your family tax after you die
- ☐ Testamentary discretionary trusts may protect the inheritance from divorce and bankruptcy risks
- ☐ Testamentary discretionary trusts offer flexibility and protection for families with young children or grandchildren
- ☐ Testamentary discretionary trusts are not just for complex situations or the wealthy
- ☐ You only get one chance to access the fantastic estate planning benefits of a testamentary discretionary trust…it must be in your Will!
- ☐ Testamentary discretionary trusts only begin after you die (this is different to a family trust someone sets up during their lifetime)

What is a testamentary discretionary trust?

In a standard Will, the assets of the person who has passed away go directly to the beneficiaries named in the Will (such as a spouse or children). Once a beneficiary receives their inheritance, they own those assets outright. If the beneficiary is under a certain age, their inheritance is held in a trust until they reach that age. This type of trust is called a "fixed" trust, but it doesn't offer the same benefits as a TDT. When the beneficiary reaches the required age, they receive their inheritance and take full ownership of the assets.

With a TDT, the assets from the Will don't go directly to the beneficiaries. Instead, they are placed into a trust—the TDT. A trustee manages this trust, overseeing the investment, sale of assets, and distribution of income and assets to the beneficiaries (like a spouse or children). The beneficiaries benefit from the trust, but they don't own the assets within it.

The trustee has specific responsibilities, such as acting in the best interests of the beneficiaries and carefully considering their needs when distributing income or assets from the TDT.



An effective TDT should have many people who can potentially benefit from the assets in the trust (the technical term for these people is "beneficiaries"). What makes a TDT so **powerful for asset protection** is that each beneficiary's right to the trust's assets is entirely at the discretion of the trustee.

Because beneficiaries don't own the assets in the trust and only have the right to be considered by the trustee, it's challenging for anyone to claim that the assets actually belong to any one beneficiary.

In some cases, the trustee might also be one of the beneficiaries of the TDT. When this happens, the **TDT's assets might "feel" like the trustee's own** because they can decide whether to benefit themselves or their family members. However, for beneficiaries who are not also trustees, their entitlement to receive anything from the trust is completely up to the trustee.

One of the great advantages of a TDT is its **tax flexibility**. It's the only arrangement that offers such favourable tax treatment, largely because the Australian Taxation Office recognises that the trust exists due to someone's passing.

For tax purposes, trusts are treated as "flow-through" entities. This means that any income earned each year from investing the trust's assets is distributed to the beneficiaries and each beneficiary is taxed on their portion of that income at their own marginal tax rate.

Each year, the trustee can decide which beneficiaries should receive income based on their individual tax situation, potentially splitting the income among them to minimise the overall tax burden.

One **unique benefit of a TDT**, not available with any other type of trust, is that beneficiaries under 18 years old are treated as adults for tax purposes. This means they can receive up to approximately $20,000 per year in income from the trust, tax-free.

Advantages a TDT may offer your family

If you tick any of the following boxes, then you should consider using a TDT in your Will.

USE A TESTAMENTARY DISCRETIONARY TRUST IF:
☐ There will be at least $500,000 of assets available for investment in the TDT (remember to include your super and life insurance when calculating your assets)
☐ You want to leave an inheritance to anyone under 18 years of age who can each receive approximately $20,000 tax free income each year from the TDT
☐ It is important to you that the inheritance has protection from relationship risks (such as separation or divorce)
☐ It is important to you that the inheritance is protected from bankruptcy risks
☐ You are leaving assets to someone who cannot be trusted to manage their inheritance appropriately and you are worried they will waste it
☐ You have young children or grandchildren and want flexibility for when they receive the control of their inheritance
☐ You want income tax flexibility with the ability to stream income depending on each person's individual tax rate
☐ You want to protect the inheritance for your children in the event your spouse re-partners
☐ You want to leave an inheritance to beneficiaries with mixed needs, for example where one beneficiary has greater financial need or requires greater assistance compared to other beneficiaries

Case study – you have children under 18

A TDT is a very powerful tool for families with young children. A TDT may offer the following advantages:

☐ **Safeguarding inheritance:** if your surviving spouse enters a new relationship after your passing, the inheritance you've set aside for your children remains protected within the TDT. This ensures that the assets are shielded from the influence of a new partner and safeguarded against potential family law disputes.

☐ **Managing access until maturity:** in the event that both you and your spouse pass away, your children won't automatically receive their inheritance when they turn 18. Instead, you can designate someone (such as a trusted family member or financial advisor) to manage the inheritance and make financial decisions on their behalf until they reach financial maturity and can handle the assets responsibly.

☐ **Tax-free income for family needs:** imagine you pass away and leave behind a spouse and three young children. With a TDT, the first approximately $60,000 of income earned each year from investing your inheritance could be tax-free. This money could then be used to cover your children's living and education expenses without any tax burden.

☐ **Generational tax savings:** without a TDT, your surviving spouse would have to pay tax on that income at their marginal tax rate (in addition to their salary and other income) before using what's left to cover those expenses. The tax savings with a TDT can be substantial, not just for your immediate family but for generations to come. Your children can eventually use tax-free income from the trust to support their own children.

Just think about paying living expenses with tax-free income—what a difference that could make for your family's financial wellbeing!

Case study – you have children over 18

If you have adult children, you should consider leaving an inheritance to them through a TDT, rather than as a direct gift. A TDT may offer the following advantages:

☐ **Protection from relationship breakdown:** the inheritance you leave your child is far less likely to be exposed to family law risks, such as separation or divorce.

☐ **Protection from bankruptcy:** if your child is in a high- risk occupation —like being self-employed, a director, or working in fields prone to negligence claims (eg. accountants, financial advisors, lawyers, engineers, health professionals)— the inheritance you leave your child could be exposed to bankruptcy risks if you do not use a TDT.

☐ **Amplifying the impact of the inheritance:** a TDT allows your child to access tax-free income to cover their children's (your grandchildren's) living and education expenses. For example, if your child has three young children, the first approximately $60,000 of income earned each year from investing the inheritance through the TDT could be tax-free. This money could then be used to pay for your grandchildren's expenses without any tax burden.

☐ **Generational tax savings:** without a TDT, your child would have to pay tax on that income at their marginal tax rate (in addition to their salary and other income) before covering your grandchildren's expenses. The tax savings with a TDT can be significant, not just for your child but for future generations as well.

Testamentary discretionary trusts can be a powerful tool for estate planning. The advantages of a testamentary discretionary trust may not suit every individual's circumstances. The exact workings of a testamentary discretionary trust depend on the terms drafted in the Will.

You must receive legal advice to determine whether your estate may benefit from a testamentary discretionary trust. The information in this document is general in nature only and is not legal, financial, or taxation advice.