

TR 94/D8 - Income tax: child maintenance trust arrangements



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Draft Taxation Ruling

Income tax: child maintenance trust arrangements

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What this Ruling is about

1. This Ruling considers whether the entitlements of, or distributions made to, a child under a child maintenance trust (CMT) arrangement are 'excepted trust income' under subparagraph 102AG(2)(c)(viii) of the *Income Tax Assessment Act 1936* (ITAA).
2. A CMT arrangement, briefly stated, is a means by which a non-custodial parent distributes income in the form of maintenance payments through a series of trusts to children of the marriage.
3. The Ruling is not concerned with CMT arrangements entered into for the benefit of minor beneficiaries who are 'excepted persons' (eg a minor who is married, in a full-time occupation or disabled) under section 102AC of the ITAA.
4. The wording of subparagraph 102AG(2)(c)(viii) of the ITAA is very similar to that of subparagraph 102AE(2)(b)(viii) of the ITAA. The Ruling is not concerned with the interpretation of subparagraph 102AE(2)(b)(viii). Many of the explanations made in the Ruling of the provisions of subparagraph 102AG(2)(c)(viii) apply, however, to the provisions of subparagraph 102AE(2)(b)(viii).

Ruling

5. Income derived by a trustee of a CMT (usually a custodial parent), being income:
 - to which a minor beneficiary of the CMT is presently entitled; or

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- distributed under a CMT arrangement from a discretionary family trust to the trustee(s) of another trust (or trusts) and in turn to a minor beneficiary of the CMT,

is not, for the purposes of subparagraph 102AG(2)(c)(viii) of the ITAA, derived from the investment of property transferred to the trustee of the CMT for the benefit of the beneficiary pursuant to a decree or order of dissolution or annulment of marriage or a decree or order of judicial separation or a similar decree or order.

6. The entitlements or distributions are not 'excepted trust income' under subparagraph 102AG(2)(c)(viii) of the ITAA. By subsection 102AG(1) of the ITAA, Division 6AA applies to the entitlements or distributions. They are 'eligible assessable income' for the purposes of subsection 102AE(1) of the ITAA; they are not 'excepted assessable income' under paragraph 102AE(2)(e) because they answer the description in subsection 102AE(4) of income to which Division 6AA applies.

7. The entitlements or distributions are subject to the higher rates of tax that apply to amounts to which Division 6AA of Part 111 of the ITAA (Income of Certain Children) applies. The tax-free threshold for the entitlements or distributions is limited to \$416 in a full year of income.

Date of effect

8. This Ruling applies to years of income commencing both before and after its date of issue. However, the Ruling does not apply to a taxpayer to the extent that it conflicts with the terms of a settlement of a dispute agreed with the taxpayer before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

9. If a taxpayer has a private ruling which is inconsistent with this Ruling, then this Ruling only applies to entitlements of, or distributions made to that taxpayer from and including the 1994-95 year of income unless the taxpayer asks that it apply (subject to any limitations imposed by statute) to earlier income years.

Explanations

How do CMT arrangements operate ?

10. A CMT is a trust set up by a parent for the purpose of paying amounts in the form of maintenance for the children (or a child) of the

parent. A CMT arrangement is more likely to be put in place by a non-custodial parent who does not pay tax by instalments (PAYE).

11. The arrangements customarily operate as follows:

- a CMT is established, the minor beneficiaries of which are children of a non-custodial parent;
- a unit trust is established, in which the sole unit holder is the non-custodial parent;
- the non-custodial parent either:
 - transfers to the trustee of the CMT units in the unit trust which have rights to income from the unit trust; or
 - transfers a nominal sum of money to the trustee of the CMT who purchases the units carrying rights to income;
- the unit trust is made a beneficiary of a discretionary family trust, which generally is already in existence;
- the discretionary family trust derives income from the business or investment activities of the non-custodial parent;
- income sufficient to meet the maintenance obligations of the non-custodial parent under the child support scheme is distributed to the unit trust;
- the income of the unit trust is in turn distributed to the trustee of the CMT on behalf of the children who are the beneficiaries of the CMT and is then distributed to the custodial parent;
- ordinarily the income to which each child beneficiary is entitled in an income year does not exceed the amount of the tax-free threshold (currently \$5400); and
- the obligation to pay child maintenance under the child support scheme is met by the non-custodial parent by diverting pre-tax business or investment income from the discretionary family trust to the unit trust and then to the trustee of the CMT.

12. The CMT arrangement is intended to avoid the child maintenance being taxed in the hands of the trustee of the CMT (on behalf of the beneficiary children) at the higher rates provided for Division 6AA.

13. The non-custodial parent who seeks to employ a CMT arrangement does not ordinarily transfer any property of substantial value for the benefit of the children. In any event, the parent makes no substantial investment on behalf of the children. The trustee of the

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CMT makes no substantial or arm's length investment either. The amount of income that flows to the CMT for the benefit of the children is subject to the discretion of the parent employing the CMT arrangement, either directly, through a nominee, or through a trustee who can be appointed and removed by that parent.

14. Some taxpayers claim that the income of the CMT is 'excepted trust income' under subparagraph 102 AG(2)(c)(viii) of the ITAA and that the income is subject to tax in the hands of trustee at normal rates of taxation (the tax-free threshold is available for each child beneficiary).

Provisions of Division 6AA

15. Division 6AA was inserted in Part 111 of the ITAA to deal with the income of certain children and applies to the year of income that commenced on 1 July 1979 and in relation to all later years of income. It applies to persons who are under 18 years of age on the last day of the year of income and are not 'excepted persons'. 'Excepted persons' include minors who are married, in a full-time occupation, disabled or who receive various types of disability assistance or are double orphans.

16. If subparagraph 102AG(2)(c)(viii) of the ITAA applies, income derived by a trustee from the investment of property transferred to the trustee for the benefit of a particular beneficiary and pursuant to a decree or order of dissolution or annulment of marriage, a decree or order of judicial separation or a similar decree or order, is 'excepted trust income' and is taxed, not under the higher rates provided for Division 6AA, but at normal rates.

Are CMT entitlements or distributions 'excepted trust income'?

17. The short answer is 'No'. The reasons for this answer follow.

Investment of property transferred to the trustee - subparagraph 102AG(2)(c)(viii)

18. In a CMT arrangement, the income derived by the trustee of the CMT (commonly, the custodial parent) flows to the trustee by virtue of the rights to income attached to the units in the unit trust.

19. One of the requirements of paragraph 102AG(2)(c) of the ITAA is that the trustee of the CMT must derive income 'from the investment of.....property transferred to the trustee.'

20. If it is money that is the property transferred to the trustee of the CMT and the trustee uses the money to acquire the units in the unit trust, this requirement is satisfied. The money is invested by the trustee in the units.

21. If, however, the units in the unit trust are transferred directly to the trustee of the CMT, there will have been no 'investment of any property' for the purposes of paragraph 102AG(2)(c). The trustee has not invested the units in any income-producing property. Nor has anyone else. A trustee who merely holds units in a unit trust cannot be said to have invested the property which those units constitute. Consequently, there can be no income derived by the trustee of the CMT from the investment of property, and so, there can be no 'excepted trust income' in terms of paragraph 102AG(2)(c).

22. In many CMT arrangements, existing discretionary and unit trust structures are adopted for their new purpose. If this occurs, there may be no transfer of property to the trustee of the CMT for the benefit of the children, and so no possibility that income is 'excepted trust income' in terms of paragraph 102AG(2)(c).

Transfer of property 'pursuant to' a relevant decree or order - subparagraph 102AG(2)(c)(viii)

23. Some taxpayers argue that, in a CMT arrangement, property (namely, money) is transferred to the trustee of the CMT 'pursuant to a decree or order of dissolution or annulment of marriage.....or a decree or order of judicial separation or a similar decree or order'. They therefore argue that the income derived by the trustee of the CMT from the investment of that property is 'excepted trust income' by virtue of subparagraph 102AG (2)(c)(viii). These arguments are wrong.

24. Even if property (ie money) is transferred to the trustee of the CMT, the property is not transferred to the trustee '*pursuant to*' a decree or order a decree or order of dissolution or annulment of marriage.....or a decree or order of judicial separation or a similar decree or order. A decree or order of this nature does not usually require particular property to be transferred to the trustee of a CMT, or require any CMT arrangement to be set up. Matters such as custody, maintenance and property settlements are dealt with in separate proceedings from those seeking a decree for the dissolution of the marriage.

25. The expression '*pursuant to*' in its context in subparagraph 102AG(2)(c)(viii) of the ITAA means:

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- 'under', or 'according to the terms of': *Habel v Tiller* [1929] SASR 170 at 176 and *Groves v Groves* [1944] SASR 187 at 189; or
- 'in accordance with' or 'consequent and conformable to': *Garbin v Wild* [1965] WAR 72 at 76,

26. A transfer of property in a CMT arrangement is not made 'under or according to the terms of', 'in accordance with', or 'consequent and conformable to', a decree or order of dissolution, annulment or judicial separation, etc. The transfer therefore cannot be said, for the purposes of subparagraph 102AG(2)(c)(viii) of the ITAA, to have been made 'pursuant to' a decree or order of dissolution, annulment or judicial separation, etc.

27. It is sometimes claimed that a consent order of the Family Court of Australia under the *Family Law Act 1975* (FLA), or a consent agreement or departure order under the *Child Support (Assessment) Act 1989*, is itself made 'pursuant to' such a decree or order. So, it is claimed, entitlements or distributions from the CMT are derived pursuant to such a consent order, consent agreement or departure order, and so, pursuant to the decree or order itself. This claim is wrong.

28. A consent order, consent agreement or a departure order is not made 'pursuant to' a decree or order of dissolution, annulment or judicial separation, etc. The order or agreement is not made 'under or according to the terms of' the decree or order. Nor is the order or agreement made in accordance with, or consequent and conformable to the decree or order. For comparison, the Administrative Appeals Tribunal (Purvis J) has held that an amount included in the assessable income of a trust estate, which income was derived from the investment of property transferred under a maintenance agreement registered under section 86 of the FLA, was not 'excepted trust income' within the meaning of section 102AG of the ITAA (*Case V 105*, 88 ATC 678; *AAT Case 4480* (1987) 19 ATR 3678).

Income derived by the trustee from the investment of property - subparagraph 102AG (2)(c)(viii)

29. If property is transferred to the trustee for the benefit of the children, the question also arises whether any income that is derived by the trustee is income derived from the investment of that property, as paragraph 102AG (2)(c) requires.

30. In CMT arrangements, the income that flows to the CMT is not income derived from the investment (ie units) other than as a matter of form. Any income is derived by the trustee of the CMT by discretionary distribution from the discretionary family trust, liable to

be increased, reduced or eroded as the parent setting up the CMT arrangement may desire.

31. We consider that unit trust entitlements or distributions in a CMT arrangement cannot be regarded as 'income from the investment of...property' so as to constitute 'excepted trust income' within the meaning of paragraph 102AG (2)(c). That paragraph is concerned with income derived from the investment of property transferred for the benefit of beneficiaries as a result of such events as legal settlements of damages actions or payments on death. The paragraph is not concerned with entitlements in situations where no amount is actually received. Nor is the paragraph concerned with a distribution of an essentially discretionary nature made to a unit holder in a unit trust unrelated to any substantial sum invested.

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legislative references

- FLA 86
- ITAA 102AE
- ITAA 102AE(1)
- ITAA 102AE(4)
- ITAA 102AG
- ITAA 102AE(2)(b)(viii)
- ITAA 102AG(2)(c)
- ITAA 102AG(2)(c)(viii)
- ITAA 102AE(2)(e)
- ITAA Part III Div 6AA

case references

- Habel v. Tiller [1929] SASR 170 at 176;
- Garbin v. Wild [1965] WAR 72 at 76;
- Groves v. Groves [1944] SASR 187 at 189;
- Case V 105 88 ATC 678; (1987) AAT Case 4480 19 ATR 3678;