Estate affairs

Welcome to Estate affairs – December 2013 edition

IN THIS ISSUE

- **Testamentary life interest trusts**
- **Consequences of selling the family home**

Testamentary life interest trusts

In our July edition, we introduced our small APRA fund solutions for blended families - a unique strategy for clients with blended families on how to deal with superannuation in the event of their death. Since then, we have received a number of enquiries from financial advisers requesting information on how their clients can create a life interest in their Will. In this edition, we will discuss how this can be achieved through the creation of a testamentary life interest trust.

A testamentary life interest trust provides support to a beneficiary (such as a surviving spouse or partner) following the client's death, for a specified period of time. At the end of that period, the estate is distributed in accordance with the client's wishes. These types of trusts are most commonly used to provide income to a spouse during their lifetime, with the assets passing to the children upon the spouse's death.

What is a testamentary trust?
In general, a trust is 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 a person's Will but does not take effect until after their 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 a client's lifetime. A testamentary trust may be created using specified assets, a designated portion of an estate or the entire remaining balance of an 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) can be used to ensure that a client's surviving spouse receives adequate support for the remainder of their life. Once the spouse no longer needs support, the estate will be distributed according to the instructions in the client's Will. While a life interest can be constructed according to a client's 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 trust 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 the client's 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 the Will or vest at any time after the client's death. The terms of the Will, however, ensure that the distribution of the trust capital will occur in accordance with the client's wishes regardless of when the trust vests.

Estate affairs

What are the advantages of a life interest?
There are a number of advantages of creating a life interest including:

- flexibility for the primary beneficiary
- protection of assets, and
- taxation advantages.

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 the client has allowed in their Will.

If the primary beneficiary has no need for the trust, it can be wound up at any time and the trust capital will be distributed in accordance with the instructions in the client's Will.

Protection of assets
As the assets form part of the trust, they can not 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 are protected from legal proceedings, such as the beneficiary's marital breakdown or bankruptcy.

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 individual marginal rates on the amount of income they receive from the trust. However, unlike tax on income from a family trust, beneficiaries of life interest trusts under age 18 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 can be substantial.

Family home
A regular provision of a Will is to provide a right for a surviving spouse to reside in the family home for their lifetime. Where it is a client's intention to provide such a right, it is essential to account for events such as downsizing, ill health, moving into aged care or other changes in family circumstances. It is common for the life tenant to have the right to sell the property and purchase another residence on the same terms that were established in the Will for the first residence. The subsequent purchase will be in the name of the executor of the estate and the surviving spouse as tenants-in-common. The treatment of any surplus on the sale and purchase also needs to be considered and documented.

It is also important to consider how other expenses are paid for - insurance, rates and other expenses for maintaining the home are to be paid for. Commonly, the life tenant will be responsible for paying expenses from other income producing assets in the trust. Alternatively, the estate may be responsible, however, this requires very careful drafting in the terms of the Will.

Consideration also needs to be given as to how the furniture and contents of the home are to be treated in the Will. Generally, these will be passed directly to the beneficiary who has the right to reside in the home.

Estate affairs

Great care needs to be taken in drafting the Will and we advise seeking professional estate planning advice to prevent unexpected outcomes. There is not necessarily a right way to deal with these issues provided that they are all identified, discussed and documented.

Case study - Steve and Maria
Steve and Maria have been married for two years and are both aged 52. They both have two adult children from previous marriages. They have a comfortable lifestyle and currently have the following income and assets:

Income	Ownership	Annual amount
Salary	Steve	$250,000
Investments	Steve	$50,000
Salary	Maria	$100,000
Total		**$400,000**

Asset	Ownership	Value
Family home	Tenants-in-common	$1,500,000
Cash	Joint	$100,000
Shares	Steve	$1,400,000
Superannuation	Steve	$1,200,000
Superannuation	Maria	$300,000
Total		**$4,500,000**

If one of them was to die, they want the survivor to be able to maintain a comfortable lifestyle and remain in the same home. Upon the death of the second spouse, they want all four children to benefit relative to the assets their parent’s brought to the relationship.

Estate affairs

Estate planning
The home ownership is already structured as tenants-in-common and Steve and Maria have converted their superannuation to a small APRA fund (SAF) as per the blended family solution. For information on our small APRA fund (SAF) solution please click here.

Steve and Maria have Wills prepared which provide a life interest for the surviving spouse to live in the family home. Steve's shares will be used to create a life interest trust on his death with the trust income to be paid to Maria and the capital paid to Steve's children following Maria's death. Maria will be responsible for paying any property related expenses.

Maria's Will also provides a life interest for Steve to live in the family home, however, as she has no other income producing assets, Steve will be responsible for expenses associated with the property.

Both of their Wills provide that the family home may be sold or replaced (if required by the life tenant) with any excess capital proceeds to be held in trust. The excess capital proceeds trust can be used to fund an aged care accommodation bond or the capital can be held to provide an income for the life tenant. However, any residual capital will pass to their four children equally.

A few years pass, Steve and Maria are grandparents to four grandchildren when Steve dies suddenly in a road accident and their estate plans are activated.

Maria continues to live in the house and she has access to income from the trust created from Steve's shares. The trust allows Maria to distribute the income to herself, her children or grandchildren, Steve's children or grandchildren or nominated charities.

In the first year, the trust produced the following investment returns:

Investment return	Amount
Interest	$23,000
Dividends	$12,000
Imputation credits	$5,000
Discounted capital gain (reinvested)	$10,000
Taxable income	**$50,000**

Estate affairs

The taxable income of the trust is $50,000 and from this, the cash proceeds of $35,000 plus the imputation credits will be distributed to Maria. Maria is on a marginal tax rate of 38.5 per cent so the tax position of the distribution is paid to her is as follows:

	Amount
Total taxable income ($35,000 + $5,000)	$40,000
Tax on $40,000 ($40,000 x 38.5%)	$15,400
Less imputation credits	$5,000
Tax payable	$10,400
Net cash received ($35,000 - $10,400)	**$24,600**

Because the trust allows discretion as to how the income is distributed, Maria can generate tax efficiencies by distributing income to their grandchildren. Maria requests that the trustee distribute $8,750 plus $1,250 imputation credits to each grandchild. The tax position of the distribution for each child is then as follows:

	Per child	**Total**
Total taxable income ($8,750 + $1,250)	$10,000	$40,000
Tax on $10,000	nil	nil
Less imputation credits	$1,250	$5,000
Tax refund	$1,250	$5,000
Net cash received	$8,750	$35,000
Disposable cash ($8,750 + $1,250)	$10,000	$40,000

By having the flexibility to distribute income to the grandchildren, Maria has increased the total disposable cash for the family unit by $15,400 ($40,000 - $24,600). The capital of the trust remains protected for Steve's children.

A few years later, Maria wishes to move to a smaller home. The family home is sold for $2 million and Maria purchases a bungalow at the beach for $1.2 million. The $800,000 surplus is invested in an excess capital proceeds trust, as stated in

Steve's Will. The income from the trust can be used to maintain the property, with any additional income available to Maria. The capital will be preserved for distribution to all four children following Maria's death.

Summary
Life interests and testamentary discretionary trusts are powerful, tax-effective structures for clients with blended families. When used as part of our small APRA fund solution for blended families this strategy not only provides a way for clients to ensure their surviving spouse is looked after during their life, but also manages the distribution of assets to their children.

Consequences of selling the family home

By Neil Page, AET Legal Counsel, Estate and Trustee Services

Australia's population is ageing. In fact, one in ten people over age 70 are currently living in an aged care facility [1]. By 2051, it's estimated that more than 25 per cent of the population will be aged over 65 [2] and the number of people over 85 is expected to be more than 1.8 million [3].

These figures paint the likely scenario that the family home will be sold during a client's lifetime to fund aged care accommodation.

While this generally will not cause a problem from an estate planning perspective, it does become a complicated issue if the residence has been gifted to a particular beneficiary in a client's Will.

More commonly, we are seeing situations where (for family or personal reasons) a residence is specifically gifted to one child to the exclusion of others. During the client's lifetime, the family residence is sold, either by the client themselves or by an attorney.

What happens to that beneficiary's interest in the residence?
The general legal principle is that if the residence is disposed of during the client's lifetime, the intended beneficiary will not receive that benefit. Logically, you cannot gift something in a Will if you do not own it at the time of your death. The legal principle is known as 'ademption'.

If the net proceeds from the house are used to purchase an aged care accommodation bond, licence to occupy or similar, then generally on the death of the client, some form of refund will be paid to their estate. However, these funds will fall into the 'residuary' estate and may potentially pass to a different range of beneficiaries, such as to other children.

In some situations, it depends on the wording of the Will as to the outcome.

For example, if the wording in the Will states *'I give my principal residence to daughter A'*, then this may be sufficient to indicate an intention that the wording 'principal residence' would also include the new accommodation and an entitlement to receive any refund on the death of the testator.

If the Will states *'I give my residence situated at….being the land comprised in certificate of title….'* then the interpretation is different because a specific property is mentioned.

The issue of whether an asset has been adeemed will depend on the circumstances of each case and is the subject of much case law and commentary. It is quite clear, however, that if the client sells the residence during their lifetime and does not update their Will to reflect that change, then the property is adeemed – no ifs, no buts.

Estate affairs

The issue is less clear when the residence is sold by someone else - for example, by an administrator or attorney for the client, due to incapacity. There has been case law suggesting that if the client did not knowingly approve of a sale, and it was done out of necessity by an attorney, then the principles of ademption do not apply.

Acting as an attorney

It is important for an attorney to understand the impact of the actions they take in relation to the sale of specific assets such as the principal residence. A properly advised attorney would want to see a copy of the client's Will before taking action to sell the residence. In that way, any impact on the beneficiaries can be properly and accurately assessed.

In Australia, *Power of Attorney* Acts differ between states.

In South Australia for instance, Section 11A of the *Power of Attorney* Act allows the court to make an order as it thinks just to ensure that no beneficiary gains a disproportionate advantage, or suffers a disproportionate disadvantage, in consequence of the exercise of an attorney's power during a period of legal incapacity.

In Queensland, Section 107 of the Powers of Attorney Act allows the court to order that a person whose interest in a Will has been affected by the actions of an attorney, be granted compensation out of the estate to cover any lost benefit.

The attorney must consider if the sale of a residence is absolutely necessary to fund aged care accommodation. If it is possible to avoid a sale, this may prevent costly court applications, however, the best interests of the client must prevail in making any determination.

How to avoid ademption issues

The issues that we see generally relate to Wills that have not been updated or drafted in such a way to take into account the possible contingencies mentioned above.

Financial advisers need to ensure that their clients' estate planning needs have been considered and addressed. An estate planning specialist needs to make provision for contingencies such as the sale of the family home. Experienced estate planning lawyers, given the opportunity, will be able to draft appropriate clauses to cover a range of scenarios that will overcome the ademption issue.

[1] Commonwealth Department of Health and Ageing and ABS.

[2] Access Economics, 2001. *Population Ageing and the Economy*, research paper commissioned by the Commonwealth Department of Health and Aged Care, ACT.

[3] Treasury's Australia 2050: *Future Challenges* (2010 Intergenerational Report).

If you have any questions, or need more information, please call us on 1800 882 218 or visit www.aetlimited.com.au