

Testamentary discretionary trusts

Too often we think about who we would like to leave our assets to when we die but not how we should dispose of them. A testamentary trust is one option to consider.

What is a trust?

A trust is an entity created to hold assets for the benefit of certain persons or entities (**beneficial owner**), with a trustee managing the assets of the trust (**legal owner**). Most trusts are founded by the person who executes a written deed of trust (**settlor**). The deed establishes the trust and sets out the terms and conditions upon which it will be administered.

Types of trusts

There are many different types of trusts. The most common forms include:

- > discretionary trusts (also known as family trusts);
- > unit trusts; and
- > hybrid trusts (combination of both fixed and discretionary entitlements).

Trusts can be established either during a person's lifetime (**inter-vivos**) or on a person's death, established in accordance with the terms of their Will (**testamentary**).

Types of testamentary trusts

There are many different types of testamentary trusts that can be included in your Will. These include:

- > **Right to reside:** gives a beneficiary the right to live in a property for their lifetime or for a specified period of time.
- > **Life interest:** gives a beneficiary the right to receive income from the trust for their lifetime, and in some cases may also be able to access the capital.
- > **Protective trust:** provides protection of an asset for the benefit of a vulnerable beneficiary (e.g. with a disability). The trustee would apply the income and capital for the benefit of the beneficiary for his or her lifetime.

- > **Capital preserved testamentary discretionary hybrid trust:** Capital is preserved for the children of the primary beneficiary providing asset protection against relationship breakdown, income is discretionary.
- > **Testamentary discretionary trust (TDT):** similar to a family trust but established by a Will.

If your accountant or financial adviser recommends testamentary trusts to you, they are usually referring to TDT.

What is a TDT?

A TDT is created by the terms of a person's Will. It has a trustee, a range of potential discretionary beneficiaries (such as spouse, children and grandchildren) who are entitled to receive income and/or capital of the trust at the trustee's discretion and, in many cases, an appointor who holds the power to appoint and remove the trustee.

Benefits of a TDT

Many of the benefits of a TDT arise from the fact that while the assets of the trust may be controlled by the intended beneficiary, the assets held in the trust do not form part of the beneficiary's personal estate.

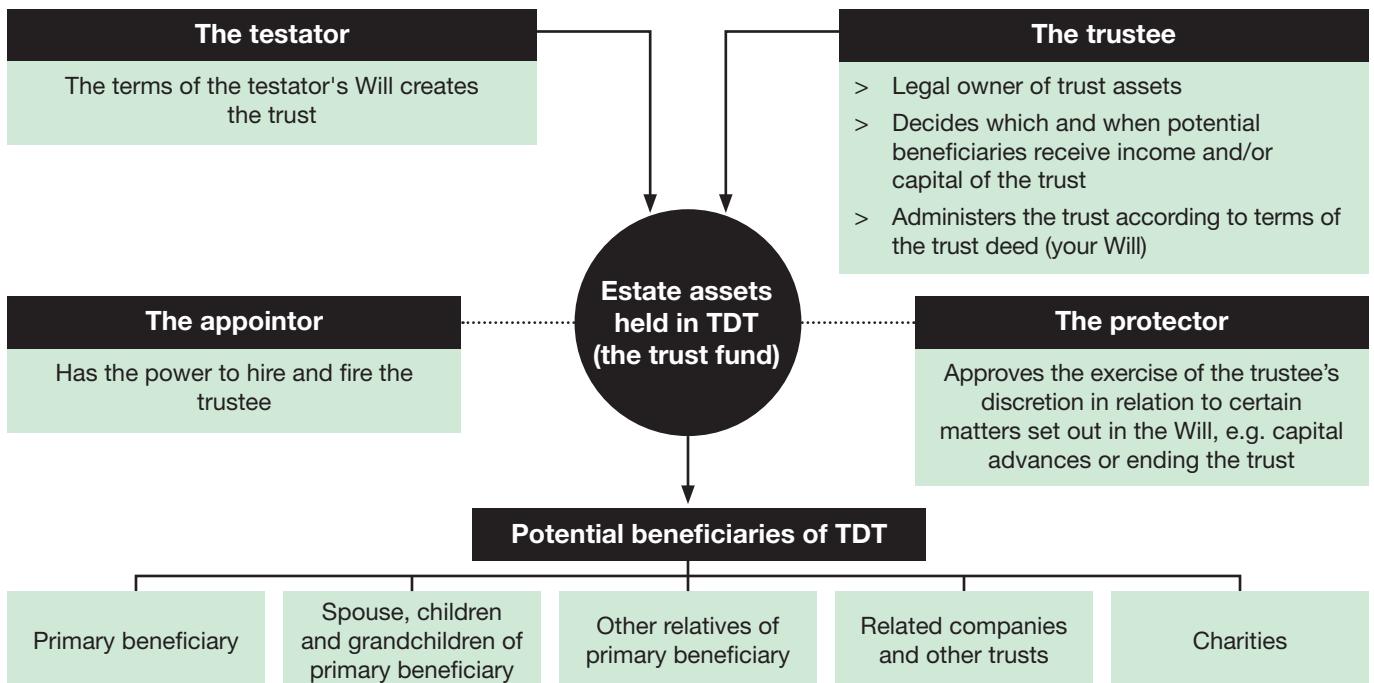
Asset protection

A TDT can protect the assets a beneficiary inherits under a Will if they:

- > find themselves in financial difficulties (bankrupt);
- > run their own business; and
- > are going through a relationship breakdown and involved in a property settlement (the level of protection is determined by the terms of the trust).

The separation between the legal owner and beneficial owner of the trust assets and the number of discretionary beneficiaries allows for this protection to exist.

Testamentary trust structure



Income splitting

The ability to split income makes this structure attractive to many testators leaving behind young children or grandchildren.

TDT's provide a favourable tax position when paying income distributions to a minor (children under 18). This is because a minor beneficiary of a testamentary trust is taxed as an adult. It means that a minor beneficiary is entitled to receive an effective free threshold of \$18,200 (2024/2025 financial year) and the standard adult tax rates thereafter.

In comparison, a minor beneficiary of an inter-vivos discretionary trust (a trust created during one's lifetime) is only entitled to a \$416 tax free threshold and any income above this amount is taxed at penalty tax rates. Figures do not include low income rebates.

Income streaming

Income streaming is the ability to pay different classes of income to different beneficiaries.

For example, paying the fully franked dividend received on BHP shares to Beneficiary A and paying rental income to Beneficiary B. This gives the trustee the greatest flexibility when it comes to distributing income to the beneficiaries and it also allows for a more tax effective trust.

Some other benefits may include:

- > as testamentary trusts are established by a Will, the testator has absolute control over the terms of the trust;

- > during the testator's lifetime, he or she can vary the terms of the testamentary trust at any time until his or her death or incapacity;
- > the testamentary trust comes into existence on the testator's death so they can retain control and ownership of their assets up until their death;
- > the testamentary trust can continue for up to 80 years (if required) to cover the life of the main beneficiary, and it is also possible for the trust to vest at any earlier date if authorised by the Will or if the trustee has the power to elect an earlier date;
- > it is possible to establish more than one testamentary trust in a Will, for example, one for each child;
- > you can create a multi generational trust ensuring the benefits extend beyond your children; and
- > you can create a bloodline trust, where only your lineal descendants can benefit.

Finally, if you are uncertain about the future need for a testamentary trust, an option is to prepare your Will in such a way as to give your beneficiaries the option to establish the testamentary trust at the time of your death.

Generational wealth management

Sometimes people want to ensure that certain assets, such as family heirlooms or a family holiday house, remain 'in the family' for years to come. Generational wealth management can be achieved by establishing a TDT in your Will. This type of trust can ensure future generations have the use and benefit of the assets for years to come. The class of beneficiaries of a TDT can be wide or restricted to include only bloodline relatives. This is sometimes referred to as a 'bloodline trust'.

Peter and Susan's story

Peter is 60 years of age and Susan is 62. They are both semi-retired and are now concerned that they have neglected their estate planning for the past 10 years.

Peter and Susan have three adult children, two are now married with young children of their own and the third is single. One child is currently experiencing marriage difficulties. They have a combined wealth of \$3,000,000 (family home, superannuation, investment property and life insurance).

Peter and Susan would like to ensure their children get the most out of their inheritance and this includes protecting it from falling into the hands of creditors or losing half of it through a relationship breakdown.

Peter and Susan were advised to include TDT's in their Wills for the benefit of each of their children. This type of trust can provide tax minimisation opportunities as well as assist in protecting their children's inheritance from both relationship breakdown and bankruptcy.

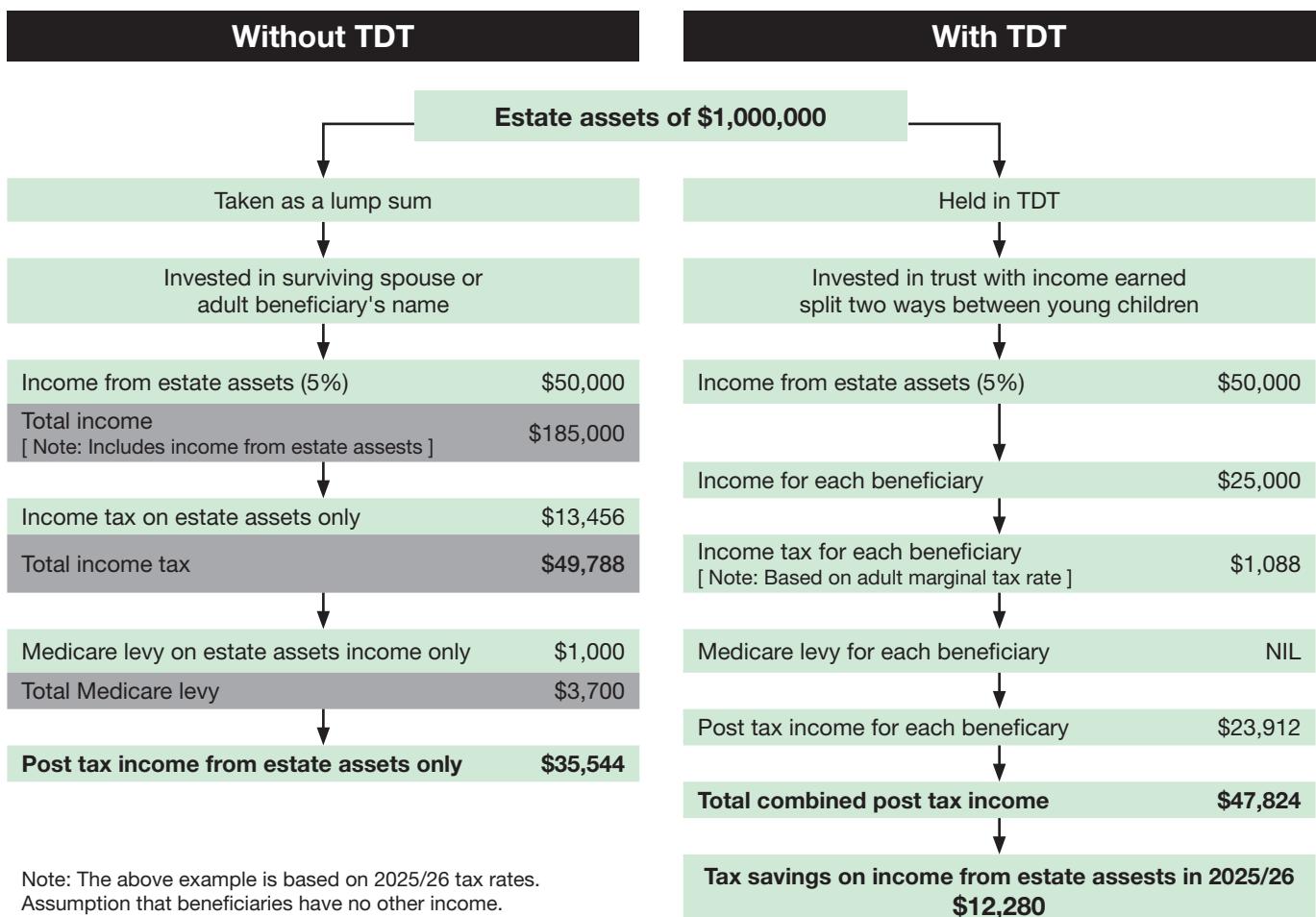
Peter and Susan died in an accident before they could update their Wills. At the time of their death, their daughter was in the process of separating from her husband and their single son was in financial difficulties after his business failed.

Unfortunately because Peter and Susan left their estate to their children in their personal names, their son's inheritance fell into the hands of his creditors and their daughter's inheritance formed part of the matrimonial assets when she and her husband divorced.

Had Peter and Susan incorporated TDT's in their Wills, their daughter would most likely have retained her inheritance, their son's creditors would still be seeking repayment and their third son could have utilised the potential tax savings available to him and his family.

Lost tax savings

An example of the potential tax savings Peter and Susan's son could have taken advantage of is demonstrated in the chart below. The potential tax savings lost by not using the testamentary discretionary trust and distributing the income earned to the two children is \$12,280 in just one year.



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