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Taxation of Australian resident and non-resident trusts

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The purpose of this paper is to provide relevant background information on the taxation of trusts in Australia, including the taxation of both Australian resident and foreign resident trust estates.

It is intended that this paper will operate as a background briefing paper for the case study to be discussed in the Conference session "Do you speak 'Trust'? Holding, managing and transferring family assets around the world through the use of trusts, foundations, nominees and other techniques".

Constitutional and general law background to trust law in Australia

1. Australia operates in a Federal structure under a written Federal Constitution. The Australian Federation is based on the model provided by the United States of America. However, Australia has a Westminster parliamentary system, and the English common law remains of significance across Australia both in civil law and in criminal law. The Australian States and Territories have separate legislatures, executives and courts.

2. The Australian Federal Parliament has no constitutional power to legislate in respect of trusts. Trust law is a matter of common law and the legislation of each Australian State and Territory Parliament. Each State and Territory has its own trusts legislation.

3. However, the Federal Parliament has used its powers under the Federal constitution to influence how some trusts operate. For example, the Parliament has used its constitutional powers to make laws in respect of corporations and old age pensions to affect how superannuation (or pension) trusts operate.

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4. Australian trust law is based upon, and retains many of the features of, trust law in the United Kingdom (UK).

The use of trusts in Australia

5. Of all common law jurisdictions, perhaps Australia has the most experience of trusts being used for trading and investment purposes.

6. Some of the uses to which trusts are put in Australia include the following:

6.1 Real Estate Investment Trusts ('REITs'): Australia was the leader in tax legislation which led to the development of REITs (or Listed Property Trusts ('LPTs') as they are more commonly known in Australia) dating from the early 1970s[2]. Australia's REIT market is the second largest in the world, behind the US and ahead of Japan[3], and was one of the first markets to be established.

6.2 Superannuation/Pension Funds: Trusts have been used in Australia to receive compulsory occupational superannuation (pension) contributions for the last 20 years. All superannuation funds operate as trusts. Superannuation funds have become an important part of tax planning in Australia. The total funds in those superannuation trusts exceeded A$1 trillion for the first time this year[4]. Australia is reported to now have the fourth largest funds management industry in the world[5]. A study by Trowbridge Deloitte, released in August 2007, forecasts that Australia's superannuation wealth would rise by 300 percent over the next 15 years (that is, to A$4 trillion), at a rate of 10 percent per annum. Andrew Gale, Trowbridge Deloitte managing partner, said that self-managed superannuation funds were predicted to double between 2015 and 2021 when they would hold the bulk of funds under management.

6.3 Trading and investment by private individuals: Apart from partnerships, trusts for many decades have been the only 'flow through' or 'transparent' vehicles for tax purposes in Australia (as it is generally the beneficiaries who are taxable on trust income rather than the trustee). Shares are commonly held in trusts by nominees, and joint ventures are frequently conducted through unit trusts. Private high wealth individuals tend to have structures consisting of numerous trusts and companies in order to maximise planning opportunities for tax, asset protection and succession. Unlike partnerships, trusts offer limitation of liability protection for investors in them. One of the key limitations on trusts in Australia though, is that, unlike companies, trusts are not capable of perpetual existence. However, as trusts are transparent for tax generally, and as individual beneficiaries of trusts may receive more favourable tax treatment than companies (for instance, beneficiaries can access a 50% discount on capital gains which is not available to companies), trusts remain a popular structure for investment.

7. Also, although some Australian laws have been introduced which have, to an extent, affected the use of trusts where trusts are used to shelter assets from creditors[6],

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[2] The first Australian REIT was the General Property Trust which was established in 1971.
[3] Asian Legal Online, 27 August 2007
[4] Total superannuation assets in Australia reached $1.1 trillion during the March 2007 quarter according to figures released by the Australian Prudential Regulation Authority (APRA).
[5] Australia's managed funds industry is ranked fourth behind those of the US, France and Luxembourg, according to the Federal Government's global investment arm, Axiss Australia.
[6] Australia's bankruptcy laws have become increasingly sophisticated due to the use of trusts to protects assets from creditors. The relevant act is the *Bankruptcy Act 1966*. There are a number of provisions for the recovery of

discretionary trusts remain useful because they divorce the ownership of assets from the use of, or access to, assets.

8. One of the major attractions of companies is that the liability of shareholders is limited to the value of their shares. On the other hand, a trustee of a trust is personally liable for any debts and liabilities he, she or it incurs in the course of carrying on trust business. While the trustee generally[7] has the right of indemnity from trust assets to satisfy liabilities incurred in its capacity as trustee, the trustee is also personally liable for any excess liability. Using a corporate trustee provides a mechanism to limit such liability. However, it should be noted that the directors of a corporate trustee are subject to the same liabilities as directors of any company. Beneficiaries of a discretionary trust are usually not liable for the debts of the trust and generally will not be liable to indemnify the trustee[8].

Australia's taxation regime – introduction

9. Australia's Federal taxation regime is based upon the taxation of income, including capital gains. Australia does not impose estate tax or gift tax at either the State or Federal level. Australian States and Territories impose stamp duty, which affects trusts.

10. Australia generally taxes its residents on global income, and taxes non-residents only on income from Australian sources. However, this general principle in respect of non-residents is modified by the withholding tax regime which applies to outbound payments of dividends, interest and royalties (which are not subject to assessment as income). Non-residents do not have to pay tax on capital gains other than gains in respect of Australian real estate and in respect of the disposal of interests in certain 'land rich' entities, that is, in resident or non-resident entities whose ‘underlying’ value is principally attributable to Australian real property, and the assets of Australian permanent establishments.

11. Australia has a sophisticated regime for the taxation of foreign sourced income derived by its residents, including the controlled foreign company ('CFC') regime and the complementary foreign investment fund ('FIF') rules. These regimes are dealt with later in this paper.

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property of a bankrupt which relate to avoiding transactions during various periods prior to bankruptcy and avoiding sham transactions. The trustee in bankruptcy is able to recover property owned by an entity that, during the ‘examinable period’, was controlled by the bankrupt and benefited from his or her personal services (e.g. property which appears to be owned by a trust or company but has come into existence through the personal efforts of the bankrupt and in reality is beneficially owned by the bankrupt) as well as property owned by a natural person but which, during the ‘examinable period’, the bankrupt uses or derives a benefit from and either;
(i) the property is acquired as a direct or indirect result of the bankrupt’s financial contributions; or
(ii) the value of the person’s interest in the property increases as a direct or indirect result of the bankrupt’s financial contributions (section 139A) (e.g where a bankrupt has diverted his income to purchase a house property in his partner’s name, and the bankrupt derives a benefit from living in that property). The ‘examinable period’ is either 4 years prior to the commencement of the bankruptcy in relation to property acquired by a related entity, or from the first point of insolvency in the year prior to that if the bankrupt became insolvent in that year.

[7] A trustee has no right of indemnity from trust assets where the trustee has acted in breach of trust.

[8] Section 197(1) of the *Corporations Act 2001* provides that a director of a corporate trustee will be personally liable only where the trustee's right of indemnity is lost through conduct by the trustee which disentitles it to indemnity, or if the terms of the trust deny the indemnity. The section was amended in late 2005 to include this limitation on liability for directors of corporate trustees. The need for the amendment arose as a result of a decision of the South Australian Supreme Court in *Hanel v O'Neill* (2004) 22 ACLC 274 where the court held that directors of trustee companies would be personally liable if there were insufficient trust assets out of which the trustee corporation could be indemnified.

12. Australia has comprehensive double taxation agreements ('DTAs') in place with over 40 countries. These DTAs are largely based on the OECD Model Convention, although a number of DTAs entered into before Australia's capital gains taxation ('CGT') regime commenced do not contain provisions to deal with the taxation of capital gains. In any event, foreign residents will not now be taxed on capital gains other than those which are in respect of Australian real estate and permanent establishments as outlined above.

13. A number of Australia's DTAs contain most favoured nation clauses.

Taxation of trusts

14. Generally, trusts in Australia are not taxed as entities, except for certain prescribed corporate and public trading trusts. Trusts other than corporate and public trading trusts (which are dealt with in more detail below) are, broadly, taxed as 'flow through' vehicles: that is, any part of a trust's net income to which a resident beneficiary is presently entitled is taxed in the hands of the beneficiary at that beneficiary's marginal rate of tax. Income of the trust may be taxed in the hands of the trustee if there is no beneficiary with a present entitlement to the income, or if the beneficiary is under a legal incapacity (for example, if the beneficiary is a minor[9]). To avoid being taxed on trust income, the trustee must resolve by the end of each income year to distribute all trust income to beneficiaries so that the beneficiaries are presently entitled to it. If the income of the trust is accumulated it is taxed in the hands of the trustee. In that case, the trust income will not be taxable again in the hands of the beneficiaries when distributed. An exception to the flow through treatment described above is in respect of the taxation of Australian trusts with non-resident beneficiaries, or in relation to the taxation of Australian beneficiaries of non-resident trusts. The tax treatment applicable in these situations is discussed below.

15. For the purposes of the provisions relating to the taxation of trusts, other than the CGT provisions, a trust is a resident of Australia for an income year if one of the following applies at any time during the income year:

    (a) the trustee is an Australian resident; or

    (b) the central management and control of the trust is in Australia.

16. A trust is a resident trust for CGT purposes if:

    (a) for a trust that is not a unit trust, a trustee is an Australian resident or the central management and control of the trust is in Australia; or

    (b) for a unit trust:

        (i) one of the following requirements is met:

            (A) any property of the trust is situated in Australia; or

            (B) the trust carries on a business in Australia; and

        (ii) one of the following requirements is also met:

[9] The age of majority is 18.

(A) the central management and control of the company is in Australia; or

(B) Australian residents hold more than 50% of the beneficial interests in the income or property of the trust.

17. Net capital gains (net of capital losses) are included in the net income of a trust. Where a trust holds an asset for at least 12 months, the beneficiaries are usually eligible for a 50% CGT concession in respect of their share of any capital gain made on disposal of the asset. Corporate beneficiaries are not eligible for the concession.

18. Trusts which conduct a business may be entitled to further CGT concessions under so-called 'CGT small business concessions'. Recent amendments mean the small business CGT concessions now apply to entities with more complex structures and greater wealth than previously[10].

19. Generally, losses incurred by a trust cannot be transferred or distributed to any of the beneficiaries. Subject to certain specific requirements being met, losses must be 'quarantined' in a trust to be carried forward by the trust indefinitely until offset against future net income. If the trust terminates before the losses can be offset against income they are lost. There are provisions which prevent the injection of income into a loss trust unless certain conditions are met. These are dealt with later in this paper.

20. Australia's tax rates applicable to individuals are set out in Schedule 1.

21. A corporate trustee is not taxed as a company, and is not therefore is not obliged to pay company primary tax on trust income.

22. Some trusts, however, are taxed in the same way as companies. The relevant provisions were introduced to counter the use of trusts to carry on businesses that would otherwise ordinarily be carried on by companies (and where the income derived would be taxed at the company rate).

(a) The net income of 'corporate unit trusts' is taxed to the trustee at the corporate rate of tax. Distributions to beneficiaries (unit holders) of corporate unit trusts are taxable in the same way as dividends paid to shareholders. An Australian resident trust will be a 'corporate unit trust' if:

(i) as part of an arrangement for the reorganisation of a company or company group, the unit trust acquires property or a business that at some earlier time has been the property or business of a company or of an associate of a company, and shareholders of the company received a right to take up units in the unit trust; and

(ii) the unit trust is a 'public unit trust'.

[10] On 12 April 2007, the Tax Laws Amendment (2006 Measures No. 7) Act 2007 received Royal Assent. This Act amends the small business CGT concessions provisions, generally with effect from 1 July 2006. Formerly, only up to two controlling individuals, or one controlling individual and their spouse who had an interest in the business, could access the concessions. The new test is a 'significant individual test' requiring only a 20% interest to be held, which can be held either directly or indirectly through one or more interposed entities. The new significant individual test enables up to eight taxpayers (being four significant individuals plus their spouses – spouses must have an interest percentage of greater than nil) to benefit from the concessions.

Generally, a unit trust is a public unit trust if any of the following apply:

(i) any of the units are listed for quotation on a stock exchange;

(ii) the units are held by 50 or more unit holders; or

(iii) any of the units are offered to the public.

(b) The net income of a 'public trading trust' is also taxed to the trustee at the corporate rate of tax, and, as is the case for a corporate unit trust. Distributions by the public trading trust are taxed as though they were corporate dividends. An Australian resident trust may be a 'public trading trust' if it is a public unit trust (the criteria are broadly the same as for corporate unit trusts above) and is also a 'trading trust': that is, if it carries on a trading business or controls such a business, either directly or indirectly. A trading business is any business which involves business other than primarily investment in land for rental or other than investment or trading in financial instruments. The exemption under the public trading trust rules for investment primarily in land to derive rent is the basis for Australia's REIT industry.

23. Superannuation/pension funds

(a) Australia's taxation of retirement income is unusual in that tax is imposed at three stages: on contributions made to retirement or pension funds, on earnings within the fund, and on income streams and lump sums received from the fund.

(b) Deductions are allowed for contributions to pension funds by employers, and in certain circumstances fund members can also claim deductions or rebates for contributions to funds.

(c) As part of ongoing reform, from 1 July 2007, Australians aged 60 and over will not pay tax on income streams or lump sums received from their retirement fund if the fund has already paid tax on contributions to and earnings of the fund. Once a fund commences to pay a pension, it is not subject to tax on its earnings or capital gains.

(d) As retirement incomes are no longer assessable to tax if the person is over 60 when the benefits are paid, there is an incentive to continue to work while drawing down on retirement funds. As part of its policy of encouraging longer workforce participation, the Government is also allowing people to draw down pensions from their pension fund from the age of 55 while continuing to work. Prior to age 60, these pensions are taxable.

(e) International commentators have queried whether or not the new concessional retirement fund provisions can be accessed by non-residents of Australia. Although non-residents can become members of, and make contributions to, Australian funds, the availability of the concessional tax treatment of payments from retirement funds to foreign residents is limited primarily because:

(i) contributions to Australian funds will be subject to limits, and

(ii) generally money from a non-resident non-complying fund cannot be transferred on a tax effective basis into an Australian fund.

24. Will trusts

(a) It can be said that death is 'the ultimate tax scheme' in Australia: there is no death or gift duty, any CGT on death can be deferred until ultimate sale of the assets by the beneficiaries of the will, certain transactions can be undertaken tax free if done by will: for example, forgiveness of any commercial debt, and income may be split among beneficiaries through the use of trusts in the will.

(b) Will trusts (also called 'testamentary trusts') can be used to split income and secure adult tax-free thresholds and marginal rates for minors. The impact of the application of adult marginal rates and tax-free thresholds also means using a testamentary discretionary trust often has a better tax outcome than using a company, as advantage can be taken of the arbitrage between lower personal rates of tax and the company tax rate. Note there are some limitations on the use of these provisions to secure adult tax-free thresholds for minors, but these are beyond the scope of this paper.

25. Prescribed private funds ('PPFs')

(a) PPFs are a form of charitable trust, introduced in Australia in 2001. Donations to a PPF are tax deductible. The purpose of their introduction was to provide individuals and families with greater opportunities than previously existed to set up private trust funds for philanthropic purposes.

(b) Limits apply to the accumulation of money within a PPF. PPFs must only make gifts to certain prescribed, generally charitable, bodies.

Taxation of Australian trusts with non-resident beneficiaries

26. Where a non-resident beneficiary is, or becomes, presently entitled to a share of the income of an Australian resident trust, broadly the trustee is liable to pay tax on that share of income. The beneficiary is also required to include the income in its assessable income, but the beneficiary may claim a credit for tax paid by the trustee. If the tax payable by the beneficiary is less than that paid by the trustee (for example, because some of the income of the trust was from foreign sources), then the non-resident beneficiary is entitled, upon application, to a refund from the ATO for the excess.

27. The assessable trust income does not include either income subject to withholding tax or franked dividends which are exempted from withholding tax.

Capital gains tax and non-residents of Australia

28. Until recent CGT reforms, which apply in relation to CGT events happening on or after 12 December 2006, non-residents were subject to Australian income tax on realised gains on assets that had the 'necessary connection with Australia'. This included shares or units held in Australian companies or trusts (except for portfolio holdings of less than 10 per cent in listed companies and unit trusts) at any time during the five years prior to the relevant disposal. Interests held by non-residents in non-resident entities did not have the necessary connection with Australia and generally were not subject to Australian income tax.

29. For CGT events happening on or after 12 December 2006, non-residents are subject to CGT on disposal of interests in resident or non-resident entities whose 'underlying' value is principally attributable to Australian real property. Non-residents are now only subject to Australian CGT in respect of 'taxable Australian property ('TAP'). The following are all TAP:

(a) assets used in carrying on a business through a permanent establishment (PE) in Australia;

(b) real property situated in Australia (including mining tenements);

(c) 'indirect Australian real property interests'; and

(d) options or rights to acquire any of the things listed above.

30. An 'indirect Australian real property interest' is essentially a membership interest of at least 10 per cent (on an associate inclusive basis) in a resident or non-resident entity (including a trust) where the market value of the entity's assets that are taxable Australian real property is more than 50 per cent of the entity's total assets.

31. Accordingly, Australia now generally imposes CGT only on non-residents where the interest held is an interest (direct or indirect) in Australian real property, but not otherwise on shares or units in Australian companies or trusts.

32. Earlier this year, the ATO issued an Interpretive Decision, ATO ID 2007/60, which expresses the view that the foreign resident CGT exemption will not apply to net capital gains or losses to which a non-resident of Australia is presently entitled through an Australian resident trust other than a fixed trust. Although this Interpretive Decision does not have the force of law, it does provide an indication of the approach the ATO will take on this issue.

33. It is important to note that, in any event, any assets acquired before 20 September 1985 will not be subject to CGT on disposal, as they were acquired before Australia's CGT regime commenced and therefore fall outside the regime.

34. Although foreign residents are only subject to CGT on TAP, where an individual ceases to be an Australian resident, a CGT event happens to all CGT assets that the taxpayer owns (including 'indirect Australian real property interests'), other than TAP.

35. Ordinarily, this would mean that a capital gain or loss could arise in respect of all such assets held by the individual when the individual ceases to be an Australian resident. However, the individual can elect to ignore any capital gain or capital loss arising as a result of ceasing to be an Australian resident. The assets are then treated as taxable Australian property and, if disposed of, are subject to the CGT regime. That is, the capital gain may effectively be deferred.

36. An individual will not be subject to Australian CGT on disposal of an asset in respect of which an election has been made to ignore any capital gain under the provisions described in the preceding paragraph if he or she is a UK or US resident when the disposal occurs. This is because the Australia/US and Australia/UK DTAs give exclusive taxing rights to those other jurisdictions in respect of such a disposal[11]. This means that where taxpayer

[11] See, for example, Article 13(6) of the Australia/US DTA.

makes a choice to disregard making a capital gain on an asset on cessation of Australian residency, and the taxpayer becomes a US or UK resident and then disposes of the asset, Australia will not seek to tax the disposal of the asset.

37. The Australia/Canada DTA adopts a different approach by allowing an elective 'step up' to market value where a person ceases to be a resident of Australia and is taxed in Australia on the gain on deemed disposal.

38. There are some other specific exemptions from the imposition of CGT on ceasing to be a resident, including an exemption for short term residents, but a discussion of all applicable exemptions is beyond the scope of this paper.

39. No CGT event occurs when a non-resident becomes an Australian resident, or a trust becomes a resident for CGT purposes. However, upon becoming an Australian resident, the person is deemed to acquire all of their assets other than TAP. Special rules apply in relation to the cost base of assets and the date of acquisition of assets.

40. Many of Australia's DTAs[12] were entered into before the introduction of CGT in 1985[13] and have not been reviewed or amended since CGT was introduced. These treaties therefore do not contain provisions which deal specifically with the tax treatment of capital gains and losses made in respect of assets which have the relevant connection with Australia. The position taken by the Commissioner of Taxation in relation to Australia's pre-CGT DTAs is that the alienation of property article acts as a 'sweep up' provision allowing the taxation of gains from the disposal of property.

41. Section 3A of the *International Tax Agreements Act 1953* effectively allows Australia's alienation of property article to deal with alienation of interests in any entity, Australian resident or not, whose assets consist wholly or primarily of Australian real property. The enactment of section 3A arguably resulted in a unilateral change of the alienation of property article in many of Australia's DTAs. This section was enacted in response to the decision of the Full Federal Court in *Commissioner of Taxation v Lamesa Holdings BV*[14] that the alienation of property article only allowed the ATO to 'look through' one entity rather than tiers of entities to determine whether there had been a disposition of property.

Taxation of Australian resident beneficiaries of non-resident trusts

42. Australia has introduced three regimes which attribute certain foreign sourced income to Australian resident taxpayers. The purpose of these regimes is to ensure that foreign sourced income of Australian residents is taxed at Australian rates of tax, and to prevent offshore accumulation of income in low or no tax jurisdictions.

43. The regimes are:

[12] TR 2001/12 identifies the pre-CGT treaties at para 6. A number of the treaties, including Germany, Belgium, Malta and Finland, have not been renegotiated since the introduction of CGT.
[13] The *Income Tax Assessment Amendment (Capital Gains) Act 1986* Cth subjected capital gains arising out of disposals on or after 20 September 1985 to taxation by inclusion in the assessable income of a taxpayer. The Act took effect from 24 June 1986.
[14] (1997) 77 FCR 597

(a) the controlled foreign company ('CFC') regime (which makes 'tainted' passive income of Australian controlled non-resident companies, which has not been comparably taxed offshore, taxable in the hands of Australian residents);

(b) the 'transferor trust' regime (which attributes income of non-resident trusts, which has not been comparably taxed offshore, to Australian resident beneficiaries where resident Australian entities have transferred property to, or provided services to, the trust); and

(c) the 'foreign investment fund' ('FIF') regime, which applies where neither the CFC regime nor the transferor trust regime apply (and which attributes income sheltered in offshore companies and trusts to Australian residents).

44. The transferor trust regime and the FIF regime, which apply to non-resident trusts, are discussed in detail below.

45. There is a fourth regime, the deemed present entitlement regime, which is another attribution mechanism forming part of Australia's general provisions for the taxation of trusts. Generally, Australia's domestic trust taxation provisions apply to non-resident trusts in the same way as to resident trusts. However, the deemed present entitlement provisions[15] do affect how these domestic trust provisions apply to non-resident trusts.

46. Deemed present entitlement regime

(a) Under the deemed present entitlement provisions, if a beneficiary holds an interest in a non-resident trust, including a contingent or future interest, then the beneficiary is deemed to be presently entitled to the relevant share of the income of the trust.

(b) That is, the beneficiary is deemed to have received income from the trust and will be taxed on it accordingly, regardless of whether or not the income was in fact received.

(c) These deemed present entitlement provisions, read literally, have a broad potential scope of operation. They are not drafted in any way to mesh with the FIF or transferor trust regimes. Their operation in practice is therefore uncertain and problematic.

(d) The government has announced its intention to repeal the deemed present entitlement provisions, but no amending legislation has been prepared and no indication has been given of when this might occur.

46.2 Transferor trust regime

(a) The objective of the transferor trust regime is to prevent Australians accumulating concessionally taxed or tax free income in low tax jurisdictions.

(b) Generally, the transferor trust provisions apply where Australian residents do the following while Australian residents or did the following before they became Australian residents::

[15] Sections 96B and 96C of the *Income Tax Assessment Act 1936*

(i) transfer assets or value (including services) to a non-resident discretionary trust for inadequate or no consideration, including where the transfer is made to establish the trust; and

(ii) after 12 April 1989, transfer assets or value (including services) to a non-resident non-discretionary trust for inadequate or no consideration, including where the transfer is made to establish the trust.

(c) Where Australian residents have made such a transfer, the whole of the 'attributable income' of the trust is generally included in the resident's assessable income. Attributable income is calculated according to legislative formulae depending upon whether or not the trust estate is resident in a 'listed' country: that is, a country which is considered to have a tax system which is comparable to that of Australia[16].

(d) Attributable income is, broadly, calculated as follows:

(i) For trusts resident in an unlisted country, the whole of the net income of the trust estate, less any amount subject to full taxation in either Australia or a listed country;

(ii) For trusts resident in a listed country, that part of the net income of the trust that is concessionally taxed, less any amount subject to full taxation in either Australia or a listed country (no amount is included in the income of the transferor Australian resident if the aggregate attributable income derived by trusts to which the transferor has transferred value is equal to or less than the lesser of 10% of the aggregate of the net incomes of the trusts; or $20,000).

(e) There are exemptions from the transferor trust measures, including the following:

(i) where the transfer is made in the ordinary course of business and there were comparable arm's length transfers made to other ordinary customers;

(ii) where the transfer is made pursuant to an arm's length transaction and the transferor (and its associates) was not in, and did not come to be in, a position to control the trust estate;

(iii) where a transfer is made on or before 12 April 1989 to a discretionary trust where neither the transferor nor any of its associates were in a position to control the trust after that date;

(iv) where a transfer is made by trustees of a deceased estate pursuant to the wishes set out in a will of a deceased person or pursuant to a court order varying the terms of the will (there are certain limitations to this exception); and

(v) where a natural person:

(A) transfers assets or value (including services) to a trust which is a non-resident family trust at all relevant times between the start of the

[16] Listed countries include Canada, France, Germany, Japan, New Zealand, the UK and the US.

taxpayer's 1990/1991 income year and the end of the relevant year of income; or

(B) first becomes an Australian resident after 12 April 1989 and makes a transfer to a non-resident family trust before residency commences, provided the trust always remains a non-resident family trust.

(f) For the purposes of the transferor trust provisions, a trust is a 'family trust' if it is either:

(i) a post-marital family trust (which, broadly, comes into existence as a result of marriage breakdown) where the primary potential beneficiaries of the trust are non-resident natural persons who are either the spouse or former spouse of the transferor, a child of the transferor or of the spouse of the transferor, or a person who was a child of the former spouse of the transferor when the marriage subsisted.

(ii) family relief trusts, which are established to provide assistance to certain persons (who must be named in the trust deed), provided the assets of the trust are not excessive having regard to the requirements of the beneficiaries and provided no transfers of property or services have been made to the trust since 12 April 1989.

46.3 FIF regime

(a) The FIF rules apply to foreign trusts which are not subject to the transferor trust provisions.

(b) Generally, the FIF provisions apply to Australian residents who have either an interest in the corpus or income of a non-resident trust (which includes a unit in a unit trust) or an option or similar instrument which gives a right to acquire such an interest.

(c) The FIF provisions attribute to such Australian residents a share of the income of the non-resident trust. Any amount so attributed is subject to taxation in Australia.

(d) There is a number of exemptions from attribution which are relevant to interests in FIFs, including:

(i) where the taxpayer has a 'balanced portfolio': that is, where the total of the taxpayer's interest in taxable FIFs is less than 10%;

(ii) complying Australian superannuation funds and certain assets of life insurance companies;

(iii) foreign employer-sponsored superannuation funds;

(iv) interests in certain US entities, including:

(A) a full exemption for FIF interests in REITs, regulated investment companies, and entities that are treated as corporations and taxed on global income under US revenue law; and

(B) a limited exemption for FIF interests in limited liability companies, and limited partnerships, that are taxed as partnerships in the US, and US common trust funds.

(v) FIF interests held as trading stock and brought to account at market value;

(vi) interests held by Lloyd's members which form part of a Lloyd's premiums trust fund;

(vii) when all the taxpayer's interests held in FIFs collectively total less than $50,000 at the end of the income year; and

(viii) temporary visitors and temporary residents.

47. Complex anti-overlap rules are intended to prioritise the CFC, FIF and transferor trust regimes to eliminate double taxation. The anti-overlap rules do not extend to the deemed present entitlement regime. If none of the regimes apply, then a resident beneficiary receiving a distribution from a non-resident trust may, in any event, be taxed upon receipt under Australia's ordinary income tax provisions.

48. Despite the existence of anti-overlap rules, the way the regimes operate in practice gives rise to much confusion. The regimes overlap each other at times, and are both complex and give rise to inconsistent outcomes. For example, none of the exemptions in the FIF or transferor trust regimes are available under the deemed present entitlements rules. This means that, for instance, an Australian resident who has an interest in a trust created on the death of a non-resident is arguably caught by the operation of the deemed present entitlement rules, even though he or she is specifically exempted from tax under the other regimes. Such an outcome seems to obviate the need for the carve outs under the FIF and transferor trust regimes and is plainly an anomaly.

49. The Treasurer has announced that the Board of Taxation is to undertake a review of the foreign source income anti-tax-deferral regimes[17]. The Board released a discussion paper in May 2007[18], and is to provide a final report to the Treasurer during the second half of 2007. The objectives of the review are to:

(a) reduce complexity and compliance costs, and

(b) examine whether the anti-tax-deferral regimes strike an appropriate balance between countering tax deferral and unnecessarily inhibiting Australians from competing globally.

Trusts and companies: a brief comparison

50. Prior to the introduction of the system of full imputation of taxation of company profits in 1987, Australia had the 'classic' system of taxation of company profits. The profits of companies were taxed in the hands of the company at the prevailing company tax rate (now 30%) and then dividends paid from the companies were taxed again in the hands of shareholders at the shareholders' own marginal rates of tax. This effectively led to the

[17] A copy of the Treasurer's media release (Number 109 of 2006) can be obtained from the Treasurer's website at http://www.treasurer.gov.au/tsr/content/pressreleases/2006/109.asp
[18] A copy of the discussion paper can be obtained from the Board of Taxation website at http://www.taxboard.gov.au/content/anti_tax_deferral.asp

double taxation of company profits and was a significant historical reason for the use of trusts to operate businesses in place of companies.

51. With the introduction of the dividend imputation system the situation changed. To the extent that dividends paid to shareholders by a company have already borne tax in the hands of the company (that is, to the extent that the dividends have been 'franked'), the shareholder will by imputed with the tax on the profits out of which the dividend is paid. The shareholders receive a credit or offset of tax for the tax paid by the company on the profits from which the dividends were declared. In addition, if a shareholder's tax rate is less than the 30% company rate they may receive a tax refund of the excess franking credit above the tax payable by them on the dividend. This is especially advantageous to Australian superannuation (pension) funds which have a 15% tax rate and tax exempt bodies such as charities.

52. Non-residents do not receive full imputation credits, but may have their dividend withholding tax reduced to the extent that the dividend is franked. So, if the dividend is fully franked, the dividend withholding tax is reduced to zero.

53. There is no requirement upon companies to pay out their profits each year to shareholders. It is therefore possible to retain profits in a company as working capital.

54. These changes, together with the reduction of the rate of company tax to 30%, and limits upon the amount of income which trusts may effectively distribute to minor children, have meant that some of the taxation advantages formerly held by trusts over companies have been removed.

55. Despite that, trusts still retain advantages over companies in respect of their inherent flexibility and the CGT advantages of access to the 50% CGT discount not available to companies.

56. A major disadvantage of trusts is that they cannot be used tax effectively to retain profits, because of the requirement that trustees must, in order to avoid being taxed on trust income, resolve to distribute the income of the trust so that the beneficiaries are presently entitled to all of the trust income.

Anti-avoidance measures

57. Trust loss measures

57.1 If a trust operates at a loss, the loss will be quarantined within the trust and cannot be distributed amongst the beneficiaries or the trustee. It is generally only possible to use those losses as deductions against income in the trust for succeeding income years if the trust satisfies certain tests relating to ownership or control of the trust.

57.2 The trust loss rules apply to corporate unit trusts and public trading trusts, as well as to fixed and discretionary trusts. Deceased estates are granted a period of grace for the completion of administration of the estate before the rules apply.

57.3 A trust defined as a 'family trust' can utilise the losses without having to satisfy any further requirements, even if income is injected into the trust from other family entities to soak up the losses, if it makes a 'family trust election'.

58. Under separate rules which are designed to prevent trading in imputation credits, if a discretionary trust holds shares, it cannot satisfy the '45 day holding period rule (which requires that shares be held at 'risk' for more than 45 days), as no beneficiary has an identifiable interest in the shares until the trustee's discretion has been exercised. The consequence is that it cannot pass franking credits attaching to dividends it receives to the beneficiaries. Again, as with the loss trust rules, the exception is if the trustee makes a 'family trust election'.

58.1 In making a 'family trust election', a test individual must be specified to define the 'family group'. The family group includes members of the test individual's family and any companies/trusts in which family members have fixed entitlements to all of the income and capital[19].

58.2 The significance of making a 'family trust election' is that once it has been made, any distribution (income or capital) by the trust to persons or entities outside of the family group will be subject to a special tax called the 'family trust distribution tax' at a rate of 46.5% (that is, the top marginal rate of tax for individuals plus Medicare levy)[20].

59. A number of other provisions are contained in the tax legislation to deal with arrangements utilising trusts. For example:

(a) Section 99B of the *Income Tax Assessment Act 1936* ('ITAA 1936') applies to tax amounts paid to, or applied for the benefit of, a beneficiary who is a resident at any time during the income year where the amount represents trust income of a class that is taxable in Australia but has not previously been subject to tax in the hands of the beneficiary or trustee.

(b) Section 100A of the ITAA 1936 operates to combat 'trust stripping' schemes whereby trust income is diverted to third parties and away from the real, intended, beneficiary. The third party then reimburses the intended beneficiary with a tax-advantaged distribution. Section 100A operates to tax such distributions linked to 'reimbursement agreements' at penal rates of tax.

60. The general anti avoidance rule - Part IVA of the *Income Tax Assessment Act 1936* (Cth)

(a) Part IVA is the general anti-avoidance provision of the Tax Act. Briefly Part IVA applies where:

(i) A taxpayer enters into a 'scheme' (this is very widely defined and includes any form of agreement, understanding, arrangement etc);

(ii) As a result of the scheme any person obtains a tax benefit - the expression 'tax benefit' is defined as either the allowance of a deduction from assessable income which would not have been allowed, or would not have been expected to be allowed, but for the scheme or the exclusion of income from assessable income which would have been included, or would have been expected to be included, in assessable income but for the scheme; and

[19] There is a Bill presently before Parliament which will, if enacted, widen the definition of 'family group' to include lineal descendants and distributions to former spouses, widows/widowers and former step-children: Tax Law Amendment (2007 Measures No. 4) Bill 2007
[20] *Family Trust Distribution Tax (Primary Liability) Act 1998*

(iii) The sole or dominant purpose of any party in entering into the scheme was to obtain the tax benefit for the taxpayer.

(b) The test for determining if a tax benefit exists and for determining the sole or dominant purpose in entering into a scheme is an objective test. There are a eight specified factors which must be considered in respect of this test of dominant purpose, including the manner in which the scheme was entered into, the form and substance of the scheme and the nature of any connection between the taxpayer who obtains the benefit and any other person whose financial position changes as a result of entry into the scheme.

(c) Unlike some other countries, Australia has no business purpose exemption from this general anti avoidance rule, and Australian courts have interpreted the general anti-avoidance rule according to its terms[21].

Particular issues under Australian law

61. Foreign tax credits

(a) Australia's foreign tax credit regime allows for credits for foreign tax paid on foreign income which is assessed to tax in Australia. A credit is available up to the amount of Australian tax payable in respect of that foreign income.

(b) For a credit to be available, the taxpayer has to be personally liable, and must pay, the foreign tax. However, the taxpayer will be deemed to have done so where the foreign tax is paid by:

(i) another person by arrangement;

(ii) a trust estate in which the taxpayer is a beneficiary;

(iii) a partnership in which the taxpayer is a partner; or

(iv) the imposition of withholding tax by the source country.

(c) There is an issue as to whether or not a taxpayer has 'paid' foreign tax where a trust, of which the taxpayer is a beneficiary, receives income which is subject to tax (for example, withholding tax) but the tax is paid not by the trustee of the trust but rather by an unrelated third party (in the withholding tax example, this tax would be paid by the entity making the payment to the trust). The foreign tax is not 'paid' by the trust estate, and has not been paid in respect of income actually received by the taxpayer (but rather has been paid by a third party on income received by the trust). Therefore, the beneficiary taxpayer cannot receive any foreign tax credit in respect of tax paid by the third party.

62. ATO taxation administration

The ATO in recent times has attempted to use trust law to strike at arrangements using trusts. This is so, even though the Commissioner has no direct interest in the trust and the

[21] The following paper by the author contains a discussion of the way in which Australian courts have applied Part IVA: 'Applying Part IVA' *The Tax Specialist* Volume 10, No 4, April 2007 pp 186 to 200.

relevant trust law rules are only relevant as between the trustee and the beneficiaries. Some recent examples follow:

(a) The rule against perpetuities

(i) The 'rule against perpetuities', or the rule against remoteness of vesting, operates to prevent a trust continuing forever. This rule can be a concern for some ultra high wealth families who seek a perpetual structure to hold assets.

(ii) Under the common law rule against perpetuities, the trust must terminate within 21 years of the death of a named person living at the date of creation of the trust (that is, the duration of the trust is determined by reference to a life in being).

(iii) Most Australian states (other than South Australia, which is discussed below), allow a trust to fix a perpetuity period of 80 years from the date on which a settlement takes effect while retaining the common law period as an alternative.

(iv) Australian trust deeds often specify a period of 80 years as a default period for duration of the trust: that is, the trust deed provides that the trust operates for the longer of the period determined by reference to the life in being, or the period ending 80 years after settlement of the trust.

(v) Under a statutory 'wait and see' rule, interests which would previously have been void from the outset because they might infringe the rule against perpetuities are now valid until it is certain that the vesting, if it occurs, must occur outside the period allowed by that rule.

(vi) One Australian State, South Australia, has now legislated to abolish the rule against perpetuities and allow perpetual trusts.

(vii) The perpetuity period of a trust is especially relevant where a distribution is made from one trust to another. It is important to ensure that the trust receiving the distribution must end before the trust which is making the distribution. Otherwise, the distribution may be void for infringing the rule against perpetuities. The ATO is keen to pursue these types of arrangements.

(viii) See for example the decision in *Nemesis Australia Pty Ltd v Federal Commissioner of Taxation*[22], where the trustee of a family trust had attempted to make appointments of trust income to the trustees of other family trusts. The perpetuity period in the appointing trust deed was 80 years, and the vesting dates in the other trusts fell outside the 80 year period. Dismissing the ATO's arguments that the appointment was void for breaching the rule against perpetuities, the Federal Court relied upon the 'wait and see' rule and held that, as the trustees of the other trusts could advance the vesting date pursuant to powers contained in the trust deed, it

[22] [2005] FCA 1273

was not certain that the vesting would occur after the end of the original 80-year period.

(b) Resettlements

(i) Where a trust deed is amended, and the amendment gives rise to a fundamental change in the trust relationship, the ATO may consider that the trust has been 'resettled': that is, the trust has terminated and a new trust has commenced.

(ii) The tax effect of a resettlement can be significant: for example, on the basis that a resettled trust is not the same trust estate, a resettlement may cause carried forward tax benefits to be lost, and beneficiaries may be deemed to have disposed of their interests in the original trust (and acquired interests in the new trust) with associated CGT consequences.

(iii) A recent decision by the New South Wales ('NSW') Supreme Court in *Stein v Sybmore Holdings*[23] shows that the courts may be willing to allow trustees to circumvent a resettlement of the trust by authorising trustees to amend the terms of the trust deed to change the vesting date, even if doing so would result in some variation to the interests of beneficiaries. In *Stein's* case, the trustee was expressly prohibited from amending the trust deed to extend the vesting date. However, under powers granted by the NSW trusts legislation, the court granted the trustee the power to amend the trust deed to do so, even though the amendment resulted in a variation to beneficial interests, on the basis that the amendment advanced the objectives of the trust. The ATO is reviewing this decision.

Conclusion

Trusts remain a popular vehicle for trading and investment in Australia. Despite the intrusion by trust laws and the Commissioner into the operation of trusts for tax purposes, and despite the existence of some complex regimes in respect of the taxation of non-resident beneficiaries of Australian resident trusts, the inherent flexibility of trusts and the asset protection and tax planning benefits they provide will ensure their continued popularity.

W D Thompson

[23] [2006] NSWSC 1004

Schedule 1

Individual tax rates: Australia

Resident individual rates: 2007/2008 financial year

Taxable Income	Tax on this Income
$0 - $6,000	Nil
$6,001 - $30,000	15c for each $1 over $6,000
$30,001 - $75,000	$3,600 plus 30c for each $1 over $30,000
$75,001 - $150,000	$17,100 plus 40c for each $1 over $75,000
Over $150,000	$47,100 plus 45c for each $1 over $150,000

The above rates **do not** include the Medicare levy of 1.5% that is applied at a rate of 1.5% to taxable income.

Non-resident individual rates: 2007/2008 financial year

Taxable Income	Tax on this Income
$0 - $30,000	29c for each $1
$30,001 - $75,000	$8,700 plus 30c for each $1 over $30,000
$75,001 - $150,000	$22,200 plus 40c for each $1 over $75,000
Over $150,000	$52,200 plus 45c for each $1 over $150,000

Non-residents are not required to pay the Medicare levy.

Resident minors individual tax rates: 2007/2008 financial year

Div 6AA Taxable Income	Tax on this Income
$0 - $416[24]	Nil
$417 - $1,307	66% of the excess of $416
$1,307+	45% of the total amount that is not excepted income

24 Note that it is possible to combine this figure with the low income rebate (which is a maximum of $600) to effectively increase the Div 6AA tax-free threshold for unearned income of eligible resident minors from $416 to $1,334.