

Why should I consider a testamentary life interest trust?

Estate Planning Client Guide

If you wish to provide for your spouse's needs during their lifetime, but control who ultimately receives your estate assets, a testamentary life interest trust is a flexible solution.

A testamentary life interest trust enables you to support a particular beneficiary after your death for a period chosen by you. At the end of that period, your estate is distributed in accordance with your wishes.

What is a testamentary trust?

In general, a trust describes an ownership structure where 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) as 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.

What is a testamentary life interest trust?

A testamentary life interest trust (also called a 'life interest') is normally used where:

- you wish to ensure that a particular beneficiary (the 'primary beneficiary') is adequately provided for from your estate during the remainder of their life (or some other specified period) should you predecease them, but
- you would like to retain the ability to control the disposition of your estate when the primary beneficiary no longer needs to be provided for.

A life interest gives the primary beneficiary the discretion to distribute income to themselves or between a group of beneficiaries nominated in your Will.

However, an important feature of a life interest is that the primary beneficiary does not control access to the capital of the trust.

The terms of your Will dictate who is to receive the assets that are subject to the life interest when the trust is no longer required.

The primary beneficiary may allow the trust to run for the term set out in your Will or vest it (that is, end it) at any time after your death. However, the terms of your Will ensure that, regardless of when the trust vests, the distribution of the trust capital will occur in accordance with your wishes.

What are the advantages of a life interest?

Flexibility for the primary beneficiary

The primary beneficiary has discretion to distribute income to themselves or to any other beneficiary at any time and in any proportions. There may be tax planning reasons for the primary beneficiary to allocate income to a number of beneficiaries, or the primary beneficiary may simply not require as much financial support as you have provided for.

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 a trust, they cannot be taken out of the trust unless the primary beneficiary agrees to wind up the trust and distribute the assets to the beneficiaries in accordance with your Will. None of the assets are legally owned by the beneficiaries, which may protect the assets of the trust from legal proceedings, such as in the event of a beneficiary's marital breakdown or bankruptcy.



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Taxation advantages

Taxable income generated by the trust can be allocated among the beneficiaries of the trust in a tax-effective manner. The discretionary powers given to the primary beneficiary in relation to income distribution make the testamentary life interest trust a flexible tax planning vehicle.

The beneficiaries pay income tax on the share of income allocated to them according to their normal marginal tax rates. However, unlike tax on income from a family trust, beneficiaries under 18 years of age are taxed at normal adult rates rather than at penalty tax rates. 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 on which they are taxed at the top marginal tax rate of 46.5%.

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 and any capital growth on that amount, but 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 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.

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

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

Interest	\$13,000
Dividends	\$12,000
Imputation credits	\$4,000
Discounted capital gain (reinvested)	\$11,000
Taxable income	\$40,000

From this income, the cash received will be \$25,000.

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.

Scenario 1: Mike distributes the income to himself.

The taxable income is \$40,000.

Tax on \$40,000 (46.5% tax rate)	\$18,600
Less imputation credits	\$4,000
Tax payable	\$14,600
Cash received	\$25,000
Less tax	\$14,600
Disposable cash	\$10,400

Scenario 2: Mike distributes the income equally among his four grandchildren. The taxable income for each child is \$10,000 (\$40,000 ÷ 4).

Tax on \$10,000	\$nil
Less imputation credits	\$1,000
Tax refund for each grandchild	\$1,000
Cash received	\$25,000
Add tax refund for all four grandchildren	\$4,000
Disposable cash	\$29,000

In summary, the disposable cash received each year is:

Income distributed to Mike (Scenario 1)	\$10,400
Income distributed to Mike's grandchildren (Scenario 2)	\$29,000

The difference in the two scenarios is \$18,600, which is the after-tax cash saving from distributing the trust income among Mike's grandchildren. The flexibility in the life interest allows Mike the option of generating additional after-tax income of \$18,600 each year.

However, this has no impact on Carol's wish that her children will eventually inherit the \$500,000 and any capital growth on that amount. Mike's discretionary powers are limited to deciding the manner in which income of the life interest trust is distributed. He cannot access the capital of the trust, but 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.

Would you like further information?

For further information please contact your AET Estate Planner on 1800 882 218.

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