TESTAMENTARY TRUSTS BY MICHAEL HINES OF THE VICTORIAN BAR

About the Presenter

Michael Hines has been a member of the Victorian Bar for over 20 years and is on Dever's List.

In 2008, he appeared in the High Court in an important case, *Kennon v Spry* [2008] HCA 56; (2009) 83 ALJR 145 on discretionary trusts and the alteration of property interests under the *Family Law Act 1975* (C'th). Mr Hines practises in property law, commercial law, tax, equity and trusts and estates, and more recently family law property settlements. He has written numerous articles and a LBC looseleaf service on stamp duties and has been a part-time senior lecturer and fellow of the University of Melbourne law school teaching post graduate tax.

Introduction

A testamentary trust is a trust created by a valid last Will. It is created when the executor has completed administration of the deceased's estate. It can be a fixed or discretionary trust granting limited estates or interests to various persons or purposes.

Testamentary trusts are an important and popular device for estate planning, family provision, asset protection (ie, protection of the trust property from creditors of beneficiaries or their spouses), and tax planning. They are a way of distributing a testator's wealth after his death to those of his or her descendants in a lower tax bracket (such as infants), and they offer a useful means of reposing discretion in a suitable person who take changing circumstances into account, not foreseeable by the testator. They may be a check on spendthrift beneficiaries and a help to beneficiaries under a disability, such as incompetents or infants.

Cost

The terms of a Will can give a beneficiary the option of taking his share of property direct or appointing it to a testamentary trust, eg, for his immediate family.
There is additional work in drawing a testamentary trust and expense in administering it. There are certain ongoing annual costs for the administration of a trust – such as the cost of lodging a taxation return and drawing up accounts.

It has been pointed out[1] that whether or not it is worthwhile creating a testamentary trust will usually depend on

- the size of the estate – the annual operating costs usually make the cost of a testamentary trust prohibitive if the trust property will be less than a few hundred thousand dollars;
- the needs of beneficiaries. If a beneficiary is at risk of bankruptcy or suffering a disability, then it will generally be worthwhile making a testamentary trust will – regardless of the likely value of the assets. Otherwise, it may not be.

Form and terms of trust

The terms of the trust are generally set out in the Will or a document incorporated by reference to the Will, such as schedules or appendices. The terms may be augmented or qualified by legislation, such as the *Trustee Act* 1958 (Vic). Usually, the terms of the trust will provide for such matters as the trustee's powers and duties, the appointment and removal of trustees, the appointment and vesting of trust property, the accumulation of and additions to trust property, alteration of the terms of the trust, and the trustee's indemnities.

The "beneficiaries" may include mere objects of a power to appoint trust property, any of whom may gain rights to trust property – income or capital or both - but only upon the exercise of the power in their favour. The beneficiaries may, for example, be the children

[1] See "Estate & Business Succession Planning" (2nd ed) by Bernie O'Sullivan.

and remoter issue of the testator. If, however, the testator wishes to protect the trust property from falling into the hands of his or her child's spouse in the event of divorce, both the child and the spouse (and their alter ego trusts or companies) should be excluded from any possible benefit if either (or their alter ego) can become the holder of a power of appointment,[2] or at least their possible entitlement should be limited so as not to extend to the property to be protected.

For technical reasons, it is prudent not to include as beneficiaries trusts which may be settled by the testator after making his Will, or trusts which the testator may revoke or vary.[3]

Usually, the power of appointment over income and capital is held by a trustee who may be a natural person or persons or a company. Usually, the appointor has an absolute discretion to exercise or not to exercise the power, and should he or she exercise it, to do so in favour of any one or more of the objects. The power may be subject to the supervision or veto of somebody else.

The trustee may be the same person as the executor.

Until and unless they gain rights to trust property upon the exercise of a power of appointment, the mere objects of the power have no more than a right to due administration of the trust by the trustee.[4]

There will be beneficiaries who have entitlements to trust property – again, either income or capital or both – in default of the exercise of the power of appointment. Such entitlements normally amount to interests in the trust property, that could –at least in theory - be taken by a trustee in bankruptcy or subjected to orders made by the Family Court. Such entitlements may, however, be difficult to value, or might be elusive because not vested in possession.

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[2] See *Kennon v Spry*, supra.
[3] See *Re Edwards* [1948] Ch 440 and *Re Schintz* [1951] Ch 870.
[4] The donee of the power, should he also be an object of the power, may be considered as having a right tantamount to ownership of the trust property: see *Federal Commissioner of Taxation v Vegners* (1989) 90 ALR 547.

Usually, the terms of the trust grant a power to some person to appoint and remove trustees. Sometimes this person may be the testator's spouse, some trusted relative, or (less often) an agent, such as a solicitor or accountant.

Often the terms of the trust include a power to vary the trusts. Usually the power is exerciseable by the trustee, sometimes conditional upon his obtaining some other person's consent. As a matter of construction of the term, does a power to vary trusts extend to adding new beneficiaries? Sometimes expressly or implicitly it appears from the terms of a trust, that new beneficiaries can be added. For example, this was so in *Kearns v. Hill* (1990) 21 N.S.W. L.R. 107, where there was expressed to be a power to vary or amend any of the provisions of the trust deed. In that case, there were references in the deed to persons who were not beneficiaries but were 'capable' of becoming beneficiaries, so that it was either impossible to locate any unalterable substratum or alternatively the relevant substratum was the benefit of a class which included the added beneficiaries.[5]

Section 48 of the *Wills Act 1997* (Vic) abolishes the rule against delegation of testamentary power, so that the terms of a testamentary trust can now validly repose in a trustee the power to add beneficiaries.

Although Div 115 of the *Income Tax Assessment Act 1997* (C'th) makes provision for trustees to be liable for tax at ordinary rates on capital gains from which a beneficiary does not benefit, the trustee has a limited time (2 months after the end of the income year) within which to choose such an assessment. If he fails to do so, there is a danger that a beneficiary of trust income may be liable for tax on a capital gain from which he or she does not benefit, unless the trust terms include capital gains in trust income: see ss97 and 98 of the *Income Tax Assessment Act 1936*.[6] For this reason, it is useful to include in the trust terms which define what trust property may be treated by the trustee as income of the trust, and for the terms to give the trustee a wide discretion. For example, it is useful for the trustee to have the power to determine that the source of a distribution was income

[5] See pages 110 and 111.

[6] See *Commissioner of Taxation v Bamford* [2010] HCA 10 and the Commissioner's Decision Impact Statement thereon available on the ATO website

or capital of the trust, or a particular receipt of income, for example, franked dividends, and to determine capital gains to be income of the trust. It is useful to provide the trustee with similar powers to determine outgoings and losses and what constitutes a derivation (a receipt or accrual) or an outgoing for the purposes of, for example, determining the trust's distributable income for a period.

Such powers can enable the trustee to reduce the tax liability of the trust estate and to adjust the distribution of tax liabilities amongst the beneficiaries.[7]

The trustee should be given power under the terms of the trust to make a family trust election, so as to ensure that franking credits on company dividends can be passed on to beneficiaries.

The trustee should be given power to make loans to beneficiaries. In some cases, for example, it may be preferable for the trustee to lend money to a beneficiary rather than to give it to him. If the beneficiary divorces, the loan (if genuine) will count as a liability, rather than as property divisible by the Family Court between the parties to the marriage.

Taxation benefits

Minors' unearned income (with some exceptions), over and above a small amount (in effect $3,000 in the ordinary case for the 2009/10 year of income) is subject to the highest marginal rate of tax (45% for that year of income and the next) under Div 6AA of the *Income Tax Assessment Act 1936* (C'th). One of the exceptions is assessable income of a trust estate that resulted from a will or codicil or order under testator's family provision, or is derived by the trustee of a trust estate from the investment of any property that devolved for the benefit of the beneficiary from the estate of a deceased person: s102AG(2)(a) and (d). There are some anti-avoidance provisions in the Act, but their effect appears to be limited and uncertain and I am not aware of the Commissioner's having sought to apply them: see ss102AG(3), (4), (5) and (7), which limit the scope of

[7] Ibid.

s102AG(2)(d)(ii) (limited opportunity for beneficiary under Will to create trust having similar taxation advantages.)[8]

Where the concession applies – as is the case with a testamentary trust - minor beneficiaries are taxed at normal adult rates. Hence, a testamentary trust can enable all or part of the income of property which belonged to the deceased to be split amongst minors with a lower marginal rate of tax than that of other possible beneficiaries who already earn a significant income. Over several years and if there are several minors, the tax savings can be significant.

An alternative way of getting some of the taxation concessions is for the testator to leave property to the trustee of an existing discretionary trust. The availability of concessions may be more limited here, however, than in the case of a testamentary trust, because the concessions do not apply to trust property not devolved from the estate.

The question arises whether in the event of further contributions to a testamentary trust, the income, or the income attributable to the contributions, would be assessable income of a trust estate that resulted from the will, etc, so as to fall within the exception attracting the concession: see s102AG(2)(a) ITAA36. A related question is whether the receipt of such contributions could make the trust one no longer falling within the class described, thus disqualifying all its income? Income from reinvestments of the corpus is income of a trust estate that results from the will, etc: see *The Trustee for the Estate of the late AW Furse No5 Will Trust v FCT* 91 ATC 4007; but that does not answer either question posed. I am unaware of any ruling that attempts to deal with these issues. Someone may have to apply for a private ruling to get a decision binding on the Commissioner.

In some circumstances, it may be advantageous for a person nearing death to transfer assets from a trust to him or herself and to provide for its devolution to a testamentary trust.

Like other trusts, testamentary trusts can be used to stream income, for example, by paying franked dividends to those beneficiaries best able to take advantage of the imputation credits, for example, beneficiaries with a higher marginal tax rate.

When recommending the testamentary trust as a tax effective vehicle, I have in mind trust property consisting of investments, rather than for example, a beneficiary's residence.

[8] See also s102AG(2A) for a further limitation of this opportunity.

The CGT exemption there requires that the owner be a natural person, rather than a trustee.

See also s50-20 of the ITAA97.

Asset protection

There are at least two relevant dangers against which testators may wish to protect the trust property: the danger of bankruptcy, and the danger of relationship breakdown or divorce.

Property divisible amongst creditors does not extend to property held by a bankrupt in trust for another person: s116(2) of the *Bankruptcy Act 1966* (C'th). Moreover, a special power of appointment is personal and not property liable to be taken by the appointor's trustee in bankruptcy: see *Re Burton; Wily v Burton* (1994) 126 ALR 557; *Pope v DPR Nominees Pty Ltd and Ors (1999) SASC 337*;cf *Australian Securities and Investments Commission; In the matter of Richstar Enterprises Pty Ltd (No 6)* [2006] FCA 814 and *Public Trustees v Smith* [2008] NSWSC 397.

On the other hand, the interest of a beneficiary in trust property and the rights of a mere object of a power of appointment in a discretionary trust may be property which the beneficiary's or object's trustee in bankruptcy could take: see *Kennon v Spry*.[9]

The position is rather different under the *Family Law Act 1975* (C'th.) Under that Act, the Family Court can adjust interests in property of the parties to the marriage or either of them: see ss79 and 85A. Such property includes powers of appointment and rights of objects of powers: *Kennon v Spry*. It may include property if a spouse has the practical means of its control, provided such control can be lawfully exercised.[10] Hence, it is more difficult to draw terms of a trust which afford protection to the trust property from orders of the Family Court than from bankruptcy.

The draftsman should pay close attention to the circumstances of the family. It is often not the case that one size fits all.

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[9] Supra.

[10] See for example, *Ashton v Ashton* (1986) FLC 91-77; *Goodwin v Goodwin* (1991) FLC 92-192 and *Davidson v Davidson* (1991) FLC 92-187.

Michael Hines is a member of the Victorian Bar Professional Standards Scheme approved under Professional Standards Legislation. His liability is limited under that Scheme. A copy of the Scheme will be supplied on request.