Testamentary Trust - Frequently Asked Questions

What is a Testamentary Trust?

A testamentary trust is established by a will and doesn't come into force until the death of the will maker.

Instead of leaving assets directly to a beneficiary, they are transferred into a trust and held on behalf of a single or group of beneficiaries.

A testamentary trust can range from the will being drafted with simple terms and fixed entitlements for beneficiaries, through to defined trust terms similar to a modern inter vivos trust deed with a range of potential beneficiaries at the Trustee's discretion.

What are the key benefits of a resident Testamentary Trust?

There are significant advantages derived from a testamentary trust, the trust may provide asset protection as well as tax advantages.

Compared to an inter vivos trust (i.e., a trust established by someone during their lifetime), a testamentary trust broadly provides the following tax benefits:

- Ability to distribute income to a child and have concessional tax rates apply
- Ability to accumulate income to the trust and have concessional tax rates apply
- Capital gains tax concessions

Tax rates for children

Income from a testamentary trust distributed to a child is taxed at concessional rates (effectively adult marginal rates) as follows:

Taxable income	Tax on this income* (2022–23 income year)
0 – $18,200	Nil
$18,201 – $45,000	19c for each $1 over $18,200
$45,001 – $120,000	$5,092 plus 32.5c for each $1 over $45,000
$120,001 – $180,000	$29,467 plus 37c for each $1 over $120,000
$180,001 and over	$51,667 plus 45c for each $1 over $180,000
*Applies to Australian tax residents Plus Medicare Levy of 2% applies (not applicable to low income earners)	

Whereas, income from an inter vivos trust distributed to a child is taxed at penalty rates (effectively top marginal rate) as follows:

Taxable income	Tax on this income* (2022–23 income year)
$0 – $416	Nil
$417 – $1,307	66% of the excess over $416
Over $1,307	45% of the total income that is not excepted income
*Applies to minors who are Australian tax residents, are not excepted persons and have no excepted income No low income tax offset applies, as it only reduces tax payable on excepted net income Plus Medicare Levy of 2% applies (not applicable to low income earners)	

This means if a child has no other income, they could receive a distribution from a testamentary trust of up to $21,884 with $0 tax payable. Compare this to a child receiving the same distribution from an inter vivos trust, which would incur tax of $9,847.80.

Tax rates on income accumulated to a trust

The Trustee of a trust is assessed on net income that is not distributed to the beneficiaries.

Income accumulated in a testamentary trust is taxed at concessional rates (adult marginal rates, excluding the tax-free threshold of $18,200) as follows:

Taxable income	Tax on this income* (2022–23 income year)
$0 – $416	Nil
$417 – $670	50% of the excess over $416
$671 – $45,000	$127.30 plus 19% of the excess over $670 If taxable income exceeds $670, the entire amount from $0 will be taxed at the rate of 19%
$45,001 – $120,000	$8,550 plus 32.5% of the excess over $45,000
$120,001 – $180,000	$32,925 plus 37% of the excess over $120,000
$180,001 and over	$55,125 plus 45% of the excess over $180,000
*No low income tax offset Plus Medicare levy of 2%	

Whereas, income accumulated in an inter vivos trust is taxed at top marginal rate of 47%.

To continue the example, this means if $21,884 of taxable income was accumulated in a testamentary trust, tax of $4,595.64 would be payable. Compare this to the same income accumulating in an inter vivos trust, which would incur tax of $10,285.48.

Capital gains tax (CGT) concessions

There are a number of CGT concessions that are available to a resident testamentary trust including:

- ATO practice of allowing an asset to be transferred from the deceased, to the estate, to a testamentary trust and on to a beneficiary, with no capital gain or loss incurred, if specific conditions are met.
- Ability to reduce the CGT payable in respect of a pre-CGT dwelling or main residence dwelling of the deceased in certain situations.
- Access to the 50% CGT discount for gains from assets which have been held for at least 12 months.
- Access to the small business CGT concessions, if specific conditions are met.

So… What is the catch with a Testamentary Trust?

A number of the tax benefits are designed to apply to income generated from the property of a deceased estate. This includes accumulations of income or capital from property of that deceased estate, and conversions of such property from one asset type to another.

Concessions will not apply to income generated from property injected into a testamentary trust. Examples of injected property include:

- additional funds or assets gifted to a testamentary trust
- distribution of income or capital from an inter vivos trust
- additional assets acquired with money borrowed by a testamentary trust

This means that the concessional tax treatments can be lost or limited by actions taken by the Trustee after the testamentary trust has been established.

Maintaining the concessional tax treatments means less flexibility in the operation of the trust and additional record keeping requirements in addition to the many tax matters the Trustee needs to address throughout the life of the trust.

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On establishment of a Testamentary Trust what key tax matters need to be addressed?

Consideration should be given to the residency status of the trust and certain ATO compliance matters including obtaining a Tax File Number and TFN reporting obligations.

Resident or foreign trust

It is crucial to note different tax issues can arise depending on whether the testamentary trust is considered to be a resident or foreign trust.

The residency status of a testamentary trust is determined separately for each income year. The trust will be a resident for a particular income year if, at any time during the income year:

- a Trustee is an Australian resident; or
- the central management and control of the trust is in Australia.

On establishment, the residency status of a testamentary trust is important as it may affect the tax position of the deceased and the estate.

Further, whether the testamentary trust is a resident or foreign trust throughout its life effects taxation aspects such as the type of income that is taxed, the capital gains implications on different types of assets and the cost base and deemed acquisition date of assets distributed in-specie.

The key take away point is that the residency status of the testamentary trust should be determined prior to the transfer of any assets. Questions should also be asked such as whether the current residency status of the trust was the intention at the will drafting stage; can or should the Trustee be changed or an additional Trustee be appointed; or who can or should make decisions about the management of the trust's affairs?

Tax File Number (TFN)

A testamentary trust is a separate taxpayer to the deceased estate and is required to obtain its own TFN.

Whilst it is not necessary for a TFN to be applied for on establishment of the testamentary trust, having the TFN at hand to provide to financial institutions and share registries saves the inconvenience of TFN Withholding or the complications caused by the Trustee providing their own personal TFN.

TFN Reporting

The Trustee is required to collect and report to the ATO the TFN of a beneficiary prior to the beneficiary receiving a payment from the trust or becoming presently entitled to the trust income.

Where the beneficiary has not provided their TFN and personal details to the Trustee, the Trustee is required to withhold tax at the top marginal rate of 47% on the beneficiary's payment or entitlements.

Whilst it is not necessary for a TFN Report to be lodged on establishment of the trust, lodging a report early on for at least the primary and default beneficiaries (if applicable), may minimise compliance complications down the track.

What are my ongoing tax responsibilities as Trustee?

Tax responsibilities of a Trustee throughout the life of a testamentary trust include:

- ensuring that all necessary resolutions have been made for beneficiaries to be presently entitled to income or capital gains of the trust, if it is intended for the beneficiary to pay any tax due.

- complying with TFN reporting obligations - when resolutions are prepared to make the beneficiaries presently entitled, it is important to check that the TFNs of the beneficiaries have been reported to the ATO.

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- considering whether it is necessary to make a Family Trust Election (FTE) - if the testamentary trust incurs tax losses or if the total franking credits per beneficiary is greater than $5,000, the Trustee may need to consider lodging an FTE to access certain tax concessions. However, the downside to an FTE is it narrows (for tax purposes) the permissible beneficiaries of the trust to the family group of a nominated person known as a test individual. The election is only required to be made once and can only be varied or revoked in limited circumstances. Once an election is made, any distribution to a person or entity outside of the family group will be subject to Family Trust Distribution Tax (payable by the Trustee at top marginal rate of 47%).

- ensuring trust tax returns are prepared and lodged.

- providing beneficiaries with the information they need to include distributions in their own personal tax returns and in certain cases withholding tax on their behalf.

- paying any tax liabilities of the trust if income has been accumulated.

How can we help you?

T&E Accounting works with you so you have a clear understanding of your Testamentary Trust and provides specialised accounting services to ensure that the tax requirements are met now and into the future.

If you have any questions, please feel free to contact us on 1300 082 633
It would be our pleasure to assist you further.

Current as at 1 October 2022
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