CHILD MAINTENANCE TRUSTS - WHEN AND WHY

Jamie Burreket

Family life is full of major and minor crises -- the ups and downs of health, success and failure in career, marriage, and divorce -- and all kinds of characters. It is tied to places and events and histories. With all of these felt details, life etches itself into memory and personality. It's difficult to imagine anything more nourishing to the soul.

Thomas Moore

1. Introduction

1.1 Division 6AA of the *Income Tax Assessment Act 1936* came into force in 1980. It imposed a regime of tax at a 'penalty' rate on income of minors that was, for use of a better word, 'unearned'. The higher rate of tax effectively discouraged the increasing practice of 'income splitting' between parents and their children. Today the 'penalty' rate of tax is 47% on all income earned by a minor in excess of $416.

1.2 Trust income distributed to a minor will avoid the 'penalty' tax rates if it falls within one of the stated categories of 'excepted trust income' in division 6AA. It is from one of these categories of excepted trust income that Child Maintenance Trusts developed. In particular from Section 102AG(2)(c)(viii) which states:

> "… an amount included in the assessable income of a trust estate is excepted trust income in relation to a beneficiary of the trust estate to the extent to which the amount … is derived by the trustee of the trust estate from the investment of any property transferred to the trustee for the benefit of the beneficiary … as the result of a family breakdown."

1.3 Child Maintenance Trusts remain rare. The number of situations in which they are worth considering is small. Usually they are limited to situations where there is significant wealth or high income. Yet in this small number of cases the benefits that may flow from a Child Maintenance Trust are significant. But there are strict requirements that make a Child Maintenance Trust prohibitive for most separating parents.

1.4 The principal role of a Family Lawyer in contemplating Child Maintenance Trusts is to be able to identify from all the matters that enter their office, which ones may benefit from some further advice about these entities. To meet this obligation a Family Lawyer must understand how Child Maintenance Trusts operate and more particularly what are their advantages and disadvantages.

2. The taxation benefits that flow from a Child Maintenance Trust

2.1 The most widely known advantage of a CMT is the savings in Income Tax. For many people this is the primary reason for considering a CMT.

2.2 Tax is levied as a percentage of an individual's income. As an individual's income rises the rate of tax rises. The more income you earn the higher the rate of tax you pay on those higher income amounts. To avoid paying tax on higher income amounts many Australians move part of their income to related people who might not be otherwise earning income themselves. This is called ‘income splitting’.

2.3 Since 1980 the *Income Tax Legislation* has in most situations effectively prevented income splitting to minors by imposing a penalty rate of tax on their ‘unearned’ income. The distinction between the normal rates of tax and the ‘penalty rates’ of tax is substantial[1].

<table>
<tr><th>Taxable income</th><th>Normal Tax Rate</th><th>Minor’s Penalty Tax Rate</th></tr>
<tr><td>$0 – $416</td><td>Nil</td><td>Nil</td></tr>
<tr><td>$417 – $1,445</td><td>Nil</td><td>Nil + 66c for each $1 over $417</td></tr>
<tr><td>$1,446 - $6,000</td><td>Nil</td><td rowspan="5">47% of the total income</td></tr>
<tr><td>$6,001 – $21,600</td><td>Nil + 15% for the excess</td></tr>
<tr><td>$21,601 - $63,000</td><td>$2,340 + 30% for the excess</td></tr>
<tr><td>$63,001 – $95,000</td><td>$14,760 + 42% for the excess</td></tr>
<tr><td>Over $95,000</td><td>$28,200 + 47% for the excess</td></tr>
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Taxable Income	Tax at Normal Tax Rate	Tax at Minors Tax Rate
$25,000	$3,360	$11,750
$50,000	$10,860	$23,500
$100,000	$30,550	$47,000

2.4 An obvious exception to Division 6AA is income earned by a minor from actual employment (Section 102AE(2)(a)). It would be unfair to tax this at the penalty rate. Another exception is income earned from property received as the result of a death of a person (Section 102AE(2)(c)(i)). A less obvious class of excepted income is income earned from the investment of property transferred to a minor as the result of a family breakdown (Section 102AE(2)(b)(viii) or to a trust for the benefit of a minor in the same situation (Section 102AG(2)(c)(viii)).

2.5 There is no obligation on a parent on the breakdown of the family to transfer property to a child or for the benefit of a child. So at first glance the exceptions in either Section 102AE(2)(b)(viii) and 102AG(2)(c)(viii) are of no immediate utility. But usually there is an obligation for a parent to provide continuing financial support to a child.

2.6 A taxpayer with a taxable income of $180,000 will pay income tax of $68,150. After paying his/her tax and child support for 3 children at the maximum rate applying the formula ($40,300) there will be $71,550 of disposable income remaining. If this taxpayer's child support liability was met via a Child Maintenance Trust, he/she would pay $16,226 less in Income Tax.

	Parent	Child 1	Child 2	Child 3	Total
Income	$135,762	$14,746	$14,746	$14,746	$180,000
Tax	($47,358)	($1,312)	($1,312)	(1,312)	($51,294)
Child Support	-	$13,434	$13,434	$13,434	($40,300)
Remainder	88,404	-	-	-	$88,404

2.7 If the same taxpayer did this for 15 years the tax saved would be in the sum of $243,390. If the CMT was used to meet an obligation to pay private school fees or medical expenses on top of the maximum assessment rate the tax savings would be greater. The greater the child support liability and the longer the period it will operate, the more beneficial the CMT.

3. Other benefits that flow from a CMT

3.1 While saving in tax may be the most obvious advantage to a CMT is not the only benefit and in some cases not the most significant. Neither is it exclusively the non-resident or paying child support parent who will benefit from a CMT. In some cases the non-paying child support parent may benefit from the use of a CMT.

Capacity to Pay

3.2 In many cases a parent's necessary expenditure to support themselves is such that there is insufficient capacity to pay child support at the level a child requires or at the level a parent might like. If a CMT is used to meet a payer's child support liability, that payer's capacity to pay will increase by the amount of tax that is saved. This may make more income available for the benefit of the children. In the example set out in 2.6 above the taxpayer reduced his/her tax liability by $16,226. At the same time his/her capacity to pay child support, all other things being equal, increased by at least the same amount.

3.3 If capacity to pay is an issue and a CMT is involved it is important to remember that the increase in capacity to pay is usually greater than income tax saved. The increased capacity is not matched dollar to dollar with the saving in tax. The increased capacity actually exceeds the tax savings if the increased capacity is directed to the child back through the CMT.

3.4 The taxpayer in Clause 2.6 without a CMT has a disposable income after tax and child support of $71,550. If that amount was sufficient support for the taxpayer, he could then via a CMT increase the amount of net income flowing to the children. Without any decrease in the payer's disposable income the financial benefit to the children has increased by $25,246.

	Parent	Child 1	Child 2	Child 3	Total
Income	$103,962	$25,346	$25,346	$25,346	$180,000
Tax	($32,412)	($3,464)	($3,464)	($3,464)	($42,804)
Child Support	-	$21,882	$21,882	$21,882	($65,546)
Remainder	$71,550	-	-	-	$71,550

Protection from Creditors

3.5 Often with high incomes come high risks. The prospect of insolvency has for a long time motivated many individuals to attempt to shelter assets and/or income from the reach of creditors. Trusts are popular mechanisms for such shelters. However, only certain types of trusts have the requisite characteristics to defeat a creditor's claim on the property of the trust. A CMT, like any trust, if set up properly can provide a legitimate shelter for assets and income in an insolvency situation.

Protection from payers seeking to avoid child support

3.6 Family law cases are riddled with examples of parents attempting to arrange their financial affairs to reduce their reportable income and thereby reduce their liability to support their children. Deliberate insolvency, transfer of assets to new spouses, investment in low income ventures and at the most extreme, flight from Australia, has all been tried. There are many more examples. The law has adapted to meet these situations. In most cases there is a remedy, but in almost every one of these cases the remedy is expensive and time consuming and in the meantime child support is not being paid at the level needed.

3.7 Depending on the asset that is invested, a CMT will avoid these risks and provide a better guarantee of child support on a continuing basis and at a predictable level.

Bridging the gap in property settlements

3.8 Family lawyers try hard not to scoff when one party attempts to bridge a gap in a property settlement negotiation by suggesting the difference be kept for the benefit of the children. These approaches inevitably fail. Usually there is too little of the pot to go around to start hiving off parts for the children's benefit. Yet if the proposal is sold to the other side as part of an increased means of support for the children and guarantees can then be provided about the continuing level of support, it may become an attractive option.

4. The strict requirements of a CMT and the disadvantages that flow from them

To constitute a CMT and fall within the exception in Section 102AG(2)(c)(viii) there are strict requirements.

- There must be a transfer of property as a consequence of a family breakdown.
- The property must be transferred for the benefit of the minor.
- The income must be at an arm's length rate of return.

It is from these requirements that the disadvantages of a CMT flow. Accountants and tax lawyers have developed effective strategies to reduce the impact of these disadvantages. The fact that there are so few CMT's remains the best evidence that the disadvantages remain significant.

4.1 A transfer of property as a consequence of a family breakdown

(a) This requirement received some judicial attention in the Administrative Appeals Tribunal in the matter of *Case U202*[2]. In that matter as part of their final property settlement parents of children resolved that an existing discretionary trust would now distribute income to the children in a defined amount. The income the children were to receive was being earned from existing assets of the Trust. The AAT found there had been no transfer of property. The income the children received was not therefore capable of being 'excepted trust income'. The income was taxed at the penalty rates.

(b) It is clear the trustee of the CMT must receive some property. There must be a transfer, and the transfer must have some correlation in time with the breakdown of the family. A transfer at the same time as final property settlement is put into place would be an obvious, but not essential, occasion for the transfer. Ultimately whether a transfer is a consequence of the breakdown of a family will be a question of fact and depend on the circumstances of each case.

(c) Often the most significant issue is finding property to 'transfer'. It will be a rare case where there is an asset already in existence that neither of the parties need and are willing to give up. Two practices have developed in these situations that can be useful.

1. A sum of money can be settled on the CMT and then loaned back to one of the parents. Subject to its eventual repayment and ongoing interest payments, the settled sum can effectively be applied by one of the parents to other purposes outside the CMT. If the advance is made to a business rather than the parent directly, the interest may be tax-deductible in the business. To a similar extent real estate that is subject to a CMT can be leased back to an interested parent. In both cases, as long as the return is at market (see 4.3 below) the investment should be within the bounds of what is allowed for a CMT.

2. A more complex practice is to establish a unit trust as a beneficiary of an existing discretionary trust. Then a separately established CMT acquires the units or part of the units in the unit trust. The requirement for the transfer of property is met and the existing

discretionary trust structure preserved. There are more significant issues about calculating the level of return on those units. This is discussed at 4.3 below.

(d) It is important to understand that existing trusts can be adapted to serve as a CMT. You do not have to set up a new trust structure in order to establish a CMT. If you can adapt an existing trust you will save the set-up costs and the ongoing management costs of running two separate trusts where one might suffice.

(e) Another important matter to bear in mind is that a Trust can be both a CMT and a normal discretionary trust. The Deed can make provision in relation to certain assets or parts of an asset (the CMT class) and different provisions about the remainder.

4.2 The property must be beneficially owned by the minor

(a) This is the disadvantage that turns most people away from a CMT. For a while some commentators had expressed some doubt about this requirement, but the issue was resolved in 1994 by the introduction of Section 102AG(2A) which states:

> Paragraph (2)(c) … does not apply unless the beneficiary of the trust concerned will, under the terms of the trust, acquire the trust property (other than as a trustee) when the trust ends.

The issue was put beyond doubt by the ATO when in 1998 it issued a Taxation Ruling[3] about the operation of a CMT. It is useful to set out in full paragraph 33 of the ruling which relates to the operation of Section 102AG(2A).

> Accordingly, the child must, under the terms of the trust, acquire the trust property other than as a trustee when the trust ends. Moreover, the property must pass into the child's estate, should the child die before the trust ends. However, the trust property can be applied for the child's benefit during the trust; for example, in the most extreme case, the trust property can be applied to acquire a term annuity for the child. In such cases, the trust property may be reduced over the period of the trust, but the child is still to acquire any trust property remaining when the trust ends.

(b) This means that by the terms of the Deed by which a CMT operates, the children must be capital beneficiaries of the asset in the proportion to which the income they receive from the investment of that asset is to be regarded as 'excepted trust income'. The capital entitlements cannot be discretionary.

(c) A parent will not get back the asset or the portion of the asset that is said to be the subject of the CMT. Be cautious of advice a client may receive whereby:

   (i) They are told that they can amend the Trust Deed once the children reach 18 years to alter the fixed capital entitlements; and

(ii) They are told that they can dilute the level of the CMT's interest in an asset after the children have attained the age of 18 years by issuing more shares in the underlying asset or transferring assets out of the underlying asset to a new entity.

The writer has not found any view of the ATO that would indicate that either arrangement would be permitted; yet they continue to be expressed by accountants from time to time.

(d) If a parent cannot 'get back' the asset settled on the CMT can he/she stop the children from seeking to vest the Trust once they attain their majority? If there were no other beneficiary, the authority in *Saunders v. Vautier*[4]*,* would permit the children to do just this. The asset would then leave the control of the trustee (presumably one of the parents of the children). However, even though the capital entitlement to the asset must be fixed, the income entitlements may remain discretionary. If there are discretionary income beneficiaries other than the children, there are continuing beneficial rights that cannot be extinguished. *Saunders and Vautier* would not apply and the trust could not vest absolutely. The trust would continue and control over the asset would remain in the hands of the trustee, at least until the death of the children (in which case the capital entitlement must be satisfied and form part of the child's estate).

4.3 The income must be at an arm's length rate of return.

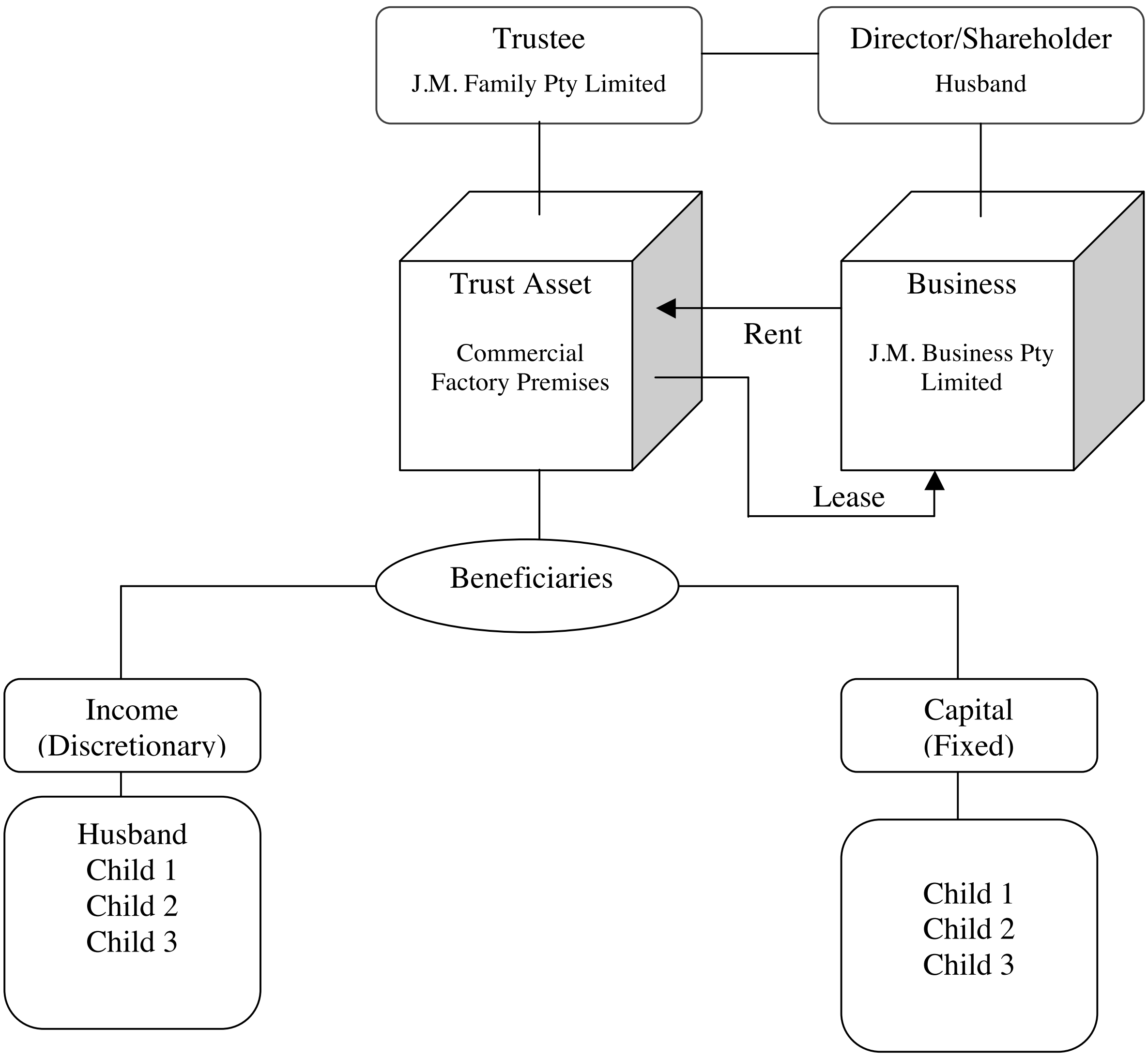
(a) If the transaction whereby the alleged 'excepted trust income' is derived involves related parties, all of the income may not be excepted. In this situation the excepted trust income will only be that part that equals the amount that would have been derived if the parties had been dealing at arms length. Section 102AG(3) provides:

> . . . if any 2 or more parties to:
>
> **(a)** the derivation of the excepted trust income . . . .; or
>
> **(b)** any act or transaction directly or indirectly connected with the derivation of that excepted trust income;
>
> were not dealing with each other at arm's length in relation to the derivation, or in relation to the act or transaction, the excepted trust income is only so much (if any) of that income as would have been derived if they had been dealing with each other at arm's length in relation to the derivation, or in relation to the act or transaction.

(b) If as was suggested in 4.1(c) above the investment is a loan to one of the parents, the arms length rate of return can easily be calculated. The same applies to real estate rented to a related person. There is an open public market for these investments and the rate of return can be compared with the return if the asset was placed on the market.

(c) If, however, the investment is in a unit trust, and the income that trust derives comes from a discretionary family trust, the issue is far more difficult to resolve. Particularly if a nominal amount was paid for the units in the first place. With this in mind, these types of arrangements need to be regarded with the utmost caution and entered into with the assistance of an accountant who has dealt with these structures before.

5. **A simple child maintenance trust at work**



5.1 In the trust structure represented above, the husband or an entity he controls has transferred to a Trust some commercial premises. That trust then leases those premises to another entity the husband controls, which is the entity from which the husband's income is earned ('the operating entity') and which occupies the commercial premises. The lease payments are tax deductible to the operating entity. The lease payments are income to the trust.

5.2 The Trust will qualify as a 'Child Maintenance Trust' if:

- the transfer is a consequence of the a family breakdown
- the capital beneficiaries of the trust are fixed and are the children
- in the event of a child's death the capital interest is part their estate
- the rent that the operating entity pays is market rent

5.3 The Trust will survive each of the children attaining the age of 18 years because the husband remains a discretionary beneficiary.

5.4 The Trust may distribute income to the children to the extent necessary and obtain the tax advantages that flow. An excess income can be distributed to the husband or other appropriate beneficiary.

6. **When and Why?**

6.1 Child Maintenance Trusts do work. With the correct advice even the most basic investment structure can be adapted to serve this purpose. There are ranges of benefits that can be achieved. The most significant remains the reduction in tax that might otherwise be paid. And accountants and lawyers have developed mechanisms that deal with the requirement of the legislation in a flexible and commercially viable manner/

6.2 In each case that presents it will be necessary to look at all of the benefits and disadvantages. Weighing them up will almost always require more specific and detailed advice than we as family lawyers can provide. The client will therefore need to be referred on for this advice. It is not suggested that we as family lawyers should do otherwise.

6.3 An understanding of the benefits and drawbacks of a CMT however, should enable you to know when a client might benefit from receiving some advice about a CMT and explain to them why. It may also assist you in identifying advice that client's might receive from their family accountant that may cause them problems with the ATO later on.

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7 August 2005

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1 The tax rates used in this paper are those proposed in the Tax Laws Amendment (Personal Income Tax Reduction) Bill 2005. The majority of the Senate has indicated it will pass the Bill.

2 87 ATC 1129

3 TR 98/4 'Income tax: child maintenance trust arrangements'

4 (1841) 4 Beav 115