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Reforms to limit tax concessions for minors receiving income from testamentary trusts

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On 1 July 2020 the Treasury Laws Amendment (2019 Measures No. 3) Bill 2019 came into force. This Bill reformed the *Income Tax Assessment Act 1936* (Cth) (**ITAA**), and was intended to limit the amount of tax concessions available to minors for income from a testamentary trust.

Background to taxation of trusts

Under Division 6AA of the ITAA, any minor that receives unearned income is subject to a penalty tax rate. Currently this is 66% for income between $416 – $1,307, and 45% from $1,380 and above. This penalty tax rate discourages trustees from making distributions to minors, as the tax rate will negate any income splitting advantage that would be gained.

Division 6AA does not apply to distributions made from testamentary trusts. All income generated from testamentary trusts was 'excepted trust income' (**excepted income**), meaning that a minor could receive this income and normal tax rates applied. A trustee was able to engage in income splitting more effectively by utilising the minor's tax free threshold.

The reason for the reform was that trustees could inject new assets into a testamentary trust, which would generate further excepted income. This could significantly increase the income of the trust, and a minor was eligible to receive that income without incurring a penalty tax rate.

New tax Rules

To address this issue, section 102AG(2AA) was introduced to the ITAA. This imposed a new test on which assets can generate excepted income. Now income is not excepted income if it is generated from assets:

1. acquired by or transferred to the trustee of the trust on or after 1 July 2019, and
2. are unrelated to property of the deceased estate.

For example, if the deceased leaves $100,000 in a testamentary trust, this is excepted income as it formed part of the deceased estate. If this amount is invested, any return on the investment is also excepted income.

However, if the trustee borrows $100,000 from a lender and injects it into the trust, this amount and any return is not excepted income. The borrowed funds have no connection to the deceased assets, so it does not satisfy the test under section 102AG(2AA).

How will this reform impact testamentary trust?

Trustees must now keep adequate records to ensure they can identity which income is excepted, and which assets are derived from the deceased estate. If both excepted and non-except income is co-mingled, this can make identifying the different types of income difficult.

Despite these additional record keeping requirements, there are advantages t#tax using a testamentary trust. A testamentary trust can:

1. provide flexibility in allocating estate assets;
2. qualify for tax concessions; and
3. protect assets from legal action.

If you would like further information on this change in the law, or advice on estate planning matters, please contact John Gray on 02 8235 1205.

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