The Mischel & Co. Group
Accountants & Advisors

What is Estate Planning?

Estate Planning is not just about having a Will.

It involves the review, management and control of your personal, family and business affairs while you are alive and when you pass away.

Estate Planning can be as simple as having a Will, but often involves powers of attorney, enduring guardianships and sometimes more.

A well-considered Estate Plan can cover:

- current lifestyle needs
- your retirement plans
- your business arrangements
- your tax position
- future critical events such as divorce
- health scares and family disputes as well as ensuring your assets go exactly where you want them to.

A common method of administering your assets after your death is the creation of a testamentary trust.

Testamentary trusts are created by a will to provide a greater level of control over the distribution of assets to beneficiaries. There are also tax advantages available through testamentary trusts, making them an effective estate planning tool.

A testamentary trust is a trust created by your Will and does not come into effect until after your death. The significant advantage of a testamentary trust is that the assets are effectively owned by one person(s), the trustee, and the benefit of the income and capital of the trust passes to another person/s, the beneficiaries.

The maximum life of a Testamentary Trust (as is applicable to a Family Discretionary Trust) is usually 80 years although some Wills may reduce the period of time that the trust may exist.

There are 2 types of testamentary trusts:

Discretionary testamentary trusts.

Executor gives the beneficiary the option to take part or all of their inheritance via testamentary trust. The primary beneficiary has the power to remove and appoint the trustee and they can appoint themselves to manage their inheritance inside the trust.

Protective testamentary trusts.

Beneficiary must take their inheritance via the trust and does not have the option to appoint or remove trustees. May be useful where the beneficiary is not in a position to responsibly manage their inheritance due to age, disability or spendthrift tendencies.

<u>What is a Testamentary Trust?</u>

A Testamentary Trust (Will) is a trust established under a Will that is designed to provide maximum flexibility and allow for distribution of capital & income, as well as providing protection of your beneficiaries from third parties such as creditors.

1. Flexibility on capital and income allocation

    A trust allows for optimum allocation of income and capital, which in turn may permit beneficiaries to qualify for aged, disability and sole parent pensions, Austudy or the like, for which they would otherwise not have qualified under a normal inheritance.

2. Protection of beneficiaries

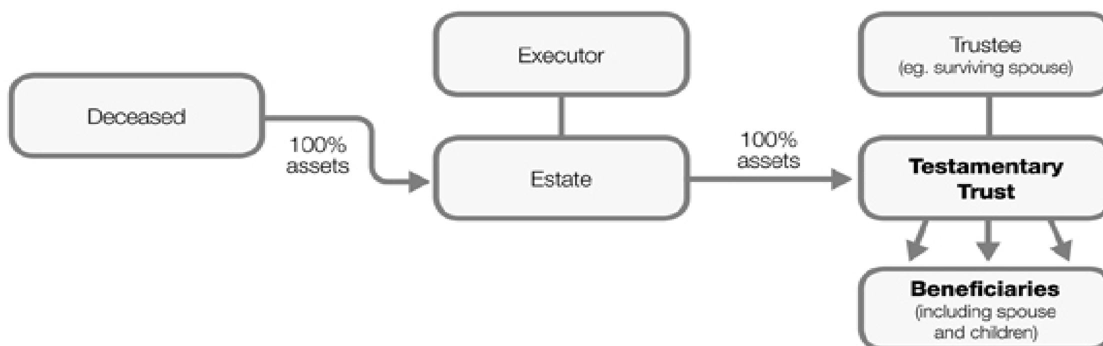
    Usually an advisor will assist your executors to determine how best to manage your estate for the benefit of your beneficiaries, taking into account risk management, taxation and other issues.

The incorporation of testamentary trusts into a Will is not relevant to every situation but in many cases they offer valuable advantages over simple Wills. Testamentary trusts, sometimes referred to as a Will trust – which can be discretionary trusts, capital protected trusts or tailored to suit your requirements, are similar in many respects to trusts created by deed whilst you are alive.

An example of how Testamentary trusts look diagrammatically

<u>What if everything is to be left to a single primary beneficiary?</u>

Trustee of a testamentary trust can be your surviving spouse or child (as the case may be). If flexibility is desired the trustee will control the gift **<u>as if</u>** they own the assets in the trust but will enjoy the protection afforded by the trust.

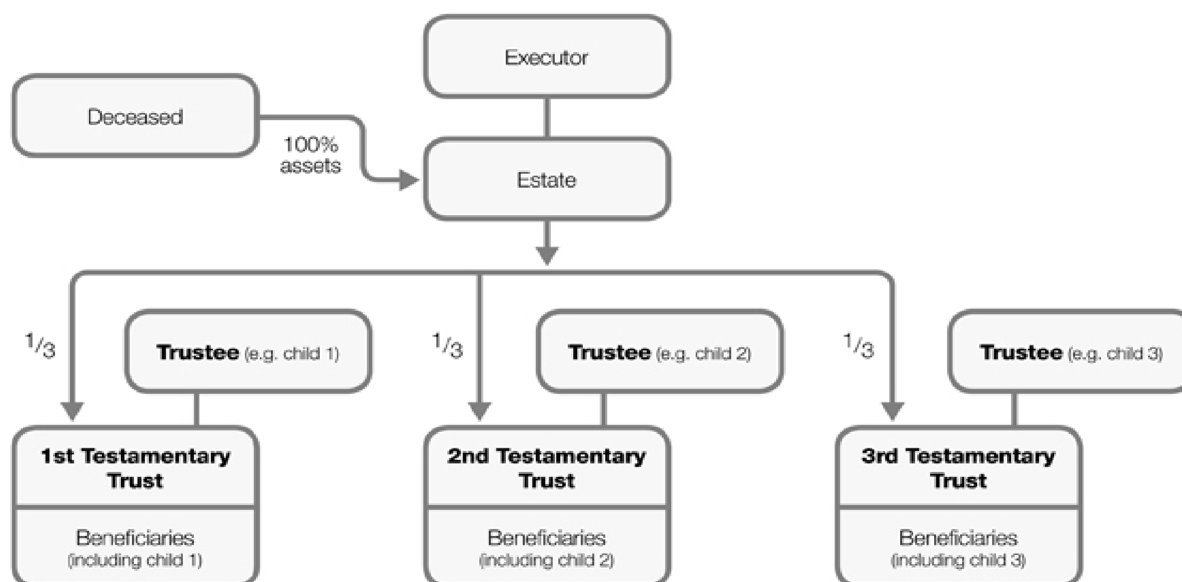


If you wish to restrict the control your spouse or child has over the trust assets you can:

- Use a third party as trustee, but still retain a discretionary trust.
- Add a third party as a joint trustee along with your spouse or child, but still use a discretionary trust
- Regardless of who the trustee is, restrict access to the capital in the trust by only allowing access to income and/or a percentage of the capital as determined by you (i.e. use a capital protected trust rather than a discretionary trust)

How does a Testamentary Trust Will work for "say" 3 children?

Trustee of each Will trust is one of the children. If flexibility is desired, the trustee will control the gift as if they own the assets in the trust but will enjoy the protection afforded by the trust.



If you wish to restrict the control your child has over the trust assets you can use a third party as trustee, but still retain a discretionary trust

- Add a third party as joint trustee with your spouse or child but still use a discretionary trust
- Regardless of who the trustee is, restrict access to the capital in the trust by only allowing access to income and/or a percentage of the capital as determined by you (i.e. use a capital protected trust rather than a discretionary trust)
- Other special forms of trust (some with special taxation relief) are available and we can discuss these if appropriate. For example, trusts set up for a disabled person or to fund education of children may qualify for special taxation treatment

What succession issues can arise from ownership of trusts?

- It is important that you review trust deeds, as succession issues related to trusts can be complex.

In a small portion of cases the trustee (whether an individual or company) determines the future control of the trust and its assets. In such cases the succession of the role of trustee (if an individual), or ownership of shares in a trustee company (if a company trustee), must be specifically spelt out in your Will if you wish to expressly determine who is to take control of the trust upon your death. It is important to remember that control of the trust is for all practical purposes tantamount to ownership of the assets in the trust.

In the majority of cases however, it is not the trustee who determines ultimate control of the trust. Most trust deeds provide that the future control of a discretionary trust is determined by a person described in the trust deed as an 'Appointor', 'Guardian', 'Principal' or similar. Such a person (usually the individual(s) who established the trust) will have the power to remove and replace the trustee and thus the succession of the 'power of appointment' is critical to the future control of the trust.

Some trust deeds include detailed provisions regulating the succession of the power of appointment upon the death of the original appointor. Most trust deeds however simply refer the power also to the deceased appointor's executor to manage.

Thus it is critical that you determine how your trust deed deals with this issue. If the trust deed contains specific succession provisions you must ensure they are consistent with your succession planning wishes and if not, that you amend the trust deed to reflect your wishes.

On the other hand if the trust deed refers the issue to the executor of your estate to manage then you must ensure that your Will includes specific instructions to your executor about how to deal with the succession of the power of appointment. That is, who do you want to pass that power to? Again keep in mind that this power effectively results in the person inheriting the power, inheriting all the assets in the trust.

An important issue in succession planning is whether in future the trust will be controlled by one person or several? If this is not dealt with, children may inherit the power of appointment jointly, and this can lead to disputes over how the power is to be exercised.

We recommend that if possible you pass the power of appointment to one beneficiary, to limit the potential for disputes.

If one child inherits control of the trust and its assets, your Will can be drafted so that the net value of the trust assets can be treated as a benefit under the estate. Thus the estate's executors can take that into account when ensuring the children obtain an equal distribution of all your assets, whether in the estate or falling outside your estate, because they are 'owned' in part by a trust in your control.

If, because of the value of the assets in the estate (or any other reason), it is not possible to leave the role of appointor to one child as part of that child's inheritance, then we recommend that the trust deed include provisions requiring all decisions be made jointly, and in the event of dispute, that alternate dispute procedures are triggered. This will assist (but not overcome) any disputes. It is possible to include a provision which will trigger a winding up of the trust in the event of an unresolved dispute, with the trust deed specifying the joint appointors as the default beneficiaries so that on a forced winding up each receives an equal share. This can be achieved when first setting up a trust, while an existing trust deed can be altered to achieve the same result. However, care must be taken to avoid adverse stamp duty and other tax consequences if changes to an existing deed are proposed.

Why a testamentary trust?

In summary:

Creditor protection	To protect the bequest from creditors of a beneficiary. It can also protect the bequest from the debts that a beneficiary may incur by guarantees given by that beneficiary of their spouse's business debts.
Divorce of a child	Assets held in the trust are not assets of any individual and the Family Court cannot make an order requiring the distribution of those funds.
Education	If you are a grandparent, leaving bequests via a testamentary trust for payment of boarding school and tuition fees for your grandchildren is a more tax effective method of providing for their education rather than leaving additional bequests to their parents.
High risk beneficiaries	Where one of the beneficiaries is in a high risk profession or business where negligence claims are likely.
Remarriage of spouse	Where you want to provide for your spouse but are concerned that they may remarry and divert the family assets to the new family or use the family assets in risky or unprofitable ventures at the suggestion of the new spouse.
Children with issues	In the case of spendthrift children/gambling difficulties/drug addiction for example, you can provide for such a child through a trust ensuring his/her share is kept intact.
Tax benefits	Income splitting through trust; distribution tax free to children under 18 up to marginal rate.
Will challenges	If your beneficiaries receive your estate in a trust, and it remains in the trust, as it is not in their estate it cannot be subject to a Will challenge when they die.
Disabled children	Where you need to ensure that any disabled or intellectually impaired children are looked after.

<u>The principal advantages of incorporating discretionary testamentary trusts in Wills</u>

<u>Taxation Benefits</u>

Trust income can be distributed to children under the age of 18 is taxed at their own marginal tax rates. Accordingly, there will be a tax-free threshold each year for each child.

The current tax-free threshold is $18,200.00 (which will increase depending upon low income rebates) which is significantly higher than the tax free threshold where distributions are made to children under family trust deeds. Where there are several children the tax relief can be very significant, particularly where there are a number of years until the children attain the age of 18. Income can also be streamed to low income adults to reduce overall taxation exposure.

A Case Study – Taxation Benefits of a Discretionary Trust

Mary wants to leave her estate to her husband Tom. Tom currently pays the top marginal tax rate (including Medicare levy) of 47%. Mary and Tom have 2 minor children who attend private schools and don't earn any income. Assume that on her death Mary's estate, if invested, would generate income of $40,000 per year.
If Mary left her estate to Tom outright (i.e. not in a discretionary testamentary trust) and he received the $40,000 income per year then Tom's after-tax position would be:

Income	$40,000
Tax + Medicare levy	$18,800
Low income tax offset (only applicable where taxable income is less than $66,667)	nil
Net Income after tax	$21,200

If the income was divided equally between Mary and Tom's children (either via an existing family trust or an outright gift), the after tax position of the children would be:

	Child A	Child B	Combined
Income	$20,000	$20,000	$40,000
Tax *	$9,000	$9,000	$18,000
Net Income after tax	$11,000	$11,000	$22,000

If instead Mary leaves her estate to a discretionary testamentary trust with Tom as the trustee and the trust income is distributed equally between Mary and Tom's children, the after-tax position would be:

	Child A	Child B	Combined
Income	$20,000	$20,000	$40,000
Tax **	NIL	NIL	NIL
Net receipt	$20,000	$20,000	$40,000

Summary of benefit

The discretionary testamentary trust saves $18,800 tax per annum, leaving more available to spend on the children's education and welfare. The tax savings that can be achieved by using a testamentary trust will depend on the individual circumstances of the Will maker and their family members. In particular, it will depend on the tax position of their adult beneficiaries, how many children under 18 those beneficiaries have and the tax position of those children.

Note: the example assumes:

* trust distributions to minors are taxed at 45%

** in a testamentary trust minors can receive tax free distributions up to $18,200 (2014/2015) or $20,542 (if low income tax offset applies)

*** the calculations are based on the individual tax rates for the 2014/2015 tax year and are subject to change

Capital Gains Tax

Capital gains can be "streamed" to one or more beneficiaries who are able to take best advantage of the averaging rule or CGT losses. Accordingly, the tax on capital gains ultimately payable on realised assets can be considerably reduced where one or more of the designated beneficiaries have a low income in the year of distribution.

Creditors Protection

Under a normal Will, if a beneficiary is experiencing solvency difficulties or is already bankrupt at the time of a distribution, it is likely the gift will end up in the hands of creditors rather than for the intended benefit of the beneficiary. This need not be the case where a testamentary trust is used, as the beneficiary has no actual entitlement to capital or income until the trustee determines. Accordingly, assets can be retained within the family, free of creditor's claims.

Family Law considerations

A parent may wish to minimise the chances of a child's spouse/partner making a claim against an inheritance in the event of marriage/ de facto relationship breakdown. If testamentary trusts are used, an inheritance does not form part of the child's 'matrimonial property' which is to be divided upon a relationship breakdown. The Family Court often treats testamentary trust assets as a resource available to the spouse rather than matrimonial property, although the Court does have the power to treat trust assets as matrimonial property.

Incapacity

In the event that a beneficiary is temporarily incapacitated, testamentary trusts will enable the assets to be managed by the family or professionals for the benefit of the beneficiary rather than having a portion of the estate controlled by an external agency.

Superannuation and Insurance Proceeds

Where testamentary trusts are used, the individual or his estate can be nominated as the beneficiary of superannuation benefits or insurance proceeds. In this way flexibility can be retained and the level of distribution to respective dependents, depending on the circumstances prevailing at the relevant time, can maximise the preferential tax status of the proceeds.

Flexibility

Testamentary trusts generally provide complete flexibility both as to the nature of the investments of the trust and as to the distribution of income and assets of the trust. Trusts can be validly created for up to 80 years and, accordingly, can benefit two or three generations. Alternatively, the trusts can be dissolved at any time (longer in South Australia) and distributions made to the desired beneficiaries.

Life Interest or Right of Occupancy

One particular use of testamentary trusts is to create a life interest or right of occupancy. It can be used to create a fixed or flexible life interest.

Life Interest in a Will

Life interest is a form of testamentary trust where a person (usually a surviving partner) is granted a lifetime of fixed income and benefits, and use and enjoyment of all or part of the assets (erg: principal place of residence) of the deceased estate. This is useful if you wish to ensure that the capital assets are preserved after the lifetime beneficiary dies.

The executor or trustee is usually given the express power to pay any taxable capital gain that might be assessed against the lifetime beneficiary with funds from the estate.

By creating a life interest you are able to allow the life tenant to enjoy the asset (it can be the whole of your estate or just your home) for their lifetime and upon death the asset or fund is given over to someone else (for example your respective children).

The person who holds the life interest is called the life tenant and the life tenant has the right to possession and enjoyment of the asset and its income until their death or until they abandon the interest.

A whole range of conditions can be applied to a life interest but the interest always ends on death and sometimes if the life tenant finds another partner. You can even provide that it ends at the expiry of a specific period of time – for example, after 10 years.

Once the life interest ends the gift/asset reverts to the ultimate beneficiaries – usually children.

If a life tenancy is created in respect of land the life tenant has the right to occupy the land/home during the life tenancy and depending upon what conditions are imposed in the Will, can lease the property, improve the property and sell and replace with another property (for example if a down size was required due to age or infirmity).

Where the owners of the property are joint tenants it is necessary to sever the joint tenancy to a tenancy in common so that each owner can gift the other a life interest in their 'share' of the property ultimately preserving the actual gift of property for children or other beneficiaries.

This can be important in a blended family that has mixed assets or where the asset mix of the families is not equal.

A life interest in property granted to a spouse will enable him or her to have the use of the property during his or her life time. The person granting the interest can then have certainty that his or her child (or children) will benefit upon the spouse's death.

A life interest is one way to give the benefit of an asset while preserving it for the ultimate beneficiaries. It is a very useful tool where blended families are involves.

The life tenant is generally responsible for maintaining the asset during their life tenancy though it is not uncommon for an Estate to pay the costs of insurance, rates, taxes and maintenance.

The major disadvantages of life interests (in property) are that the life tenant may have difficulty leasing the asset or securing a loan against the asset as they will only hold part of the interest themselves with the other part belonging to the ultimate beneficiary.

There can also be conflict between the life tenant and the ultimate beneficiary as the life tenant may have no motive to improve the asset or may not look after the asset. Accordingly, the appointment of the executor is an important consideration.

Right of Occupation

A right of occupancy is used to extend the principal place of residence exemption from capital gains tax following the death of the owner. By giving a person the right to occupy a principal place of residence in a Will, the person living in the residence is considered to be the owner of the land, and land tax is not payable - but only while the person continues to use and occupy the land.

When that person dies or moves out, the residence will form part of the original owner's deceased estate and be distributed in accordance with the Will of the original owner.

Unlike a life interest, a right of occupancy will not allow the resident to sell or rent out the property and all rights will cease once the property is no longer occupied.

Mobility

Both a life estate in your home and a right to occupancy you home can be drafted so that the individual can sell the property and acquire a replacement property and the same rights will apply to that property.

This assists with downsizing as people age and with funding an accommodation bond for a retirement village or nursing home.

Types of Trust

Different types of trusts can be created by your Will, depending on the benefits you wish to achieve or the concerns you wish to address. Depending upon the circumstances:

Maximum Flexibility

If you believe the beneficiary (spouse or child) is capable of managing their inheritance then it's common to use a discretionary trust and nominate the beneficiary as the trustee.

This enables the beneficiary maximum flexibility in the management and control of their inheritance whilst at the same time providing the taxation benefits and asset protection benefits afforded by the trust.

Managed Control

If for some reason you wish to restrict the control your beneficiary has over their inheritance you can:

1. Add a third party as a joint trustee along with your beneficiary, but still use a discretionary trust (this option is only appropriate in a limited number of situations).
2. Use a capital protected trust controlled by someone other than the beneficiary. These are designed to provide for beneficiaries who have difficulties managing moneys.

Most common trust structures

The main features of the two most commonly used trust structures are:

Discretionary Trusts (created by your Will):

- Allows the beneficiary to use, invest, change and control assets freely.
- Generally the beneficiary (or their nominee) is also the trustee of their own trust. A third party can be appointed trustee in place of, or in addition to, the beneficiary where there is good reason. Examples include where the beneficiary is facing bankruptcy, matrimonial problems or has limited capacity to manage their own finances.
- Generally no practical restrictions are placed on how the trustee is to manage or maintain the assets, although the trustee does have legal duties and obligations that must be complied with. The trustee can dispose of all assets as he/she see fit. Once you leave the assets to a beneficiary using this type of trust, the trustee/beneficiary will have total control, unless restricted through the intervention of a third party trustee whose consent is required.
- This type of trust provides maximum flexibility for tax purposes.
- Provides varying degrees of protection of assets for your beneficiaries from third parties in the event of bankruptcy or family breakdown.

Capital Protected Trusts (created by your Will):

This type of trust is designed to protect and preserve assets for the benefit of a beneficiary or for future generations.

They are often used where:

1. there is a concern that the beneficiary is unlikely to be able to manage their own financial affairs or are under the adverse influence of a third party; or
2. you wish to maximise the chances that assets will survive the beneficiary for the benefit of a subsequent generations.

A protective trust enables you to pre-determine some degree of control or influence over the way the assets can be managed, used and accessed by your beneficiaries.

Terms of such trusts vary;

1. Some provide for an income stream to the beneficiary with no access to capital.
2. Some empower the trustee to provide for the education, accommodation, maintenance and betterment of a beneficiary but does not allow access to capital and perhaps very restricted access to cash

The trustee will be a third party, not the beneficiary. Commonly the trustees are other family members, lawyers, accountants or trustee companies.

Special Purpose Trusts

Other special forms of trust (some with special taxation relief) are available. For example, trusts set up for a disabled person or to fund education of children may qualify for special taxation and Centrelink treatment.

Disadvantages

You should be careful about the taxation rules for superannuation death benefits if the trust beneficiaries are not confined to dependants.

You should also be aware of any taxation implications for the exemption from capital gains tax on the family home if the residence is held in the trust and for tax concessions for active assets for small businesses in the trust.

You should consider what is to happen if the trust continues past the primary beneficiary's death and think about dispute resolution formulas for a 'second generation' situation.

One disadvantage is the cost of administering a testamentary trust. If a professional is appointed trustee, there will be fees for this service. There will be ongoing administrative costs involved in maintaining a trust, such as accountancy fees for preparation of trust taxation returns. You should consider whether the income generated by your estate will be sufficient to warrant a testamentary trust. If, for example, all your assets are owned jointly with another person or by a family trust, there may be insufficient assets in your estate to make the establishment of a testamentary trust worthwhile. If you are uncertain about whether you will have sufficient assets in your estate, a testamentary trust can be included as an option in your Will, with the trustee(s) making the decision whether or not to implement the trust at the relevant time.

If you already have a family trust the assets of your family trust do not form part of your estate. If all your assets are presently owned by your family trust, there would be no point in establishing a testamentary trust unless you planned to wind down your family trust and transfer the assets in it to yourself.