Why Everyone Should Upgrade to a Smarter Will

IMPORTANT NOTICE

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Smarter Estate Planning Is Not Just for the Wealthy

DON'T LET YOUR HARD-EARNED LEGACY GO TO WASTE

Even if all you own is your house/apartment, you should still upgrade from a so-called 'simple' will to a more sophisticated will that properly protect your assets and reduces **unnecessary tax.**

Short, simplistic wills do NOT avoid complications – in fact, they do the opposite, by preventing flexibility and leaving gaping holes for tax leakage.

They also leave your estate exposed to **creditors and predators.**

You've worked all your life to build what you have: don't waste tens of thousands of dollars in unnecessary tax, and expose your hard-earned assets to risk, for the sake of a few hundred dollars now.

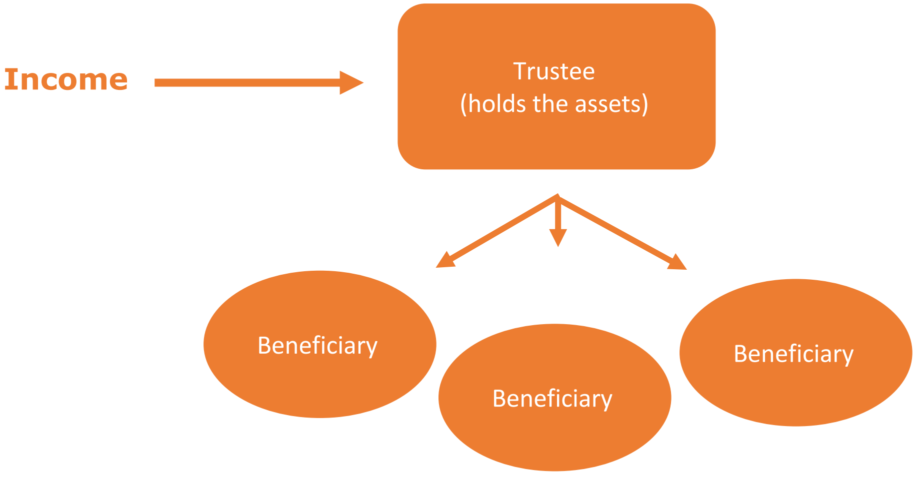
This guide illustrates how upgrading to a smarter will can add tens of thousands of dollars to the value of your estate.

A Few Key Words to Learn

It's important to know the meaning of a few key terms in order to understand why upgrading to a more sophisticated will is so valuable.

Trust

A trust is a common and powerful structure where the "legal" and "beneficial" ownership of an asset are separated. The trustee has official legal title to the asset but holds the asset for the benefit of the beneficiaries. Income earned from the assets is passed to the beneficiaries via the trustee.



Discretionary Trust

A discretionary trust is a type of trust where the beneficiaries have no fixed interest in the assets – whether or not a particular person can benefit under the trust is entirely discretionary to the trustee. Many people have a "family trust" that is set up as a discretionary trust.

Testamentary Discretionary Trust

A testamentary discretionary trust is a special type of discretionary trust that is created pursuant to a person's will. The trust is constituted after the will-maker passes away. Instead of passing the assets directly to the beneficiary, the executor puts the assets into a discretionary trust. The intended recipient becomes a beneficiary under the trust and can control the identity of the trustee.

Streaming

Streaming means passing income earned from the trust assets through the beneficiaries via the trustee and doing so in the most tax-efficient way possible.

This is extremely useful where the trust has low-income beneficiaries who are in lower tax brackets.

The Power of Income Streaming

The key is that, with a testamentary discretionary trust, minors (ie, children under 18 years old) are taxed like adults with the same tax rates, including the tax-free threshold.

This is contrasted with a normal family trust, where distributions to minors are taxed at penalty rates. See the table below:

Income tax rates for resident minors *

Distribution ($)	Family Trust	Testamentary Trust
0 - 416	-	-
417 – 1,307	66%	-
1,308 – 18,200	47%	-
18,201 – 37,000	47%	19%
37,001 – 80,000	47%	32.5%
80,001 – 180,000	47%	37%
180,001+	47%	47%

*Based on FY18 rates

When a recipient in your will earns income from a gift – eg. rent on an investment property, or capital gains when they sell it – that income will be taxable. While they have children under 18 years old, that income can be 'streamed' to the kids to take advantage of their preferential tax rates. This requires a special structure called a 'testamentary discretionary trust' that can only be created under a will.

Income can also be streamed to low-income-earning adults, such as full-time or part-time students, which similarly provides a valuable mechanism for reducing tax.

Your house/apartment becomes your beneficiary's investment property, generating $40K+ in taxable rental income for your beneficiary every year.

That income can be 'streamed' to low-income relatives of your beneficiary to save thousands in tax, year after year after year.

Your Home Becomes an Investment Property

Case Study

FACT SCENARIO:

Jane's only significant asset is her primary residence, which is a modest 2-bedroom apartment worth $800K. Jane leaves everything to Mary who is her only child. Mary has a job paying $120K p.a. and 2 children who are still in school.

Mary lives in a 3-bedroom townhouse, which she rents as she can't yet afford to buy her own home. Once Jane's apartment passes to Mary, to help pay the bills, Mary rents out Jane's old apartment as an investment property, which earns $40K p.a. in rental income.

Mary holds Jane's apartment as an investment property for 10 years and then sells it for $1M, making a $200K capital gain on the sale.

TAX RATES:

To see the tax rates that apply, look at the table on page 5 – the rates in the "Testamentary Trust" column are the same as normal adult rates. With a smarter will, those rates can also apply to children under 18 years old who otherwise have no income.

'SIMPLE' WILL:

With an existing income of $120K p.a. from her job, the additional $40K p.a. in rental income from Jane's old apartment all falls within the $80,001 - $180,00 tax bracket, the rate for which is 37%. 37% of $40K is $14,800, which is the extra tax that Mary will pay on the additional rental income every year.

In the final year, the $40K rent + $100K capital gain (after the 50% CGT discount) will all add to Mary's income, pushing her total taxable income up to $260K, taking her well into the top tax bracket of 47%.

SMARTER WILL:

Mary streams the additional $40K in rental income to her 2 children, splitting it equally between them (ie, $20K each). Her children each pay only $342 in tax as the first $18,200 for each of them is tax-free. **Instead of paying $14,800 in extra tax every year, Mary reduces the extra tax down to only $684, which is a saving of $14,116 per year, every year.**

In the final year, the additional $140K income (ie, $40K rent + $100K taxable capital gain) can similarly be split equally between Mary's 2 children $70K each. This way, **nothing falls within the top 47% tax bracket at all.**

RESULT: TOTAL TAX SAVED = $156,000

Your Home Becomes an Investment Property

Case Study

The result is that, over the 10 years while Mary held Jane's former apartment as an investment property, Mary saved a whopping $156,650 in unnecessary tax! Here's the breakdown:

Year	1	2	3	4	5	6	7	8	9	10
Salary	120K	120K	120K	120K	120K	120K	120K	120K	120K	120K
Rental Income	40K	40K	40K	40K	40K	40K	40K	40K	40K	40K
Capital Gain *	-	-	-	-	-	-	-	-	-	100K
Total Income	160K	160K	160K	160K	160K	160K	160K	160K	160K	260K
Simple Will Tax	46,832	46,832	46,832	46,832	46,832	46,832	46,832	46,832	46,832	90,232
Smarter Will Tax	32,716	32,716	32,716	32,716	32,716	32,716	32,716	32,716	32,716	60,626
TAX SAVED	14,116	14,116	14,116	14,116	14,116	14,116	14,116	14,116	14,116	29,606

* These numbers take into account the 50% CGT discount for assets held for more than 12 months.

PLEASE NOTE: This guide should not be relied on as a substitute for obtaining legal, financial or other professional advice. This case study is intended to provide a general example in relation to income tax only and is not comprehensive. Other taxes also need to be considered – eg, GST, stamp duty, land tax, etc. You must seek your own tailored professional advice.

With a 'simple' will, applicable assets passing to a foreign beneficiary can trigger CGT. With a smarter will, that can be overcome by using a testamentary discretionary trust. Even if your children live in Australia now, they may move overseas in the future.

FOREIGN BENEFICIARIES – CGT

When a person passes away, any capital gain they made in respect of an applicable asset owned just before passing away is disregarded, unless the asset passes to a beneficiary that is an "exempt entity" (this is known as "CGT event K3").

A foreign resident for Australian tax purposes is an exempt entity. This means that, where an applicable asset passes directly to a foreign resident as per a 'simple' will, capital gains tax (CGT) is triggered.

That CGT can be overcome by instead passing the applicable asset into a testamentary discretionary trust with an Australian trustee of which the foreign resident is a beneficiary.

This is important, even if all of your beneficiaries currently live in Australia, because they may live overseas in the future.

ASSET PROTECTION

Under a 'simple' will, the assets pass to each beneficiary directly. This means that the assets are at risk:

- **Bankruptcy –** Assets held in your beneficiary's own name are vulnerable to claims from the beneficiary's creditors. For example, if the beneficiary makes an investment that goes bad, or someone has an accident for which the beneficiary is held liable, then your hard-earned assets may be used to pay the debts.

- **Family Law claims –** If your beneficiary is involved in a marriage or de facto relationship that breaks down, the beneficiary's former spouse may make claims against the beneficiary's assets. The Family Court of Australia has broad powers to divide the beneficiary's property between the spouses and require the payment of maintenance (ie, alimony).

  Placing your assets in a testamentary discretionary trust of which your beneficiary is not the trustee may help to insulate your hard-earned assets from such claims. This is because technically the trustee owns the assets and, as it is a discretionary trust, the beneficiary does not have a fixed entitlement to the assets.

Preserving your Beneficiaries' Centrelink Entitlements

Many Centrelink entitlements are means-tested – ie, eligibility to receive the welfare benefit depends upon the value of the intended recipient's assets (the "assets test") and the level of the intended recipients income (the "income test"). If one of your beneficiaries receives a mean-tested welfare benefit, **assets given to the beneficiary directly under a 'simple' will – and income earned from those assets – may affect the beneficiary's entitlement to the benefit**.

Smarter wills can use the following trust structures aimed at preserving Centrelink entitlements:

Beneficiary Support Trust

Also called a “Protective Trust” or “Capital Protected Trust”, a Beneficiary Support Trust is a special type of trust created under a will for one particular beneficiary where the beneficiary does not have any control over the allocation of the assets. This is especially useful where there is a concern that the beneficiary may be unable to manage his/her own finances – eg, by virtue of having an intellectual disability or a problem with drugs, alcohol or gambling.

Where assets are in a trust, in determining the assets test and the income test, Centrelink focusses on whether the recipient has control over the assets, so a Beneficiary Support Trust may reduce the risk of the beneficiary losing his/her Centrelink entitlements.

" . . . especially useful where there is a concern that the beneficiary may be unable to manage his/her own finances – eg, by virtue of having an intellectual disability or a problem with drugs, alcohol or gambling.

Special Disability Trust

A Special Disability Trust is a trust created for one particular beneficiary who has a “severe disability” (as defined by legislation). If the terms of the trust comply with the requirements of the Department of Social Services, **assets in the trust are exempt from means testing by Centrelink** and the Department of Veterans’ Affairs (up to a maximum of $657,250 for the assets test from 1 July 2017 – this amount is increased annually).

THE IMPORTANCE OF FLEXIBILITY

KEEP YOUR BENEFICIARIES' OPTIONS OPEN

Simple wills force your beneficiaries to take all of their gifts directly. That limitation may prove to be immensely costly as it:

- places the assets at risk by exposing them to claims from your beneficiaries' creditors; and

- prevents your beneficiaries from enjoying the tax savings from income streaming that, as illustrated in the case study on page 5, can easily amount to more than $100K even if your total assets are valued at less than $1M.

The key is to keep your beneficiaries' options open. Smarter wills give your beneficiaries the choice as to whether to take the assets directly or via a testamentary discretionary trust, depending upon what suits their particular circumstances in the future when you pass away.

Smarter wills allow the beneficiaries to receive the assets in the way that best suits their personal situation at the relevant time.

WHAT IF THEY WANT TO SELL THE PROPERTY TO PAY THEIR MORTGAGE?

The tax advantages of a testamentary discretionary trust are relevant where the beneficiary chooses to retain the assets to earn income from them. If the beneficiary chooses to immediately sell the property (eg, to help pay off their own mortgage) then the beneficiary may prefer to receive the property directly. Smarter wills give the beneficiary that choice.

Don't paint your beneficiaries into a corner: give them the flexibility to do what suits them best when the time comes.

POWER OF ADJUSTMENT

Simple wills are too rigid: they don't give the executor room to make adjustments to deal with unintended scenarios. For example, if two beneficiaries are intended to receive equal shares but the gift to one of them turns out to be subject to an unexpected tax, the executor needs the flexibility to increase the gift to that beneficiary to achieve a more equitable distribution on an after-tax basis. Smarter wills give the executor a general power to make such adjustments.

Smarter wills give your beneficiaries the choice as to whether to take the assets directly or via a testamentary discretionary trust, depending upon what suits their particular circumstances in the future when you pass away.

EXCLUDING PEOPLE FROM YOUR WILL

When you pass away, any "eligible person" may make an application to the court for a family provision order if they believe that there has been inadequate provision for them under your will. If an order is made, interests under your will may be adjusted and **the applicant may be able to obtain part of your estate, contrary to your will.**

WHO IS AN "ELIGIBLE PERSON"?

Broadly speaking, this may include anyone to whom you had a responsibility, potentially including a **current or former spouse or de facto partner, children, grandchildren, other dependants and even persons living in your home.**

HOW CAN THE LIKELIHOOD OF A SUCCESSFUL FAMILY PROVISION ORDER BE REDUCED?

The likelihood of a family provision order being successful might be reduced by expressly excluding people who may be eligible persons in the will, outlining the reasons why they have been excluded.

This is not usually a feature of a 'simple' will but can be included in a smarter will.

WHAT MIGHT BE A VALID REASON TO EXCLUDE SOMEONE?

There is no guarantee that any particular reasons will be acceptable. The following are some examples of potentially valid reasons:

- sufficient provision was made for the excluded person during your lifetime;
- you and the excluded person have had no contact for a long time and no relationship of love/affection exists between you;
- you have not had any responsibility for the welfare of the excluded person for many years;
- the financial circumstances of the excluded person are much better than those of the included beneficiaries; and/or
- the excluded person has received, or is likely to receive, significant assets from the estate of another person.

Please note that, as the will becomes a public document at probate, any such reasons will ultimately be visible to the public.

Supreme Court of New South Wales

FAMILY COURT OF AUSTRALIA

MORE INFORMATION

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