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Some Home Truths about Testamentary Trusts

Introduction

There has been a lot of publicity recently surrounding Testamentary Trusts so we thought it timely to highlight a few issues and discuss the benefits they can provide your clients.

Paying unnecessary tax on income from an inheritance

With a standard Will, the money is often left to the surviving spouse, who will then invest the funds to create income for the family to live on - income that is taxed at the spouse's marginal tax rate. However when there are children involved, there are better ways to optimise the returns.

Special provisions in a Will can save a great deal in tax. Children under 18 are normally excluded from distributions of family trusts and we are all aware of the force of those provisions...Division 6AA operates to force the children to pay tax at 47% on annual distributions above $640.

In relation to deceased estates however, the Tax Act contains provisions which specifically exclude those penalties in relation to deceased estates. The Will, however, must include special provisions which enable the exemption to apply. Most standard Wills that we review do not contain those specially required provisions.

Solution: With a Testamentary Trust in place, the beneficiaries could invest the inheritance and by way of distribution, create an income for each of their children. For tax purposes, they would then be treated as adults, and be taxed at their (usually much lower) marginal rate. This will save many dollars for your clients. See the box over the page for a working example.

Consequences of second marriages for estate planning...

Jointly held assets

Clients who own their family home jointly in the typical "Joint Tenancy" structure, or who have money in a joint bank account, will find that ownership automatically passes to the co-owner or account holder on their death. It completely by-passes the deceased estate and any Will that might be in place does not cover those assets. This is often overlooked when second relationships are formed and children of the first relationship can miss out on receiving their parent's share in the home or joint bank account. This posed an awkward problem for one of our clients…

His 75 year old father had recently re-married and sold his family home to move in with his new wife in her house. He placed the cash from his house in a joint bank account with his new wife. What he didn't know? If he died first, his family would receive nothing.

Solution: If this isn't what he intended, he needed to establish that account with his new wife as "Tenants in Common" rather than in the more typical "Joint Tenancy" structure, so that his share of the assets would fall into his estate.

Who gets the family home?

As mentioned, if the home is owned jointly as "Joint Tenants" it falls outside the deceased estate and goes directly to the co-owner. With the asset then passing completely to the surviving spouse in their name, the assets can then be exposed…

Is the home safe?

Special provisions can be put in place to protect the home from the consequences of future relationships. Most clients, when they know what they can do to protect their family, want to do exactly that!

A case in point .. John and Susie were married with three children. They jointly owned their home and John died leaving the whole of the home in Susie's name. Susie then married Robert. Unfortunately Robert was in business and the business failed. As Susie was involved in the business as a manager, the business failure also resulted in her bankruptcy (liability for insolvent trading is not restricted to directors). Since the home was entirely in her own name, she lost the home to Robert's creditors.

Solution: It's important to not only isolate your personal assets from any business dealings in case things do go wrong, but it's equally important to leave assets via Testamentary Trusts so that they are never owned in the beneficiary's personal name and are therefore protected.

A working example

Michael & Helen had $300,000 net assets when they died in a car accident. They left everything to their 2 children James and Kate (who are adults with their own children and both paying 47% tax).

The $300,000 is invested at 5% interest and generates $15,000 pa income. They will pay $7,050 in tax on this income.

If they inherited through a Comprehensive Will with a Testamentary Trust they would have the option of paying their own children income and saving $7,050 in tax every year.

Checklist: Do I have clients who need a testamentary trust?

If your clients satisfy <u>any one</u> of the following criteria they probably need a Comprehensive Will with a Testamentary Trust…

1. Do they have assets worth more than $300,000?

2. Do they have children from a prior relationship?

3. Does your client want to minimise any tax their beneficiaries might have to pay?

4. Does the client have children who may run their own business or have their assets exposed in any way to bankruptcy?