Australian Executor Trustees

Estate planning client guide

# Why should you consider a testamentary life interest trust?

A testamentary life interest trust enables you to support a particular beneficiary after your death for a period of time chosen by you. At the end of that period, your estate is distributed in accordance with your wishes. These types of trusts are most often used to provide for a spouse during their lifetime, with the assets passing to the children upon your spouse's death.

## What is a testamentary trust?

In general, a trust describes an ownership structure in which the assets of the trust are owned by one person or organisation (the trustee) but held for the benefit of other individuals or organisations (the beneficiaries).

A testamentary trust is a trust that is created within and by your Will but does not take effect until your death. It differs from a family trust (also known as an inter vivos trust) because a family trust is created by deed and commences during your lifetime.

A testamentary trust may be created using specified assets, a designated portion of your estate or the entire remaining balance of your estate. Multiple trusts may be created by the one Will and it's possible to have trusts with different provisions which can be tailored to the needs of your beneficiaries.

While the trustee of the trust is usually nominated by the Willmaker, the Willmaker can also give the primary beneficiary of the trust the power to appoint the trustee.

## What is a testamentary life interest trust?

A testamentary life interest trust (also called a 'life interest') can be used to ensure your 'primary beneficiary' receives adequate support from your estate, for the remainder of their life or another specified period. Once that beneficiary no longer needs support, your estate will be distributed according to the instructions in your Will.

Whilst a life interest can be constructed according to your wishes, the trustee may or may not be given discretion as to how the income generated by the trust is applied to the beneficiaries, both primary and other.

The defining feature of a life interest is that the primary beneficiary does not control access to the capital of the trust. When the trust vests (ie when the life interest period ends) or is no longer required, the terms of your Will dictate who receives the assets that are subject to the life interest.

Depending on the terms of the trust, the primary beneficiary may have the power to allow the trust to run for the term set out in your Will or vest at any time after your death. The terms of your Will, however, ensure that the distribution of the trust capital will occur in accordance with your wishes regardless of when the trust vests.

## What are the advantages of a life interest?

### Flexibility for the primary beneficiary

If provided within the terms of the trust, the trustee can exercise discretion as to the distribution of income to beneficiaries at any time and in any proportion. There may be tax planning reasons for the primary beneficiary to request the allocation of income to a number of beneficiaries or the primary beneficiary may simply not require as much financial support as you have allowed in your Will.

If the primary beneficiary has no need for the trust, it can be wound up at any time as long as the trust capital is distributed in accordance with your instructions.

### Protection of assets

As the assets form part of the trust, they cannot be taken out unless the trustee decides to wind up the trust. However, the trustee's decision to wind up the trust may be based upon a request from the primary beneficiary (for example they may not require the financial support provided by the trust). Also, because the assets of the trust are not legally owned by the beneficiaries, they have a far greater level of protection from legal proceedings, such as the beneficiary's marital breakdown or bankruptcy. In case this does occur, it's a good idea to have an independent trustee in place.

### Taxation advantages

Taxable income generated by the trust can be allocated to the beneficiaries of the trust in a tax-effective manner.

The trustee is given discretionary powers in relation to the distribution of income which makes the testamentary life interest trust a flexible tax planning vehicle.

Beneficiaries pay income tax at their marginal rates on the amount of income they receive from the trust. Unlike tax on income from a family trust, beneficiaries under 18 years of age are taxed at normal adult rates rather than the penalty tax rate applied to minors. As a result, the potential for tax savings when trust income is allocated to children may be substantial.

The taxation advantages of a testamentary life interest are shown in the case study below.

## Case study

Mike is married to Carol. They have not had any children together, but each has three children from previous marriages, all of whom are financially independent. Both Mike and Carol have incomes which place them in the top marginal tax rate bracket of 47%.

Carol dies and her estate has capital of $500,000, which is invested in shares and fixed interest securities. When she made her Will, Carol was keen to ensure that her three children (rather than Mike's three children) eventually inherited the $500,000 plus any capital growth on that amount, but she also wanted to ensure that Mike had access to the income from her investment portfolio during his lifetime.

Carol's Will, therefore, established a life interest trust (where Mike was both the trustee and primary beneficiary) under which:

- Mike could distribute the income from the $500,000 to himself, his children or grandchildren, Carol's children or grandchildren, or nominated charities
- upon Mike's death (or at an earlier time if Mike so decided), the $500,000 would be divided equally between Carol's three children.

In the five years after Carol's death, Mike's children have four children.

The annual investment returns from the $500,000 in Carol's estate are:

| Investment return | Amount |
|---|---|
| Interest | $13,000 |
| Dividends | $12,000 |
| Total income | $25,000 |
| Imputation credits | $5,000 |
| Total taxable income | $30,000 |

Mike compares how much disposable cash his family will have each year if the income from the $500,000 is allocated to him or distributed to his grandchildren, none of whom have any personal income.

### Scenario 1: Mike distributes the income to himself

| Tax payable | |
|---|---|
| Tax on $30,000 ($30,000 x 47%) | $14,100 |
| Less imputation credits | $5,000 |
| Tax payable | $9,100 |
| Net cash received ($30,000 – $9,100) | $20,900 |

### Scenario 2: Mike distributes the income equally among his four grandchildren

| Taxable income | Per child | Total |
|---|---|---|
| Distribution | $6,250 | $25,000 |
| Imputation credits | $1,250 | $5,000 |
| Total taxable income | $7,500 | $30,000 |

| Tax payable | Per child | Total |
|---|---|---|
| Tax on $7,250 | nil | nil |
| Less imputation credits | $1,250 | $5,000 |
| Tax refund | $1,250 | $5,000 |
| Net cash received ($6,250 + $1,250) | $7,500 | $30,000 |

In summary, the disposable cash received each year is:

| | |
|---|---|
| Income distributed to Mike | $20,900 |
| Income distributed to Mike's grandchildren | $29,000 |

The difference in these two scenarios is $9,100, which is the after-tax cash saving as a result of the distribution of income among Mike's grandchildren. The life interest provides a level of flexibility that gives Mike the opportunity to generate an additional after-tax income of $9,100 each year.

This, however, has no impact on Carol's wish that her children eventually inherit the $500,000, together with any capital growth. Mike's discretionary powers as trustee are limited to deciding the manner in which the income from the life interest trust is distributed.

While he cannot access the capital of the trust, he can transfer control of the trust to Carol's children at any time. Carol's children can then choose to continue the trust or terminate it.

For further information please contact your AET estate planning specialist on **1800 882 218**.

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