BEING TAX READY WITH NON RESIDENT BENEFICIARIES OF FAMILY TRUSTS

A paper presented by Michael Bennett for the Television Education Network

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1 Overview

Australia has always been a multicultural society. It continues to evolve in this regard, becoming more multicultural as time goes on. It also utilises an increasingly mobile workforce; both as to incoming workers or those leaving for expat work.

Australia sits in a world with travel – whether work related or lifestyle driven – happening more often. Mobility of the workforce has been a trend of some significant time. These large, and growing, numbers of people living and working overseas raise issues for trustees because a trust, and in particular a trust with discretionary objects, will often include resident and non-resident beneficiaries.

But to consider the tax implications for the trustees and non-resident beneficiaries of a trust it is important to first understand the basis of Australian taxation and what will make someone a resident or non-resident.

It will then be convenient to consider specific issues that arise for trustee and non-resident beneficiaries. These include:

1. Inbound Taxpayers;

2. Outbound Taxpayers;

3. Birds of Passage;

4. The Trustee's liability for Non-Resident Beneficiaries;

5. Conflicting Tax Laws of the Non-Resident Beneficiary's Jurisdiction;

6. The Withholding Tax Regime;

7. Adverse Tax Implications where an Asset passes to a Non-Resident;

8. The CGT Provisions for Non-residents and Australian Property;

9. CGT Event E8;

10. CGT Event K3;

11. Streaming to a Non-Resident Beneficiary;

12. Estate Planning for a Share Portfolio in a Testamentary Trust; and

13. Estate Planning with Real Estate and Non Resident Beneficiaries.

These topics will be dealt with separately and in the order discussed above. The paper will then look at s 99B of the *Income Tax Assessment Act* 1936 (Cth) (the '**1936 Act**') as, although it is not limited to non-resident beneficiaries, it is an extremely wide provision that arises for every resident trust estate with any offshore income.

2 Australia's Basis of Taxation

A taxpayer's tax liability can vary significantly depending on whether they are resident or non-resident taxpayers of Australia. This is because the Australian Taxation system's approach to assessing taxpayers.

Australia assess taxpayers in two broad ways:

- for those considered to be Australian resident taxpayers, liability to tax on their Australian sourced income and the worldwide income; and

- for those considered to be non-resident taxpayers of Australia, liability to tax on their Australian sourced income.

There is also, since 2006, a notion of temporary resident.

They will all be discussed below under the dichotomy of inbound taxpayers and outbound taxpayers.

These issues are of particular relevance at the moment because of the Commissioner of Taxation's (the '**Commissioner**') concern of the issues. In *Taxpayer Alert* TA 2012/1 the Commissioner announced that he is examining certain tax schemes involving non-disclosure of foreign source income. This is (at least in part) what led to Project Do It.

3 Inbound Taxpayers

For someone coming to Australia concern needs to be had to whether or not the person will be a tax resident of Australia due to Australia imposing a system where residents are, broadly, assessed on their worldwide income.

Since 1 July 2006 it has been necessary not only to consider whether someone is a resident of Australia, because, as well as being a resident a person may be treated as a temporary resident. Temporary residents are subject to different taxation treatment than residents, with important differences in relation to how they are treated when they become residents, while they are residents, and when they cease to be residents.

Once it has been determined whether someone is a resident of Australia under domestic tax law, or part of the sub-class of temporary residents, it is still necessary to consider whether a double tax treaty (also known as Double Tax Agreements, '**DTA**') may treat them as a non-resident of Australia for certain purposes.

3.1 "Australia"

For income tax purposes, "Australia" specifically includes:

a. its coastal seas;[1]

b. the territories of Norfolk Island, Cocos (Keeling) Islands and Christmas Island;[2] and

c. specified sea installations and offshore areas.[3]

Effective from 1 July 2015, Schedule 4 to the *Treasury Legislation Amendment (Repeal Duty) Act* 2015 (Cth) also codifies these inclusions into a comprehensive definition in s 960-505 of the *Income Tax Assessment Act* 1997 (Cth) (the '**1997 Act**') and provides a specific exemption for income of foreign residents that is from prescribed activities carried on in an area that is part of Australia's exclusive economic zone, or part of or above the continental shelf: s 768-110 of the 1997 Act.

3.2 Tests

To determine whether someone is a resident of Australia for tax purposes it is necessary to consider both the common law concept of 'residency' as well as certain statutory tests. The term 'resident' as it relates to individuals is defined in section 6(1) of the 1936 Act as:[4]

> ***resident*** or resident of Australia means:
>
> (a) a person, other than a company, who resides in Australia and includes a person:
>
> (i) whose domicile is in Australia, unless the Commissioner is satisfied that his permanent place of abode is outside Australia;

[1] Section 15B of the *Acts Interpretation Act* 1901 (Cth).
[2] Section 7A of the 1936 Act.
[3] Section 6AA of the 1936 Act.
[4] It has remained unchanged since 1992.

(ii) who has actually been in Australia, continuously or intermittently, during more than one-half of the year of income, unless the Commissioner is satisfied that his usual place of abode is outside Australia and that he does not intend to take up residence in Australia; or

(iii) who is:

(A) a member of the superannuation scheme established by deed under the Superannuation Act 1990; or

(B) an eligible employee for the purposes of the Superannuation Act 1976; or

(C) the spouse, or a child under 16, of a person covered by sub-subparagraph (A) or (B); …

There are therefore four tests of residency:

1. An 'ordinary concepts' test based on whether a person 'resides in Australia';
2. A 'domicile' test;
3. A 'one-half of the income year' or 183 day test; and
4. A 'superannuation scheme test'.

Although this paper has been set out in the order in which the tests are drawn from the legislation, given that the 'ordinary concepts' test requires the consideration and balancing of a number of factors, it is often easier to begin with the specific tests before considering the general test.

Being treated as a resident under only one of the four tests will be sufficient to cause the person to be treated as a resident of Australia for the purposes of domestic tax law.

3.2.1 Ordinary test of residency

The ordinary concepts test of residency is the test most usually applicable to someone entering Australia with the intention to settle, holiday or work in Australia.

As the word 'reside' is not defined in the tax acts courts in interpreting the word often look to the dictionary meaning of the term. Justice Northrop in *Applegate v FCT* adopted the dictionary meanings of the word, describing "reside" to mean "... to dwell permanently or for a considerable time, to have one's settled or usual abode, to live, in or at a particular place".[5]

[5] 79 ATC 4307 at 4313.

The Commissioner's main source of guidance concerning the ordinary concepts test for inbound persons is found in *Taxation Ruling* TR 98/17. He there states that the ordinary meaning of the word reside is broad enough to encompass someone who migrates to Australia permanently, but also someone who is 'dwelling here for a considerable time'. In the Commissioner's view, six months is a considerable time in this regard. Note that the period of time spent in Australia is not necessarily determinative of residency on its own.

In that ruling the Commissioner also states 'A migrant who comes to Australia intending to reside here permanently is a resident from arrival'.

The fact that someone intending to reside in Australia as a resident from the time they set foot in Australia means that it is vitally important to conduct any tax planning involving offshore assets before becoming physically present in Australia.

Physical presence is not on its own determinative of residency and other factors which may be pertinent in determining residency include:

- Intention or purpose of being in Australia;
- Location of family;
- Business/employment ties;
- Maintenance/location of assets; and
- Social and living arrangements.

That is, colloquially, 'where your income comes from, where your assets are, where your family is, and what your intention is'.

Intention or purpose

If the person's purpose in being in Australia is a 'settled purpose' such as education or employment, this will indicate that they are a resident of Australia. The purpose must be more than that of a traveller or visitor who is supplementing their income through employment.

Family

A person's family being present with them in Australia can indicate that they reside here. Nonetheless the absence of a person's family will not necessarily indicate that they do not reside here.

Business / employment ties

The establishment of a business here or the taking up of an employment arrangement can indicate that someone is a resident of Australia.

Maintenance / location of assets

Some weight is given to whether the majority of a person's assets are within or outside of Australia. The more significant the assets physically located in Australia the more persuasive the factor is in determining residency.

Social and living arrangements

The way that a person interacts with the society around them can indicate that they reside in a particular place. These interactions can include joining sporting or community organisations, enrolling children in school, redirecting mail to Australia and committing to a lease of residential property.

No Determinative Factor

Note that case law considering the above factors shows that the courts will interpret each person's position based on their unique facts and determining residency in some situations is particularly difficult. In some instance a ruling may be needed to obtain certainty.

These factors are to be weighed in the specific circumstances of the case. There is no one factor that will determine the issue without reference to the circumstances as a whole.

3.2.2 Domicile

Under the domicile test persons whose domicile is in Australia are treated as residents.

The test was introduced to extend the scope of the tax act to allow Australia to tax '… the High Commissioners for Australia and Agent-Generals for the Australian States together with members of their staffs'. It was not intended to affect persons entering Australia but instead persons leaving Australia to take up residence overseas.

The test is of limited relevance to a person entering the country but is of considerable significance to a person leaving the country.

3.2.3 183 day

The 183 day test is the easiest to explain and understand. A person physically present in Australia for more than one-half of the income year will be deemed to be a resident of Australia unless their usual place of abode is outside of Australia and they can show that they do not ***intend*** to take up residency here. The test is therefore in part objective (number of days) and in part subjective (intention).

It should be relatively easy for a person holidaying in Australia or working temporarily in Australia to show that they have both a usual place of residence overseas as well as no intention to reside here.

*Although this test does not usually make a person a resident the Australian Taxation Office (the '**ATO**') treat six months in Australia as a 'considerable' period of time for determining whether they are a resident according to ordinary concepts.*

3.2.4 Superannuation scheme test

A person will be a resident of Australia if they become a member of the superannuation schemes which apply to Commonwealth Government employees. This test is, like the 183 day test, more relevant to someone leaving Australia than to someone coming to Australia.

3.3 Consequences of becoming a resident (not a temporary resident)

For someone who becomes a resident of Australia there are income tax, Capital Gains Tax ('**CGT**) and superannuation issues to be considered.

3.3.1 Income tax

A person who is a resident of Australia is taxed on their worldwide income. For someone who has come in from overseas it is important to identify whether they have income that will continue to be earned from foreign sources and whether foreign tax will be imposed on that income.

If there is foreign sourced income then regard needs to be had to the foreign currency translation rules and the foreign tax offset rules.

It is also important to establish whether the person benefits from or controls an overseas entity as they may then be subject to tax under the various rules applying to controlled or affiliated foreign companies and trusts.

A person that is only resident for part of an income year is only entitled to a part-year tax-free threshold. A pro-rated amount of the annual $18,200 tax-free threshold is available for every month or part thereof that a person is a resident of Australia.

In addition a person who is a resident of Australia is subject to the medicare levy and deficit repair levy. There are some exemptions available for people travelling to Australia from other countries where they are not eligible for health benefits as a result of not being an Australian citizen or permanent resident. Where you want to claim an exemption it is necessary to apply for an exemption. An exemption is not available where Australia has a reciprocal health care arrangement with the country of origin. Australia has such agreements with countries such as the UK, Italy, Malta and the Netherlands.

3.3.2 CGT

A person who becomes a resident of Australia is deemed to have acquired for Australian tax purposes any assets that they hold that were not previously taxable Australian property.

Taxable Australian property is defined in Subdivision 855-A of the 1997 Act as being made up of:

a. Taxable Australian real property – effectively land or buildings in Australia or leases over land or buildings;

b. a CGT asset that is an indirect Australian real property interest – a holding in a company or a trust of at least 10% between a person and their associates (measured over a twelve month period in the two years prior to the test time) where more than 50% of the value of the entity consists of taxable Australian real property;

c. assets that have been used in carrying on a business through a permanent establishment in Australia;

d. an option to acquire any of the above assets; and

e. an asset that you had elected remain the in the Australia tax system when you became a non-resident.

Some of the important CGT considerations that apply to someone becoming an Australian resident are:

a. assets that were acquired by a person pre-CGT do not come into the Australian tax system; and

b. a person's main residence is subject to the same tax exemptions as apply to a person that was a resident of Australia when they acquired their main residence.

3.3.3 Super

A person that becomes an Australian tax resident is able to transfer into Australia their foreign superannuation monies without triggering an Australian tax liability if the funds are transferred into Australia within six months of becoming an Australian tax resident. If they are transferred in after this time then the growth in the value of the fund is able to be taxed in Australia (after adjustments are made for contributions after becoming a tax resident). If the foreign superannuation fund transfers money to an Australian complying superannuation fund outside of the six month period then the individual to whom the benefit relates is taxable on the growth in value of the benefits from the date of residency, but they can elect for the recipient fund to be taxed instead. If the recipient fund is taxed then it is taxed at the ordinary superannuation fund rate (i.e. 15%).

Some anomalies can arise with respect to foreign superannuation funds.

If the foreign superannuation fund is not treated as a superannuation fund for Australian purposes then the superannuation fund six month rule does not apply and instead the rules that apply to tax a distribution from a non-resident trust (section 99B of 1936 Act) can apply instead. The implications of 99B applying is that any amount not representing contributions can be taxed in Australia (i.e. the earnings) even though they may have been taxed overseas.

In this regard:

a. it is important for someone with foreign superannuation fund monies who is to become a resident of Australia to determine whether their foreign fund will be treated as a superannuation fund for Australian purposes before becoming an Australian tax resident. It may be that a withdrawal from the foreign fund before becoming an Australian resident is more concessionally taxed than a withdrawal after becoming an Australian tax resident; and

b. an amount of foreign superannuation money transferred to an Australian fund counts towards a person's non-concessional contribution cap.

Some people that become residents of Australia for tax purposes may not need to be provided with superannuation benefits by their employer under the superannuation guarantee rules if they are covered by the provisions of an International Social Security Agreement.

3.4 Temporary residents

Since 1 July 2006 there has been a sub-class of Australian tax residents known as temporary residents.

An individual is a temporary resident if all of the following criteria are satisfied:

a. they hold a temporary visa under the *Migration Act* 1958 (Cth);

b. they are not an Australian resident within the meaning of the *Social Security Act* 1991 (Cth); and

c. they do not have a spouse who is an Australian resident within the meaning of the *Social Security Act* 1991 (Cth).

A temporary visa under the *Migration Act* is one that allows a person to remain in Australia during a specified period, until a specified event happens, or while the holder has a specified status.

An Australian resident under the *Social Security Act* is then a person who resides (a defined term) in Australia and is:

- an Australian citizen;
- the holder of a permanent visa; or
- a Special Category Visa ('SCV') Holder who is a 'protected SCV holder'.

Protected SCV holders are individuals who:

- were in Australia on 26 February 2001; or
- had been in Australia for a period of, or for periods totalling 12 months during the two years before 26 February 2001 and returned to Australia after that date; or
- were residing in Australia on 26 February 2001 but were temporarily absent; or
- commenced or recommenced residing in Australia by 26 May 2001.

An example of a temporary visa that will usually result in a person being classed as a temporary resident is a Temporary Business (Long Stay) – Standard Business Sponsorship Visa (subclass 457). This is the visa type commonly used by an Australian employer to bring a foreign skilled worker to Australia for three months to four years.

A person who was previously an Australian resident under the *Social Security Act*, an Australian citizen or the holder of a permanent visa can never be treated as a temporary resident of Australia.

Even if a person comes to Australia on a temporary visa if they co-habit with a permanent resident so that that person becomes their 'spouse' then they will cease to be a temporary resident.

The anomaly in the temporary resident rules is that as presently drafted a New Zealand resident who arrived in Australia after 26 February 2001, so that they are not treated as having entered on a 'protected class' visa, is eligible to be treated as a temporary resident indefinitely.

3.4.1 Becoming a temporary resident

When a person becomes a resident of Australia, but a temporary resident of Australia, the tax consequences are different than those that apply to a non-temporary resident.

A temporary resident is only assessed on their Australian sourced income. The exception to this is foreign employment income or APSI, which is taxable in Australia[6] and certain discounts in connection with employee share schemes are assessable to temporary residents, but there are special rules that determine the amount to be assessed. They are not subject to the CFC, FIF or transferor trust rules. They are also only taxable on capital gains made on taxable Australian property.

The CGT rules that generally apply to people becoming residents where assets that are not taxable Australian property come into the Australian tax net, do not apply to temporary residents.

It is also the case that while a person is a temporary resident they do not pay CGT on assets that are not taxable Australian property. This would effectively allow them to 'play the stock market' and invest in entities whose shares are not taxable Australian property (i.e. either they are not property rich or the person does not own 10% or more) and make tax-free capital gains and losses.

While a person is a temporary resident they have the potential to invest in shares in Australian private and public companies and make tax-free capital gains.

Temporary residents are also not subject to interest withholding obligations on interest they pay to foreign lenders.

3.4.2 Ceasing to be a temporary resident

If a person ceases to be a temporary resident and becomes a non-resident then they cease to be taxed as residents.

The CGT consequences that occur for residents (discussed below) that are not temporary residents do not occur for temporary residents.

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[6] Australian residents in the main are also taxable on foreign employment income after the recent changes to the section 23AG rules.

An anomaly arises for superannuation monies held on behalf of the now non-resident however. For them to access the superannuation monies outside of a condition of release such as death or disablement (e.g. retirement) they are required to take a departing Australian superannuation payment (‘DASP’)[7]. DASPs are subject to tax at penalty rates. Taxed monies are subject to a further 35% tax while untaxed monies are subject to a 45% tax.

If a person leaves Australia and does not claim the superannuation monies the trustee of the fund must pay it to the Government after six months. The Government will pay it to the person if he later claims it but again this payment will be net of the Departing Australia Superannuation Payment tax payable at 35% for elements taxed in the fund or 45% for elements untaxed in the fund.

A temporary resident is able to have other events, such as retirement, qualify as a cashing event if they become a permanent Australian resident or an Australian citizen[8].

If a temporary resident ceases to be classed as a temporary resident but remains an Australian tax resident then the same CGT consequences occur for them as occur for someone initially becoming an Australian tax resident, that is, any non-taxable Australia property comes into the Australian tax net with a cost base equal to its market value at the time they become a non-temporary resident.

Note that there are special rules dealing with employee share scheme interests when a person becomes a non-temporary resident but remains an Australian tax resident that complement the fact that employee share scheme interests can be taxable to a temporary resident.

3.5 Section 23AG

Up until 1 July 2009 it was the case that a person engaged in continuous foreign employment while an Australian tax resident could be exempted from domestic tax on the foreign employment income under section 23AG of 1936 Act.

As was announced in the 2009 budget, the rules changed with effect from 1 July 2009 so that the exemption for foreign earnings will only apply to a person whose earnings are attributable to:

- the delivery of Australia’s overseas aid program by the individual’s employer;
- the activities of the individual’s employer in operating a developing country relief fund or a public disaster relief fund;
- the activities of the individual’s employer being a prescribed institution that is exempt from Australian income tax;
- the individual’s deployment outside Australia by an Australian government (or an authority thereof) as a member of a disciplined force; or
- an activity of a kind specified in the regulations.

[7] From 1 April 2009.
[8] Or a New Zealand citizen – see Regulation 6.01B of SISR 1994.

For individuals that continue to be eligible for the section 23AG exemption the rules will apply in their current form.

The restricted application of section 23AG is to begin to apply to payments for work done on or after 1 July 2009. From that time the foreign employment earnings will be assessable in Australia, and foreign tax credits (foreign income tax offsets) will be available for tax paid in the overseas jurisdiction. Income paid after 1 July 2009 but earned before that time will continue to be subject to the exemption.

A transitional measure provides that where foreign service overlaps 1 July 2009 the period of employment will still count towards the 91 day requirement, even though the income earned after 1 July 2009 will be subject to tax in Australia.

The removal of the section 23AG exemption will also bring employees previously subject to the exemption into the Fringe Benefits Tax system as employees. Prior to this change an employee who received only section 23AG exempt income from their employer would not be classified as an 'employee' for Fringe Benefits Tax purposes.

Employers of employees who engage in foreign service that was previously exempt under section 23AG need to be aware that from 1 July 2009 that they will be required to deduct PAYGW from wage payments made. The ATO have issued a PAYGW variation that provides that in determining the amount of Australian tax required to be deducted account can be taken of the foreign tax paid.

4 Leaving Australia

Knowing when a person ceases to be a tax resident of Australia is as important as knowing when someone becomes an Australian tax resident.

In contrast to planning for someone who becomes a resident, which is mainly about avoiding future problems, planning for someone who will become a non-resident is concerned with planning to avoid immediate tax imposts or issues.

In some cases however, there are advantages where people became non-residents in the past – particularly before 12 December 2006.

4.1 Tests

The tests for residency set out above are the ones used to determine whether someone is a resident – and therefore if none are satisfied then the person is a non-resident. Set out here are the implications of the tests for someone who 'wants' to become a non-resident.

4.1.1 Ordinary test of residency

The ordinary test of residency considers where a person's family is located, where their job or business is, where their assets are, their level of connection with Australia, and their intention.

Therefore, in the case where a person leaves Australia with their family, establishes a business or takes up employment overseas, liquidates their Australian assets and severs their connections with Australia (by cancelling insurance, licenses, redirecting mail, etc.) and intends to remain outside of Australia indefinitely (so to rebut the presumption that their domicile is in Australia) they will cease to be an Australian resident.

Where not all of these things occurs it will be a matter of judgement as to whether or not enough has been done to sever their tax residency. In some cases it may be appropriate to apply for a private binding ruling on the issue of residency.

In determining whether someone intends to remain overseas indefinitely the ATO's 'rule of thumb' is that an intention to remain outside of Australia for two or more years will be treated as an intention to remain outside of Australia 'indefinitely'.[9] However, as the following cases show, this rule of thumb is not automatic.

[9] See paragraph 25 of *Taxation Ruling* IT 2650.

An engineer who took up a two year plus appointment overseas but maintained his family home and ties in Australia to which he ultimately returned, was held to be a resident according to ordinary concepts: *Iyanger v FCT*.[10] A similar result was reached where a doctor who worked in East Timor for many years returned to Australia each year for six to eight weeks: *Pillay v FCT*.[11] Again this occurred where an Australian citizen was hired to work in Qatar for a total period of nearly two and one-half years, but continued to maintain a residence in Australia, garaged a care here, maintained internet and telephone accounts, bank accounts and an Australian superannuation account: *Sneddon v FCT*.[12] The mere fact that a taxpayer has acquire a residential property overseas was not considered sufficient to establish that he was no longer a resident of Australia in *Mulherin v FCT*.[13] On the other hand, a person who had left Australia to live permanently in Bali, where he had personal and financial ties, was held to have ceased to be an Australian resident, despite lengthy subsequent visits to Australia, his indication on immigration cards that he was an Australian resident and his receipt of Medicare: *Murray v FCT*.[14] An unmarried French citizen who visited Australia on a working holiday for just over one year, doing casual jobs and living in various residential premises, was held to have established Australian residency: *Guissouma v FCT*.[15]

Individuals who migrate to Australia are considered residence as soon as they arrive. The factors that the Commissioner considers relevant to determining whether a business migrant is a resident according to ordinary concepts are set out in *Taxation Ruling* IT 2681.

4.1.2 Domicile

The domicile test, as mentioned earlier in this paper, is of particular relevance to someone leaving Australia to take up residence (according to ordinary concepts) elsewhere in the world.

Domicile is a common law concept which, in Australia, is modified by the *Domicile Act* 1982 (Cth)[16]. A person's domicile is their 'permanent' home, despite where they may reside.

In order to establish domicile it is necessary to reside in a country and to have the intention to remain there indefinitely.

There are two types of domicile, domicile of origin and domicile of choice, and both are resident for persons leaving Australia.

Your domicile of origin is acquired at birth and is the domicile of the person on whom the infant is legally dependant. If the person is born legitimate, then they acquire the domicile of their father. If they are born illegitimate they acquire the domicile of their mother. If they are a foundling they acquire a domicile of the country in which they were found. Under section 9 of the *Domicile Act* 1982 (Cth) where a person's parents have separated, where a person is adopted or where one parent has died the domicile of the child is linked to the domicile of the parent with whom the child resides.

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[10] 2011 ATC ¶10-222.
[11] 2013 ATC ¶10-324.
[12] 2012 ATC ¶10-264.
[13] 2013 ATC ¶20-423.
[14] 2013 ATC ¶10-338.
[15] [2013] AATA 875.
[16] Section 6 of this Act abolishes the common law concept that a married woman has at all times the domicile of her husband

Your domicile of origin remains your domicile until a domicile of choice is acquired in another country where you intend to remain indefinitely. You can only have one domicile at any point in time.

In *Taxation Ruling* IT2650 the Commissioner sets out the factors he considers important in determining whether there is a new domicile of choice:

> Generally speaking, persons leaving Australia temporarily would be considered to have maintained their Australian domicile unless it is established that they have acquired a different domicile of choice or by operation of law. In order to show that a new domicile of choice in a country outside Australia has been adopted, the person must be able to prove an intention to make his or her home indefinitely in that country e.g., through having obtained a migration visa. A working visa, even for a substantial period of time such as 2 years, would not be sufficient evidence of an intention to acquire a new domicile of choice.

For persons leaving Australia whose domicile of origin is Australia it will be necessary that they either show that they have established a new domicile outside of Australia, or for them to rebut the presumption that they are a resident of Australia because of their domicile by showing that they have a 'permanent place of abode' outside of Australia.

The concept of permanent place of abode was discussed in *Applegate v FCT*. In that case a solicitor was asked to go to the New Hebrides for work (now Vanuatu). He was to establish a branch office there and manage it. He gave up the lease on his flat in Australia and moved to the New Hebrides with his family. He was to stay for an unspecified period but was forced to return to Australia within two years by ill health. He treated his foreign sourced income as non-assessable in Australia. Although the Full Court of the Federal Court found that his domicile in Australia had been maintained, they did find that he had a permanent place of abode in the New Hebrides. Justice Fisher in that case stated:[17]

> To my mind the proper construction to place upon the phrase ``permanent place of abode'' is that it is the taxpayer's fixed and habitual place of abode. It is his home, but not his permanent home. It connotes a more enduring relationship with the particular place of abode than that of a person who is ordinarily resident there or who has there his usual place of abode. Material factors for consideration will be the continuity or otherwise of the taxpayer's presence, the duration of his presence and the durability of his association with the particular place.

The ATO consider the following factors should be taken into account in determining whether someone has established a permanent place of abode outside of Australia:[18]

- the intended and actual length of the individual's stay in the overseas country;
- any intention either to return to Australia at some definite point in time or to travel to another country;
- the establishment a home outside Australia;

[17] At 4317.
[18] Taken from paragraph 5 of *Taxation Ruling* IT 2650.

- the abandonment of any residence or place of abode the individual may have had in Australia;
- the duration and continuity of the individual's presence in the overseas country; and
- the durability of association that the individual has with a particular place in Australia.

Where domicile can cause issues, as it will not be possible to show that there is a permanent place of abode outside of Australia, is where a person has left Australia and is travelling overseas without having first obtained a domicile of choice, or where a person has obtained a domicile of choice overseas but then relinquishes that domicile to travel before returning to Australia.

In both cases the person's domicile will be presumed to be their domicile of origin and if that is Australia, they will be an Australian tax resident at that time.

Where someone ceases to have a domicile in another place and surrenders their permanent place of abode their residency status may revert to Australia. This is particularly important if they have undertaken or choose to undertake transactions while they are travelling.

4.1.3 183 days test – case that says not relevant

The 183 day test is usually not considered to be relevant to someone leaving Australia to reside overseas due to the finding of the Taxation Board of Review in *Case S19* 85 ATC 225. In that case a person who had been posted to the New Hebrides (a bank manager in this case) had abandoned his place of residence in Australia and in fact did reside in the New Hebrides. The Commissioner tried to argue that because he had been present in Australia for more than one-half of the income year he did not lose his residency until the beginning of the next income year. Permanent Member Roach found that the 183 day test is not relevant to someone leaving Australia. The person was found to have ceased residency when they left Australia.

4.1.4 Superannuation scheme test

A person who is a member of either of the superannuation schemes covered by the *Superannuation Act* 1990 (Cth) or the *Superannuation Act* 1976 (Cth) will not be able to cease their Australian tax residency simply by leaving the country. The purpose of this test when it was introduced was to bring within the Australian tax net locally engaged High Commissioner staff, who had recently been extended the benefits of the Commonwealth superannuation scheme. Under this test a spouse or child under 16 years of a member of the scheme is also treated as a resident.

4.2 Income tax

A person that becomes a non-resident of Australia part-way through an income year is only eligible for a part year tax-free threshold. The tax-free threshold available is one-twelfth of the $18,200 per annum for each completed or part month that someone is resident in Australia.

Example
Tom leaves Australia for France for an 'indefinite' period on 1 June 2009. He residency ceases on that date. He will be entitled to 12 months of tax-free threshold.

From an income tax perspective a person that becomes a non-resident ceases to be taxable on non-Australian sourced income, unless Australia's taxing rules are not source dependent (such as can occur with employer termination payments).

Once a person is a non-resident for the whole of an income year they are taxed at non-resident rates, that is, in the year a person becomes a non-resident they will be taxed at resident rates in that year.

A consideration for someone moving overseas and losing their Australian residency is sometimes the impact of losses that may be generated from continuing asset ownership in Australia. Such losses can be carried forward and claimed against future Australian income derived at a time when they are a resident or a non-resident. Prior to 1 July 2009 an interaction needed to be considered between the incurring of losses and the derivation of section 23AG income (where the person maintained their residency). The changes that occurred to section 23AG from 1 July 2009 to restrict the classes of people eligible have made this a very uncommon concern. The interaction to be considered is that if a person maintains their residency and derives section 23AG exempt income, their domestic losses would be reduced by that income. If they became non-residents their foreign employment income would not be taxed in Australia and their losses would be preserved. In some instances there was therefore a 'tax preference' for becoming a non-resident.

4.3 CGT

Where a person ceases to be a resident of Australia for tax purposes they will be deemed to have disposed of any asset that they own that are not taxable Australian property for its market value.[19] Although this is the default position, an individual can make a choice, for all of the asset that they own that would otherwise result in tax consequences on ceasing residency, to have those assets remain in the Australian taxation system until such time as another CGT event occurs.

The choice is not one made in writing, it is demonstrated in the way in which the tax return is prepared. Despite this it may be prudent to document a person's choice.

Choosing whether or not to trigger capital gains tax on ceasing residency will be a choice that needs to be made on a case-by-case basis. The only clear bias towards choosing to leave assets within the Australian CGT system arises where the assets are shares in a company where there are significant franked retained profits.

[19] CGT event I1

If a resident receives a fully franked dividend they are required to pay tax on the grossed up value of a franked dividend. If a non-resident receives the same dividend there is no further tax payable. Given that a person that becomes a non-resident could be expected to make a discountable capital gain if they become a non-resident and pay capital gains tax on the value of the shares in a company with retained profits at a rate of up to 24.75% (the top rate of 49.5% reduced by half for the CGT general discount), there may be a benefit in leaving the shares in the Australian tax system if dividends received while a non-resident would be taxed at a rate of less than 24.75%. Consideration needs to be given to the fact that any future capital growth in the assets of the company might later be reflected in an Australian capital gains tax liability on a sale of shares as compared to no Australian tax liability if the shares had been taken out of the CGT system and they remained non-taxable Australian property.

Care also needs to be taken that the individual becoming a non-resident does not impact on the tax position of a company, trust or superannuation fund that they control. While a company will remain an Australian tax resident if incorporated here, a trust will cease to be an Australian resident if its trustees are non-residents while a superannuation fund may become non-complying if the majority of its trustees are outside of Australia when exercising central management and control or its contributing members are by majority non-residents.

4.3.1 Planning for people who ceased to be residents prior to 12 December 2006

A CGT anomaly exists for people who ceased to be Australian tax residents prior to 12 December 2006. Prior to that time, if a person ceased to be an Australian tax resident, CGT event I1[20] would only be required to pay CGT on asset that they held that did not continue to have the ***necessary connection with Australia***. Private company shares were assets that were treated as having the necessary connection with Australia.[21] Under the current law private company shares will only be taxable Australian property (and therefore within Australia's CGT provisions) if the person and their associates satisfy the 10% non-portfolio interest test and the real property test.

Some individuals that ceased to be tax residents prior to 12 December 2006 may not have made any choice (i.e. not paid tax) when leaving Australia as a result of private company shares, and from 12 December 2006 those shares may be outside of the Australian tax system.

Where this produces very strange outcomes is where a person may have shares on which little tax is payable if retained profits are taken as dividends, after which there is little tax payable under the CGT system.

[20] Or the corresponding previous section of 1936 Act, being section 160M(8).
[21] Now repealed section 136-25 of the 1997 Act.

5 Bird of Passage

There is no presumption that if an individual has permanently left Australia they remain an Australian resident until they acquire a residence elsewhere. The "bird of passage" principle operates to that at a particular time a person may have no tax residence: see *Levene v Commrs of IR* (1928) 13 TC 486 at 501; and, in Australia, Hill J in *FCT v Estate of Subrahmanyan* (2001) 116 FCR 180.[22]

Nor is there any presumption against an individual being a resident in more than one country at the same time: *Battenberg v Reston* [2007] FCAFC 195; *Mathai v wee* [2005] FCA 932 at 932 at [124]; and *Re Taylor; Expart Natwest Australia Bank Limited* [1992] FCA 296.

[22] Also at 2002 ATC 4001 at 4008; (2001) 49 ATR 29; [2001] FCA 1836.

6 Focusing on Beneficiaries of Trusts

It is now appropriate to turn our attention to trusts specifically. There are, under the following sections, specific aspects of foreign resident taxation addressed where that foreign resident is a beneficiary of a trust estate.

It is here appropriate, however, to outline some considerations for trusts generally, whether the beneficiaries are resident, foreign or both.

6.1 Interests of a Beneficiary

6.1.1 The Nature of the Interest

In *DKLR Holding Co (No. 2) Pty Ltd v Commissioner of Stamp Duties*[23] at 518 to 521 Hope JA set out the nature of a beneficiary's interest. Although lengthy it bears repeating in full (footnotes omitted):

> [14] [After discussing the origin of equitable estates and interests] … After some hesitation, a trust interest in respect of land came to be regarded, not merely as some kind of equitable chose in action, conferring rights enforceable against the trustee, but as an interest in property. The fact that equitable estates were not enforceable against everyone acquiring a legal title to the property did not prevent them from being so regarded; a legal owner of land could lose his estate in, or become unable to enforce his rights in respect of, land in a number of ways. Although there has long been a controversy whether trust interests are true rights in rem … there can be no doubt that the interest of the *cestui que trust* is an interest in property …
>
> [15] These essential features of interests arising under private trusts are thus described in Jacobs' *Law of Trusts,* 3rd ed, p 109: "…the trustee must be under a personal obligation to deal with the trust property for the benefit of the beneficiaries, and this obligation must be annexed to the trust property. This is the equitable obligation proper. It arises from the very nature of a trust and from the origin of the trust in the separate of the common law and equitable jurisdictions in English legal history. The obligation attaches to the trustees *in personam,* but it is also annexed to the property so that the equitable interest resembles a right *in rem.* It is not sufficient that the trustee should be under a personal obligation to hold the property for the benefit of another, unless that obligation is annexed to the property. Conversely, it is not sufficient that an obligation should be annexed to property unless the trustee is under the personal obligation."

[23] [1980] 1 NSWLR 510.

[16] Several consequences follow. Firstly, [sic] an absolute owner in fee simple does not hold two estates, a legal and an equitable estate. He holds only the legal estate, with all the rights and incidents that attach to that estate. If he were to execute a declaration that he held the land in trust for himself absolutely, the declaration would be of no effect; it would give him no separate equitable rights; he would remain the legal owner with all the rights that a legal owner has. At least where co-extensive and commensurate legal and equitable interests are concerned, "… a man cannot be a trustee for himself.": *Goodright v Wells,* per Lord Mansfield. "You cannot have a legal estate in trust for yourself.": *Harmood v Oglander,* per Lord Eldon. Secondly, although the equitable estate is an interest in property, its essential character still bears the stamp which its origin placed upon it. Where the trustee is the owner of the legal fee simple, the right of the beneficiary, although annexed to the land, is a right to compel the legal owner to hold and use the rights which the law gives him in accordance with the obligations which equity has imposed upon him. The trustee, in such a case, has at law all the rights of the absolute owner in fee simple, but he is not free to use those rights for his own benefit in the way he could if no trust existed. Equitable obligations require him to use them in some particular way for the benefit of other persons …

[18] This position can be analysed in a similar way in respect of all rights given to a trustee who holds property at law in trust absolutely for a beneficiary. In some cases the rights vested in the trustee may be such that he cannot be compelled to allow the beneficiary to exercise it except (unless, because of the nature of the right, it is not permissible to do so) in his, the trustee's, name. If this analysis be correct, although the beneficiary has an interest in the trust property, the content of that interest is essentially a right to compel the trustee to hold and use his legal rights in accordance with the terms of the trust. Where the trustee holds absolutely for the beneficiary, the beneficiary has a right in equity to be put, so far as practicable and generally subject to appropriate indemnities being given, into a position where directly, or indirectly, or for all practical purposes, he enjoys or exercises the rights which the law has vested in the trustee …

> [20] What then is the result of the actions of the plaintiff [B, the putative trustee] and of 29 Macquarie [A, the registered proprietor], and of the instruments executed by them; or, rather, what will their effect be when the transfer has been registered? Before the passing of the resolutions and the execution of the instruments, 29 Macquarie was the registered proprietor of the land for an estate in fee simple. It can, no doubt, be said that it was the beneficial owner of that land, but it held no separate equitable interest in the land; the statement means merely that it was the legal owner, and there was no equitable right in anyone to regulate or control the way in which it might exercise the rights which the legal ownership gave to it. The passing of the resolutions and the execution of the instruments, have not yet changed that position. When the transfer is registered, the plaintiff will undoubtedly be the registered proprietor of the land for an estate in fee simple, and will have, at law, all the rights and powers in respect of the land which the ownership of the fee simple will give. However, consequent upon its becoming entitled to these rights and powers, there will be created, at the same time as it become so entitled, an equitable estate in the land in 29 Macquarie, an estate which will entitle 29 Macquarie to require the plaintiff to hold and exercise its rights and powers, so far as practicable, as 29 Macquarie shall direct. Although it may not matter, the interest so arising in 29 Macquarie will not flow from the simple circumstance that the transfer was made without valuable consideration; it will arise (so far as it appears in the state case) because of the intention of the parties evidence by the resolutions and the declaration of trust. The interest will arise only because the rights and powers which were previously vested in 29 Macquarie have been transferred to the plaintiff. It would not have been possible for 29 Macquarie to have acquired its equitable interest by some kind of exception from the transfer of the legal title. In a loose or popular sense, it may be said that 29 Macquarie transferred a bare legal title to the plaintiff and retained for itself the beneficial ownership, but that is not a correct description of what the memorandum of transfer, and the resolutions and declarations of trust achieved. They achieved a transfer of the estate in fee simple and, thereupon, the create of an equitable state in 29 Macquarie.

From Hope JA, whose observations have been approved,[24] we may observe two important things:

(a) the content of a beneficiary's interest is a right to compel the trustee to adhere to the terms of the trust.

(b) a beneficiary's interest is engrafted onto, or imposed on, the holder of the legal title; it is not carved out of the legal estate.

In *CPT Custodian Pty Ltd v Commissioner of State Revenue (Vic)*[25] the High Court confirmed that the nature of the beneficiary's interest is shaped by the terms of the trust in question. The deed is all important.

6.2 The Trustee's Right of Indemnity

[24] See *Re Transphere Pty Ltd* (1986) 6 NSWLR 309 per McLelland J and *Commissioner of Taxation v Linter Textiles Australia Ltd (in liq)* (2005) 220 CLR 592 at 606.
[25] (2005) 224 CLR 98.

However, the beneficiary's interest is subject to the trustee's right of indemnity out of trust assets (which applies unless excluded). If an indemnity applies the beneficiary's interest in the trust assets is qualified or deferred because the beneficiary cannot assert a right to compel the trustee to adhere to the terms of the trust to hold the property on the beneficiary's behalf without allowing for that indemnity. In *Octavo Investments Pty Ltd v Knight*[26] at 367 the majority said (citations omitted) that a trustee:

> … is entitled to be indemnified against [liabilities incurred in discharge of the trust] from the trust assets held by him and for the purpose of enforcing the indemnity the trustee possesses a charge or right of lien over those assets … the charge is not capable of differential application to certain only of those assets. It applies to the whole range of trust assets in the trustee's possession except for those assets, if any, which under the terms of the trust deed the trustee is not authorised to use for the purposes of carrying on the business. …
>
> In such a case there are two classes of persons having a beneficial interest in the trust assets: first, the *cestuis que trust*, those for whose benefit the business was being carried on; and secondly, the trustee in respect of his right to be indemnified out of the trust assets against personal liabilities incurred in the performance of the trust. The latter interest will be preferred to the former, so that the *cestuis que trust* are not entitled to call for a distribution of trust assets which are subject to a charge in favour of the trustee until the charge has been satisfied.

The High Court subsequently refined the nature of a trustee's right in indemnity, confirming the right is not in the nature of an encumbrance, in *Chief Commissioner of Stamp Duties (NSW) v Buckle*[27] at 264, saying:

> [48] Until the right to reimbursement or exoneration has been satisfied, 'it is impossible to say what the trust fund is.' [*Dodds v Tuke* (1884) 25 Ch D 617 at 619] The entitlement of the beneficiaries in respect of the assets held by the trustee which constitutes the 'property' to which the beneficiaries are entitled in equity is to be distinguished from the assets themselves. The entitlement of the beneficiaries is confined to so much of those assets as is available after the liabilities in question have been discharged or provision has been made for them. [*Kemtron Industries Pty Ltd v Commissioner of Stamp Duties (Q)* [1984] 1 Qd R 576 at 587] To the extent that the assets held by the trustee are subject to their application to reimburse or exonerate the trustee, they are not 'trust assets' or 'trust property' in the sense that they are held solely upon trusts imposing fiduciary duties which bind the trustee in favour of the beneficiaries. [*Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360 at 370].

It seems, therefore, that the trustee's right of indemnity is a right in the nature of a lien or charge, but that is only to enable a court of equitable jurisdiction to authorise the sale of conversation of those assets to satisfy the trustee's right or reimbursement or exoneration.

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[26] *26* (1979) 144 CLR 360.
[27] (1998) 192 CLR 226.

The right can be enforced even if there has been a change of trustee: *Lemery Holdings Pty Ltd v Reliance Financial Services Pty Ltd.*[28]

6.3 Taxation of Trusts Generally

The provisions dealing with the taxation of trust income are contained in Division 6 of Part III of the 1936 Act (which comprises of sections 95 to 102). As a result of the enactment of *Tax Laws Amendment (2011 Measures No. 5) Act* 2001 (Cth), regard will also be given to:

(a) Subdivision 207-B of the 1997 Act – which deals with franking credits obtained by a trust estate; and

(b) Subdivision 115-C of the 1997 Act – which deals with the distribution of capital gains by a trust estate,

which are dealt with below.

Chief Justice Latham in *Tindal v FC of T*[29] at 618 observed that the object of Division 6 of Part III of the 1936 Act is to "*... secure payment of tax upon the whole of the net income of a trust estate, either from a beneficiary or the trustee, whether the income is paid over to or on account of the beneficiary...*". Further, according to Emmett J in *Bamford v Federal Commissioner of Taxation* (2009) 176 FCR 250 "*... an important assumption underlying Division 6* ... [is] *... that a beneficiary who derives a share of the net income should be in a position to pay out of that income; otherwise, the beneficiary could be placed in a difficult position*."

The starting point in determining the taxation of trust income is s 97 of the 1936 Act. Relevantly, s 97(1) of the 1936 Act provides that:

> Subject to Division 6D, where a beneficiary of a trust estate who is not under any legal disability is presently entitled to a share of the income of the trust estate:
>
> (a) the assessable income of the beneficiary shall include:
>
> (i) so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was a resident; and
>
> (ii) so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was not a resident and is also attributable to sources in Australia; and
>
> (b) the exempt income of the beneficiary shall include:
>
> (i) so much of the individual interest of the beneficiary in the exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

[28] [2008] NSWSC 1344.
[29] (1946) 72 CLR 608.

(ii) so much of the individual interest of the beneficiary in the exempt income of the trust estate as is attributable to a period when the beneficiary was not a resident and is also attributable to sources in Australia;

except to the extent to which the exempt income to which that individual interest relates was taken into account in calculating the net income of the trust estate; and

(c) the non-assessable non-exempt income of the beneficiary shall include:

(i) so much of the individual interest of the beneficiary in the non-assessable non-exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of the individual interest of the beneficiary in the non-assessable non-exempt income of the trust estate as is attributable to a period when the beneficiary was not a resident and is also attributable to sources in Australia.

That is, s 97 of the 1936 Act provides that where a beneficiary, who is not under a legal disability is presently entitled to a "*... share of the income of the trust estate ...*", the assessable income of:

(a) a resident beneficiary includes the beneficiary's share of the '*... net income of the trust estate ...*'; and

(b) a non-resident beneficiary includes so much of the beneficiary's share of the net income of the trust as is attributable to sources in Australia.

It should be noted that the term 'net income of the trust estate' for the purposes of s 97 of the 1936 Act is defined in s 95(1) of the 1936 Act. However, the term '*... the income of the trust estate ...*' as contained in s 97 of the 1936 Act is not defined in the 1936 Act. Subsection 95(1) of the 1936 Act defines the term 'net income', in relation to a trust estate as:

> **net income**, in relation to a trust estate, means the total assessable income of the trust estate calculated under this Act as if the trustee were a taxpayer in respect of that income and were a resident, less all allowable deductions, except deductions under Division 393 of the Income Tax Assessment Act 1997 (Farm management deposits) and except also, in respect of any beneficiary who has no beneficial interest in the corpus of the trust estate, or in respect of any life tenant, the deductions allowable under Division 36 of the Income Tax Assessment Act 1997 in respect of such of the tax losses of previous years as are required to be met out of corpus.

For completeness, it should also be noted that:

(a) s 98 of the 1936 Act provides that the trustee is liable to tax on behalf of a beneficiary where the beneficiary is presently entitled to a share of the income of a trust estate, but the beneficiary is under a legal disability; and

(b) ss 99 and 99A of the 1936 Act apply to subject the trustee to tax where there is some part of the net income of a trust estate that is not subject to tax under either of ss 97 or 98 of the 1936 Act. The difference as between s 99 and s 99A of the 1936 Act is the rate of tax applicable. Typically, the trustee will be subject to tax under section 99A of the 1936 Act at a penal rate of tax equal to the maximum rate of tax (currently 45%). However, the Commissioner has a discretion to apply s 99 of the 1936 Act in certain circumstances, in which case the trustee will be subject to tax at the normal marginal rates of tax.

Section 98 will be dealt with in much more detail at heading 7 below.

6.4 Effecting Distributions

This section of the paper addresses issues to be considered when making a decision regarding the distribution of the income of a discretionary trust for an income year and when carrying out that decision.

When the trustee of a discretionary trust is considering the making of a distribution in any year from that ending 30 June 2011, a number of issues arise by reason of the *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth). In particular they include streaming of capital gains and franked distributions.

6.4.1 A Proposed Checklist

A trustee with discretion to distribute may find the following checklist helpful in undertaking the process of determining how to distribute:

Item	Issues to be Addressed
1	Does the trust deed require the trustee's decision to be effected by a particular time and, if so, what is that time?
2	Does the trust deed require the consent or approval of some person (e.g. appointor, protector or guardian of the trust), either generally or in a particular circumstance?
3	Have any distributions already been made in the current income year? If so, they should be taken into account in the final decision of that year.
4	Does the nature of the trust (e.g. testamentary, child maintenance or superannuation proceeds trusts) require particular considerations to be undertaken?
5	Who are the entities to whom a distribution can be made?
6	Do any particular considerations apply to categories of entities within the class at step 5? (e.g. minors, companies, other trusts)
7	Is the trust a family trust or has an interposed entity election been made? (see heading 9 below in this regard)

8	Are there any special income tax or CGT considerations that would render a particular distribution proper or improper? (e.g. small business CGT concessions or the trust loss rules, and in particular the pattern of distribution test)
9	Does the trust deed permit the accumulation of income? If so, do the present circumstances warrant such an accumulation?
10	What amounts has the trustee derived in the current income year and what are the trustee's outgoings or liabilities?
11	Does the trust deed define the income of the trust for a income year?
12	Does the trust deed permit characterisation of income or capital gains? If so, what steps or administrative procedures must be followed to so characterise a particular amount?
13	Will the "net income" exceed the trust income for the income year? If so, what consequences follow and should any action be taken under the trust deed?
14	If the trustee's income for a income year is a negative amount, can anything be done under the deed to avoid the trustee being assessed on a positive "net income" amount?
15	What are the sources of income for the income year and is it desirable to stream any of them to particular beneficiaries?
16	If a distribution is to be made to an exempt entity the anti-avoidance rules should be considered.
17	If an asset is to be distributed in specie, it should be confirmed that the trust deed allows this and what, if any, CGT of GST consequences should be considered.
18	The trustee should confirm it is compliant with its obligations under the TFN withholding rules.

The more significant issues in effecting a distribution will now be discussed.

6.4.2 Time of Decision

A decision or resolution by a trustee with discretion to distribute the income of a trust for an income year will only be effective if it is effected by the *earlier* of:

(a) the end of the last day of the income year (being 30 June in the case of a standard accounting period); or

(b) the time prescribed in the trust deed for making the distribution.

Before the income year ending 30 June 2011 the Commissioner had adopted an administrative practice which allowed a trustee two months after the close of an income year within which to make a distribution decision or resolution which the Commissioner would accept as effective for that year: *Taxation Rulings* IT 328 and IT 329, both now withdrawn. This administrative practice never addressed the underlying trust law issues of requiring compliance with the deed. Further, the Commissioner could always have departed from the practice in a particular case: cf *Patcorp Investments Ltd v FCT.*[30]

That practice arose in recognition of the fact a trustee may not be able to determine a trust's income and expenses for a given year until sometime after that year ends. The current position suggests resolutions that provide for exact amounts are not to be preferred; rather, a decision or resolution should state percentages to beneficiaries or provide for fixed amounts with the balance of any income so determined to go to a particular beneficiary.

Though as to a two-year period following the end of an income year, see the streaming amendments such as s 115-228(1)(c) of the 1997 Act.

6.4.3 Means of Making the Decision or Resolution

Some discretionary trust deeds are silent on the way the trustee may make a distribution resolution or determination, while others specify the procedure that may be adopted. If the trust deed is silent on the issue and the trustee is a:

(a) person, it may be determined by the person merely making the decision. However, for evidentiary purposes a written record is advised to be created, and preferably a written resolution of the determination; and

(b) company a resolution or determination of the directors must be made in accordance with its constituent documents (be it a *Constitution* or the *Memorandum and Articles of Association*).

It is now clear that the crediting of trust accounts is sufficient to have resolved or determined to apply that income to a particular beneficiary, whether because the trust deed says so (*Chianti Pty Ltd v Leume Pty Ltd*[31]) or it does not: *In Re Baron Vestey's Settlement; Lloyd's Bank Ltd v O'Meara*[32] cited in *Fischer v Nemeske Pty Ltd*[33] at [59].

6.4.4 Trustee's Duty in a Discretionary Power

How a trustee may exercise their discretion to appoint or distribute income of the trust is an important consideration, including what reasoning, if any, is to be given. As will be seen, to provide reasons invites review.

The concept of "discretion" involves making a choice from a number of available alternatives, amongst which the decision-maker is free to choose.

6.4.4.1 Can the trustee's decision be reviewed?

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[30] [1967] HCA 67.
[31] (2007) 35 WAR 488.
[32] [1951] Ch 209.
[33] [2015] NSWCA 6.

The often quoted passage of McGarviie J in *Karger v Paul*[34] at 163-164 has resulted, in practice, in many trustees, especially of what are called "family discretionary trusts" not giving reasons for many decisions. His Honour there said:

> The discretionary power given to the trustees by cl 3, was a power, upon the request of Mr Smith, in their absolute and unfettered discretion to pay or transfer the whole or part of the capital of the estate to him. In my opinion the effect of the authorities is that, with one exception, the exercise of a discretion in these terms will not be examined or reviewed by the courts so long as the essential component parts of the exercise of the particular discretion are present. Those essential component parts are present if the discretion is exercised by the trustees in good faith, upon real and genuine consideration and in accordance with the purposes for which the discretion was conferred. The exception is that the validity of the trustees' reasons will be examined and reviewed if the trustees choose to state their reasons for their exercise of discretion.

There are two points to note about this passage. First, it relates to a discretion "in these terms" – that is, it is dealing with a particular trust instrument. A peculiarity of the terms of the relevant clause was that the trustees had power to transfer to one of them; at least in relation to that one any fiduciary duty not to derive a personal advantage from exercise of the power must have been impliedly negatived by the terms of the gift. Further, the power was described in these terms 'absolute and unfettered discretion'. Secondly, the allegation in the case was that the breaches consisted of not acting in good faith and not acting upon a fair and proper consideration. Thus, McGarvie's J statement as to some different allegation than what was actually made in the case would be *obiter dictum*.

These points of note, themselves, show the broadness (if taken out of context) of the above statement may not be appropriate. There are also other decisions that establish a trustee's exercise of discretion is in no way immune to review or alteration.

In *Parkes Management Ltd v Perpetual Trustee Co Ltd*[35] at 311 Hope JA (with whom Moffit P agreed) held:

> In equity, where a trustee has a discretionary power, that power "must be exercised with an absence of indirect motive, with honesty of intention and with a fair consideration of the issues": Jacobs Law of Trusts, 4th ed p 301. In Lewin on Trusts 15th ed p 32, the requirement is expressed to be that the trustee's conduct be bona fide and the determination not influenced by improper motives. There is ample authority for these propositions.

Chief Justice Barwick, in *Lutheran Church of Australia South Australian District Inc v Farmers' Co-operative Executor & Trustees Ltd*[36] at 639, said of a mere power conferred on a trustee:

[34] [1984] VR 161.
[35] (1977) 3 ACLR 303.
[36] (1970) 121 CLR 628.

> ... whilst the power is not in the nature of a trust so that the trustee must exercise it, equity would ensure that the trustee bona fide considers whether or not the power should be exercised, and that in doing so, proper considerations are in mind, and improper considerations excluded. The discretionary nature of the power does not mean that the discretion is absolute, in the sense that it can be exercised irresponsibly, capriciously or wantonly.

Another formulation of when an exercise of a discretionary power can be held ineffective is if the trustees act for reasons that are 'irrational, perverse, or irrelevant to any sensible expectation of the settlor.': *Re Manisty's Settlement*[37] at 26. Other cases have also highlighted what constitutes a valid exercise of a discretionary power – for instance, there being a duty for the donee of the power to exercise it in person and not under the dictation of someone else, and a duty not to fetter the exercise of a discretion.

In the context of a superannuation fund, Heerey J, in the Full Court of the Federal Court, in *Wilkinson v Clerical Administrative & Related Employees Superannuation Pty Ltd*[38] at 480 quoted a statement of Northrop J in the court below concerning the grounds on which an exercise of a trustee's power could be challenged in a court:[39]

> Where a trustee exercises a discretion, it may be impugned on a number of different bases such as that it was exercised in bad faith, arbitrarily, capriciously, wantonly, irresponsibly, mischievously or irrelevantly to any sensible expectation of the settler, or without giving a real or genuine consideration to the exercise of the discretion. The exercise of a discretion by trustees cannot of course be impugned upon the basis that their decision was unfair or unreasonable or unwise. Where a discretion is expressed to be absolute it may be that bad faith needs to be shown. The soundness of the exercise of a discretion can be examined where reasons have been given, but the test is not fairness or reasonableness.

The joint decision of Gleeson CJ, McHugh, Gummow, Hayne and Callinan JJ in *Attorney-General (Cth) v Breckler*[40] suggests their Honours approved of the above quote.

These cases show that the exercise of a trustee will be subject of review and how they will be reviewed.

6.4.4.2 The Karger v Paul Test

[37] [1974] Ch 17.
[38] (1998) 79 FCR 469.
[39] Citations in the quote itself are removed.
[40] (1999) 197 CLR 83.

The first task of a the court in deciding whether a trustee has exercised a discretion or formed an opinion appropriately is to turn to the trust documents. Careful attention must be paid to the exact discretion that is under review. If the trustee has not considered the correct question, the decision is not the type of decision that the trust deed empowers the trustee to make, and so it is not an effective exercise of power. If the correct question(s) was asked by the trustee the court then reviews the way the trustee answered the question.

The court can be assisted in deciding whether a trustee has complied with the *Karger v Paul* requirements for the exercise of a discretion or formation of opinion by examining the material on the basis of which the trustees have made their decision. If on that material trustees acting honestly and reasonably could not have come the conclusion to which the trustee actually came, the decision is invalid. Justice Bryson said it thus in *Sayseng v Kellogg Superannuation Pty Ltd*[41] at [63]:

> ... if the Trustee came to a conclusion which no reasonable person could have come to one of the first three grounds of challenge referred to in Rapa v Patience must be available; an unreasonable conclusion cannot be reached without either a failure to exercise power in good faith, or a failure to exercise the power upon real and genuine consideration, or a failure to exercise the power in accordance with the purposes for which it was conferred.

In finding that the decision is invalid the court need not identify precisely which of the first three grounds of challenge has been breached; it is sufficient to decide that one or other of them must have been breached. Such a process of reasoning is one that had been used by the High Court. In *Elders Trustee & Executor Co Ltd v Higgins*[42] at 451-452 Dixon CJ, McTiernan and Windeyer JJ said:

> the appellant has asked us to infer that, since mala fides or neglect is not to be imputed to a trustee from his silence alone, the various possibilities must have all been considered and a decision made to reject them. If that were so, the decision would seem to have been one that a prudent man, duly considering the relevant facts, could not reasonably reach.

The message to take from these cases would appear to be a trustee's exercise of a discretion:

(a) is not immune to challenge – the usual principles of a fiduciary nature will impose restricting constraints and require the trustee to properly conduct the trust; but

(b) it need not be the subject of recorded reasoning as to do so invites an easier critique than would otherwise be the case.

[41] [2003] NSWSC 945.
[42] (1965) 113 CLR 426.

The benefit a trustee obtains by not recording reasons is also not lost because a beneficiary applies to a court for production of documents or the provision of information in relation to the decision or determination that was made: *Mandie v Memart Nominees Pty Ltd*.[43]

[43] [2014] VSC 290.

7 The Trustee's Liability for Non-Resident Beneficiaries

The previous heading discussed the taxation of trust estates in Australia generally. It is now appropriate to consider the basis of a non-resident beneficiary's liability to tax and how that might affect the resident trustee.

7.1 Beneficiary Non Resident at the End of the Income Year

Where a beneficiary is presently entitled to a share of trust income and is a non-resident at the *end* of the income year, the trustee is primarily liable to pay tax in respect of that share. This is so regardless of whether the beneficiary is under a legal disability.

It arises by s 98 of the 1936 Act, which provides:

Liability of trustee

(1) Where a beneficiary of a trust estate who is under a legal disability is presently entitled to a share of the income of the trust estate, the trustee of the trust estate shall be assessed and liable to pay tax in respect of:

(a) so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(b) so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was not a resident and is also attributable to sources in Australia;

as if it were the income of an individual and were not subject to any deduction.

(2) Where a beneficiary of a trust estate:

(a) is deemed to be presently entitled to a share of the income of the trust estate of a year of income by virtue of the operation of subsection 95A(2);

(aa) is a natural person and is not, in respect of that share of the income of the trust estate, a beneficiary in the capacity of a trustee of another trust estate;

(b) is not a beneficiary to whom subsection 97A(1) or (1A) applies in relation to the year of income; and

(c) is not under a legal disability;

the trustee of the trust estate shall be assessed and liable to pay tax in respect of:

(d) so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(e) so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was not a resident and is also attributable to sources in Australia;

as if it were the income of an individual and were not subject to any deduction.

(2A) If:

(a) a beneficiary of a trust estate who is presently entitled to a share of the income of the trust estate:

(i) is a non-resident at the end of the year of income; and

(ii) is not, in respect of that share of the income of the trust estate, a beneficiary in the capacity of a trustee of another trust estate; and

(iii) is not a beneficiary to whom section 97A applies in relation to the year of income; and

(iv) is not a beneficiary to whom subsection 97(3) applies; and

(b) the trustee of the trust estate is not assessed and is not liable to pay tax under subsection (1) or (2) in respect of any part of that share of the net income of the trust estate;

subsection (3) applies to the trustee in respect of:

(c) so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(d) so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was not a resident and is also attributable to sources in Australia.

(3) A trustee to whom this subsection applies in respect of an amount of net income is to be assessed and is liable to pay tax:

(a) if the beneficiary is not a company--in respect of the amount of net income as if it were the income of an individual and were not subject to any deduction; or

(b) if the beneficiary is a company--in respect of the amount of net income at the rate declared by the Parliament for the purposes of this paragraph.

Note: If the trust estate's net income includes a net capital gain, and the beneficiary is a company, Subdivision 115-C of the *Income Tax Assessment Act 1997* affects the assessment of the trustee.

(4) If:

(a) a beneficiary of a trust estate (the ***first trust estate***) who is presently entitled to a share of the income of the first trust estate:

(i) is, in respect of that share of the income of the first trust estate, a beneficiary in the capacity of a trustee of another trust estate; and

(ii) is not a beneficiary to whom subsection 97(3) applies; and

(b) a trustee of the other trust estate is a non-resident at the end of the year of income;

the trustee of the first trust estate is to be assessed and is liable to pay tax in respect of so much of that share of the net income of the first trust estate as is attributable to sources in Australia at the rate declared by the Parliament for the purposes of this subsection.

Note: If the trust estate's net income includes a net capital gain, Subdivision 115-C of the *Income Tax Assessment Act 1997* affects the assessment of the trustee.

There were significant changes made in 2006, discussed in detail at heading 7.3 below. The effect of the changes was that the trustee can also be taxed in relation to distributions where the beneficiary is a non-resident trustee at the end of the income year (in addition to where the beneficiary is a company or individual).

Tax is payable by the trustee on:

a. so much of the share of the net income as is attributable to a period when the beneficiary was a resident, whatever the source of the income; and

b. so much of the share as is attributable to a period when the beneficiary was not a resident and is also attributable to Australian sources.

the tax paid by the trustee is not a final tax as a non-resident beneficiary is also taxed on the particular trust income, with a credit being allowed for the tax already paid by the trustee: s 98A of the 1936 Act. If the tax paid by the trustee exceeds the tax payable by the beneficiary, the excess is refunded to the beneficiary.

The trustee of a Managed Investment Trust (see heading 9.6 below) and Australian trustee intermediaries (to the extent their income is managed investment trust income) are not subject to taxation under s 98 of the 1936 Act, but rather are subject to taxation under Subdivision 12-H of the TAA.

7.2 The Rate of Tax

The rate of tax that a trustee pays in relation to a non-resident beneficiary (that is an individual or a company) is the rate applicable to a notional resident person or company.

The rate of tax that a trustee pays in relation to a non-resident trustee beneficiaries is the top tax rate for a non-resident individual (currently 45%).

7.3 The 2006 Changes

Amendments were made to the 1936 Act from 1 July 2006 to ensure that the trustee is assessed on a non-resident trustee beneficiary's share of the net income of a trust. This treatment is similar to the way in which trustees were, before 1 July 2006, assessed in relation to a non-resident company or individual beneficiary.

There are also special rules that apply to the assessment of the trustee beneficiary and any subsequent trustee beneficiary in the chain of trusts.

7.4 Conduit Foreign Income

The new section 802-17 of the 1997 Act ensures that distributions declared to be conduit foreign income are able to flow through trusts to non-resident beneficiaries, free of Australian tax.

If an Australian company makes an unfranked frankable distribution that it declares to be conduit foreign income to a trustee, that trustee is not liable to pay tax in relation to a non-resident beneficiary's share of the net income of the trust that is reasonably attributable to all or part of that distribution. The non-resident beneficiary must be presently entitled to the share of the trust income that is reasonable attributable to all or part of that unfranked distribution for this to apply.

Also, a non-resident beneficiary is not assessed on their share of the net income of a trust to the extent that the share of the net income is reasonably attributable to a distribution declared to be conduit foreign income.

7.5 Capital Gains

If the amount of net income on which a trustee is assessed in relation to a non-resident trustee or company beneficiary includes a discount capital gain, the trustee is assessed as if the discount had not applied to the capital gains: sections 115-220 and 115-222 of the 1997 Act.

7.6 Ultimate Beneficiary Reporting Rules

Changes were made to the reporting obligations for trustees of closely held trusts with effect from 1 July 2008. A transitional rule applies for the 2007 and 2008 income tax years to ensure that where a share of net income has been taxed under subsection 98(4) of the 1936 Act the trustee of a closely held trust will not be liable to pay ultimate beneficiary non-disclosure tax under existing sections 102UK and 102UM of the 1936 Act.

The section 98 changes referred to at heading 7.3 will affect the reporting obligations for trustees for closely held trusts under the new trustee beneficiary reporting rules. Effective from 1 July 2008 a trustee of a closely held trust will not be required to include in a trustee beneficiary statement details of the net income of the trust in respect of which the trustee is assessed under subsection 98(4) of the 1936 Act or which is reasonably attributable to such amount that has previously been assessed under that provision.

7.7 Foreign Tax Offset Credit

When an Australian resident trust derives foreign source income on which foreign tax has been paid – or an Australian resident beneficiary of a foreign trust receives a foreign source trust distribution on which foreign tax has been directly or indirectly levied[44] - a foreign tax offset may be allowed to a beneficiary assessed under sections 97 or 100 of the 1936, or a trustee taxed under sections 98, 99 or 99A of the 1936 Act.

[44] For an illustration of how the foreign tax credit regime applies to a distribution of trust income fro a trust resident in a country with which Australia has entered a DTA, see *Private Binding Ruling* PBR 39085 (2003).

8 Conflicting Tax Laws of a Foreign Jurisdiction

There is ample opportunity for conflict between the Australian taxation laws and the taxation laws of any jurisdiction in which a beneficiary may be located. There are various ways in which those conflicts are cemented or avoided as the sovereign jurisdictions relevant to the issues decide.

8.1 Examples of How Australia confirms its Right to Tax

The Australian Government is concerned to ensure it receives its rightful tax. The most recent audits, Parliamentary enquiries and Global discussions, regarding Base Erosion and Profit Shifting (that is, BEPS) shows this.

The 2009 Court proceedings, where the Commissioner was a few ours too late (at 11pm one night) in obtaining freezing order to stop private equity group TPG, and its minority partner Blum Capital, taking $1.58 billion offshore from the sale of the Myer Group.

Various measures that show the ATO taking steps to confirms its ability to procure its tax receipts are:

- the various withholding obligations for the PAYG Withholding System (discussed at heading 9 below); and

- the new foreign resident withholding regime for property sales (discussed at heading 11.3 below).

Where, however, there is a conflict of the actual taxing rights, there are a number of ways sovereign jurisdictions resolve the conflict. The most common is a DTA.

8.2 Double tax agreements

DTAs operate to allocate taxing rights between countries where a person, or their income, may be taxed in two separate countries. In the case of residency DTAs importantly contain tiebreaker tests that can apply to cause a person to be treated as a resident of only one country. However, the person must be a resident of both countries for the tiebreaker rules to apply.

To apply a DTA it is therefore necessary to know whether or not the person will continue to be treated as a resident of their country of origin.

In considering the way that a DTA may impact on a person, the following is an approach worth considering:

1. You identify whether Australia has a DTA with their country of origin – if not, there is no need to proceed further.

2. Identify whether there are any classes of income derived that may be exempted from tax in Australia because of the DTA and your client's circumstances.

3. If they are not exempted under the DTA, and they are a resident of Australia, consider whether they are a resident of the foreign country so that they may obtain the benefit of the tiebreaker rules.

Even if someone is treated not as a resident of Australia under a DTA, this does not mean that the domestic tax law does not apply to them. The ATO can still seek to impose tax on them if they are non-residents in receipt of Australian sourced income.

DTAs are also discussed, in the context of CGT, at heading 11.5 below. The discussion there canvasses cases that deal with what is to occur when there is no applicable DTA on the issue.

8.3 Relief for amounts that are taxed twice

If a person becomes a resident of Australia, and is subject to overseas tax and Australian tax on the same category of income, then Australian tax relief is afforded through the foreign tax offset rules.

Major changes occurred to these rules from 1 July 2008, with the main changes from the old regime being that the availability of an offset is now based on a 'top slice' rather than 'average tax rate' approach, credits must be used on a 'use it or lose it' basis[45] and there is a *de minimus* amount of $1,000 of foreign tax credits that can be claimed without reference to the 'top slice' approach.

Note also that at the same time that the foreign tax offset rules were change foreign loss quarantining ceased.

While foreign losses are no longer quarantined you may still need to have regard to the non-commercial loss rules.

[45] Note that there is an exception for credits carried forward from periods prior to 1 July 2008.

9 The Withholding Tax Regime

Withholding of amounts payable to non-residents is a broad topic but – given the obligations lie on the payer, which is often a trustee of an Australian resident trust – their being canvassed is necessary for this paper.

Before turning to the particular withholding rules the nature of income to non-residents must be discussed.

9.1 Assessment of Non Residents

The primary rules[46] governing the taxation of non-residents provide that non-residents are:

- Liable to Australian tax on all items of ordinary or statutory income which have their source in Australia; and
- Exempt from Australian tax on foreign source ordinary or statutory income.

However, there are some qualifications to this rule. For example, a special regime applies in determining a non-residents liability to CGT (see paragraph 11 below).

9.1.1 Non Residents

With some notable exceptions, assessable income derived by non-residents is generally taxed on the same basis as income derived by residents. Unless specifically excluded or made applicable to residents only, the same exemptions and exclusions from assessable income apply and the same business deductions and special incentives are available against gross income. Non-residents may also be liable for Fringe Benefits Tax.

While non-resident individuals are generally exempt form the Medicare levy, they generally cannot claim personal tax offsets. Moreover, non-resident individuals and non-resident trust estates are subject to higher tax and do not generally have the benefit of a zero-rated first step in the rates scale. For the year ending 30 June 2016 the non-residents' tax scales were:

Taxable Income	Tax on Taxable Income	% on excess (i.e. Marginal rate)
Nil	Nil	33
$80,000	$26,400	37
$180,000	$63,400	45

For taxable incomes over $180,000, the 2% budget repair levy applies for that part of the taxable income exceeding $180,000. Non-refundable tax offsets cannot be used to offset the budget repair levy but the foreign income tax offset can be so used.

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[46] See sections 6-5(3) and 6-10(5) of the 1997 Act.

Non-resident companies are taxed at the same rate of tax as resident companies but are treated differently on important aspects such as dividend imputation and consolidation.

Withholding applies to the payment of dividends, interest and royalties paid to non-residents. Although generally applied at a flat rate there are details and exemptions that require each to be considered separately below.

9.1.2 Temporary Residents

Individuals who qualify as "temporary residents" are exempt from Australian tax on certain foreign source income or capital gains. In this respect, they are treated similarly to non-residents, even though in many cases they would normally have been classed as residents under the normal tax rules. They are also exempt from interest withholding tax and specialty rules apply to employee shares and rights.

In general, these concessions apply for income years that being on or after 1 July 2006.

As an exception, the withholding tax concessions apply to payments made on or after 6 April 2006.

9.2 Dividend Withholding

A final withholding tax is imposed on dividends paid by a resident company to a non-resident regardless of whether the dividends are income according to ordinary concepts: s 128B(1) of the 1936 Act. Though this general rule is subject to certain exemptions discussed below.

9.2.1 Dividend Withholding Rate

Dividend withholding tax is generally imposed at a flat rate of 30% but, for dividends paid to residents of countries with which Australia has a DTA, the rate is generally 15%. Withholding tax on dividends applies irrespective of:

a. whether the dividends are received directly by a shareholder or indirectly through a nominee or trustee;

b. the source of profits out of which the dividends are paid; and

c. the location of the register on which the shares giving rise to the dividends are held.

Withholding tax is imposed on the gross amount of the dividends, i.e. no deductions may be made from the dividends, and the flat rate withholding tax applies whether or not the non-resident has other income subject to Australian tax under the ordinary assessment process.

9.2.2 Exclusions

The following dividends *are not* subject to dividend withholding tax:

a. franked dividends, except where the Commissioner determines that the paying company has streamed the dividends or a franking credit scheme has occurred (as to streaming see paragraph 14 below);

b. unfranked dividends paid to non-residents by a resident company that are declared to be "conduit foreign income";

c. dividends paid to certain registered foreign charities, scientific institutions, public educational institutions and non-profit cultural, sporting and friendly societies whose income is exempt from Australian tax and from tax in the non-residents home country;

d. dividends paid to certain offshore testamentary charitable trusts established before 1 July 1997.

e. dividends paid to certain foreign non-profit aviation, tourism, agricultural and manufacturing associates;

f. certain dividends derived by a trust estate where the trustee is liable to be assessed;

g. dividends derived from assets included in the insurance funds of a non-resident life insurance company that carries on branch operations in Australia;

h. dividends in respect of which a taxpayer is assessed under special provisions dealing with tax avoidance schemes involving tax-exempt entities;

i. dividends derived by a non-resident foreign superannuation fund from a resident company, where they are exempt in the country where the fund resides: *Interpretative Decision* ATO ID 2009/77;

j. dividends on which family trust distribution tax has been paid;

k. certain dividends paid to an overseas charitable institution by an offshore banking unit or the trustee of a trust managed or controlled by such a unit;

l. dividends paid by former exempting companies (exempt entities and companies owned by non-residents) to the extent that they are franked as "exempted dividends"); and

m. certain non-frankable non-share dividends paid by a resident authorised deposit-taking institution.

Private company loans made to non-residents which are treated as deemed dividends under Division 7A of Part III of the 1936 Act are not subject to withholding tax.

Nor are dividends paid by non-resident companies to non-resident shareholders out of Australian sourced profits which are subject to the normal assessment process. This is relevant for trustees with non-resident beneficiaries because dividends from non-resident companies received by a non-resident indirectly through a nominee or trustee are assessable to Australian tax *only if* the source of those dividends is Australia.

The anti-avoidance provisions in Part IVA of the 1936 Act have been extended to include schemes which have the sole or dominant purpose of avoiding the payment of dividend withholding tax

9.3 Interest Withholding

Unless an exemption applies, withholding tax is payable on interest that is:

a. derived by a non-resident; and

b. paid by:

   i. a resident, except where the interest is wholly incurred by the resident as an expense of carrying on a business overseas at or through a permanent establishment (such as a branch); or

   ii. a non-resident and the interest is an expense wholly or partly incurred by the non-resident in carrying on a business in Australia at or through a permanent establishment in Australia: s 128B(2) of the 1936 Act.

Withholding is required not only where interest is actually "paid" to a non-resident, but also where interest is payable and has been dealt with on behalf of, or at the direction of, the non-resident by, for example, being reinvested: *Taxation Determination* 93/146. If the interest is paid in foreign currency, it is converted to Australian currency for withholding purposes at the time of payment.

A protection measure applies where interest derived by a resident in the course of carrying on a business through an overseas permanent establishment. It is subject to withholding tax if it is paid by:

a. another resident and it is not wholly incurred by the payer in carrying on a business in a foreign country through a permanent establishment in that country; or

b. a non-resident and it is wholly or partly incurred in carrying on business in Australia through a permanent establishment: s 128B(2A) of the 1936 Act.

9.3.1 Interest Withholding Rate

Interest withholding tax is imposed at a flat rate of 10% on the gross amount of interest paid (i.e. without deducting expenses incurred in deriving that interest, et cetera). With some exceptions, this rate is unaffected by Australia's DTAs.

A special rate of 45% may apply to interest not subject to the ordinary withholding tax provisions which is paid in respect of certain bearer debentures where the company has failed to disclose the names and addresses of the debenture holders to the Commissioner: s 126 of the 1936 Act. For this purpose, the "holder" of the debenture is the person in possession of it: *Taxation Determination* TD 2001/19.

9.3.2 What is "Interest"

"Interest" is generally regarded as an amount paid as compensation to a lender for having the use of its capital. For withholding tax purposes it includes amounts which:

a. are in "the nature of" interest;

b. can reasonably be regarded as having been converted into a form that is "in substitution for" interest (e.g. a lump sum paid in lieu of interest). This may not cover a payment on a convertible security which does not constitute a loan: *Interpretative Decision* ATO ID 2009/154;

c. can reasonably be regarded as having been received for interest in connection with a "washing arrangement". This is an arrangement under which title to a security is transferred to a resident shortly before an interest payment is made and where the sole or dominant purpose of the arrangement is to reduce the amount of withholding tax payable by a person;

d. are dividends paid in respect of non-equity shares;

e. are paid on upper tier 2 capital instruments that are prescribed as debt interests and are issued on or after 21 March 2005: s 128A(1AB) of the 1936 Act.

In *Century Yuasa Batteries Pty Ltd v FCT*[47] the Cull Court of the Federal Court held that amounts paid under a "grossing-up" tax indemnification clause in a loan agreement were held not to be amounts in the nature of interest. They would also not fall within any of the statutory extensions listed above.

9.3.3 Exclusions from Interest Withholding Tax

The following interest payments are not subject to withholding tax:

a. interest derived by a non-resident carrying on business in Australia at or through a permanent establishment. The rule that deems certain non-resident beneficiaries to be carrying on business in Australia through a branch does not apply in this context: *GE Capital Finance Pty Ltd (as trustee for the Highland Finance Trust Unit Trust) v FCT*;[48]

b. interest on certain publicly offered debentures;

c. interest paid to certain foreign charitable institutions, public hospitals and non-profit cultural, sporting and friendly societies whose income is exempt from Australian tax and from tax in the non-resident's home country: s 128B(3) of the 1936 Act;

d. interest paid to certain offshore testamentary charitable trusts established before 1 July 1997.

e. interest paid to certain foreign non-profit aviation, tourism, agricultural and manufacturing associates;

f. gold fees paid by an offshore banking unit in respect of an offshore gold borrowing: s 138GB of the 1936 Act. Gold fees are an additional amount of gold paid by a borrower under a gold loan contract. The Commissioner treats such fees as payment sin the nature of interest: *Taxation Ruling* TR 92/5;

[47] 98 ATC 4380.
[48] 2007 ATC 4487; 2011 ATC ¶20-270.

g. certain interest derived by a trust estate where the trustee is liable to be assessed;

h. interest paid in relation to infrastructure borrowings;

i. interest derived by a non-resident foreign superannuation fund from a resident company, where they are exempt in the country where the fund resides: *Interpretative Decisions* ATO ID 2009/78 and 2009/79;

j. interest on which family trust distribution tax has been paid;

k. interest paid to non-residents from certain "nostro" accounts held by banks and other financial institutions that conduct banking business;

l. interest dividends paid to an overseas charitable institution by an offshore banking unit or the trustee of a trust managed or controlled by such a unit;

m. dividends paid by former exempting companies (exempt entities and companies owned by non0residents) to the extent that they are franked as "exempted dividends"); and

n. interest paid by "temporary residents": s 768-980 of the 1997 Act.

Interest paid after 9 December 2008 on state and territory government bonds issued in Australia is eligible for exemption from interest withholding tax. Interest paid after 4 December 2009 on debentures and debt interests issued in Australia by the Commonwealth Government or its authorities is also eligible for exemption. In all such cases the public offer test must be satisfied.

The anti-avoidance provisions in Part IVA of the 1936 Act have been extended to include schemes which have the sole or dominant purpose of avoiding the payment of interest withholding tax

9.4 Royalty Withholding

Royalties derived by non-resident are subject to withholding tax unless an exemption applies: s 128B(2B) an d(5A) of the 1936 Act.

Withholding tax applies where the royalties are paid by:

a. a resident, except where they are outgoings wholly incurred by the payer in carrying on a business outside Australia at or through a permanent establishment, such as a branch; or

b. a non-resident and are outgoings wholly or partly incurred by the payer in carrying on a business in Australia at or through a permanent establishment in Australia.

The broad definition of "royalties" in s 6(1) of the 1936 Act applies for these purposes. An example of how broad this is can be seen with copyright. The Commissioner considers that any amounts paid as consideration for all forms of exploitation of a copyright short of an outright sale of the copyright should generally be treated as royalties. But amounts paid for the copyright itself are not royalties. See *Taxation Ruling* TR 2008/7.

Withholding is required not only where royalties are actually "paid" to a non-resident, but also where royalties are payable and are dealt with on behalf of, or at the direction of, the non-resident by, for example, being reinvested.

A protection measure applies where royalties derived by a resident in the course of carrying on a business through an overseas permanent establishment. It is subject to withholding tax if they are paid by:

c. another resident and they are not wholly incurred by the payer in carrying on a business in a foreign country through a permanent establishment in that country; or

d. a non-resident and they are wholly or partly incurred in carrying on business in Australia through a permanent establishment: s 128B(2C) of the 1936 Act.

9.4.1 Royalty Withholding Rate

Royalties withholding tax is imposed at a flat rate of 30%. However, where the royalties flow to a resident of a country with which Australia has a comprehensive DTA, the rate of royalty withholding tax is generally limited to 10% of the gross amount of the royalties, unless the royalties are effectively connected with a branch in Australia. If the country of residence of the recipient also taxes the income, that country gives credit against its tax for the Australian tax.

The withholding tax is based on the GST-inclusive amount of the payment: *Interpretative Decision* ATO ID 2010/89.

9.4.2 Exempt Royalties

The withholding tax provisions do not apply to royalties derived by a resident of a country with which Australia has a DTA where the royalties are effectively connected with a branch of the non-resident of Australia. Such royalties are treated as "business profits" and are taxed by assessment. See *Taxation Ruling* TR 2007/11.

The following royalties are also exempt from withholding tax under s 128B(3) of the 1936 Act:

a. royalties paid to certain registered foreign charities, scientific institutions, public educational institutions and non-profit cultural, sporting and friendly societies whose income is exempt from Australian tax and from tax in the non-residents home country;

b. royalties paid to certain offshore testamentary charitable trusts established before 1 July 1997.

c. royalties paid to certain foreign non-profit aviation, tourism, agricultural and manufacturing associates;

d. certain royalties derived by a trust estate where the trustee is liable to be assessed;

e. royalties on which family trust distribution tax has been paid;

f. certain royalties paid to an overseas charitable institution by an offshore banking unit or the trustee of a trust managed or controlled by such a unit; and

g. royalties paid to foreign owners of qualifying vessels leased under a bareboat charter to an Australian resident company.

Royalty withholding tax does not apply to a non-share dividend to the extent to which an amount is a return on an equity interest.

9.5 Collection of Withholding Tax on Dividends, Interest and Royalties

The person liable for the tax is the non-resident person who derives the relevant dividends, interest or royalties: s 128B(4) to (6) of the 1936 Act. The tax is payable by the 21st day after the end of the month in which the income is derived: s 128C of the 1936 Act.

However, an amount of account of tax is required to be withheld, or deducted at source, by the payer of that income. Hence the "withholding". As explained below, this amount is credited against the payee's liability.

The rules governing how the tax is withheld and accounted for by the payer is the PAYG Withholding System.

9.5.1 The Payer's Obligations

An entity that makes a payment subject to the PAYG Withholding regime must given an annual report to the Commissioner: s 16-153 of Schedule 1 to the *Taxation Administration Act* 1953 (Cth) (the '**TAA**'). The report must either:

a. be in the approved form; or

b. consider of:

    i. copies of all payment summaries that the entity gave in respect of the financial year for payments, non-cash benefits, alienated personal services payments and reportable fringe benefits amounts; and

    ii. an accompanying statement in the approved form.

The due date for the approved form is 31 October so far as dividend, interest and royalty payments are concerned.

To ensure collection of the tax where the interest or royalty is paid to a person outside Australia, a payer of interest or a royalty is precluded from obtaining a deduction for the payment until the withholding tax is paid: *Taxation Determination* TD 1993/99.

9.5.2 Non-Resident Beneficiaries

A non-resident beneficiary who is presently entitled to a dividend interest or a royalty included in a distribution of income from an Australian trust estate is deemed to have derived the income (and may therefore be liable for withholding tax) when the present entitlement arose: s 128A(3) of the 1936 Act.

A beneficiary may be deemed to have derived the dividend, interest or royalty even if the trust estate has no net income, or has incurred a loss, for income tax purposes, in the year of income.

Unit holders generally become entitled to the distributable income of a unit trust at the end of the quarterly or half-yearly distribution periods: *Taxation Ruling* IT 2680.

9.5.3 Credit for Withholding

A non-resident whose income includes a dividend, interest or a royalty from which withholding tax has been deducted is entitled to a credit against the withholding tax liability. Often the credit equals the withholding tax liability and, accordingly, the tax liability is extinguished.

A resident beneficiary of a non-resident trust estate is entitled to a credit for Australian withholding tax where the beneficiary receives a distribution of income which includes divided, interest or royalty income from which withholding has been deducted. This is subject to the proviso that the tax was borne by the beneficiary and the tax is included in the beneficiary's assessable income in addition to the trust distribution received (i.e. the amount of the distribution is "grossed up" by the amount of withholding tax): *Taxation Ruling* TR 1993/10.

This does not apply to:

a. distributions of income to resident unitholders of non-resident public unit trusts which are treated as companies;

b. trust income which is subject to the transferor trust or former FIF measures; or

c. a resident beneficiary's foreign tax offset/credit entitlement.

9.6 Withholding of Managed Investment Trust Distributions

A concessional withholding tax regime applies to certain distributions made by Australian managed investment trusts ('**MITs**') to foreign resident investors.[49] This regime is intended to enhance the ability of an MIT (particularly property trusts) to attract foreign investment.

Liability to this withholding tax is imposed under Division 840 of the 1997 Act. If there is no underlying liability to MIT withholding tax, then there is no obligation to withhold.

The definition of MIT in s 12-400 applies to fund payments in respect of the first income year starting on or after 1 July 2010 and later income years. However, if before 26 May 2010, the trust made a fund payment in relation to an income year, that definition does not apply to the particular trust for the 2011 to 2015 financial years.

A trust is a MIT if:

a. At the time the trustee makes the first fund payment in relation to the income year or at an earlier time in the income year, the trustee was an Australian resident or the central management and control of the trust was in Australia;

b. The trust is not carrying on a trading business in relation to the income year;

[49] See sections 12-375 to 12-420 (Subdivision 12-H) of Schedule 1 to the TAA.

c. The trust's investment management activities throughout the income year are carried out in Australia;

d. At the time the payment is made, the trust is a managed investment scheme;

e. For a trust that is registered under s 601EB of the *Corporations Act* 2001 (Cth) at the time the payment is made – the trust satisfies the widely-held requirements in s 12-401 in relation to the income year; and

f. For a trust that is not so registered at the time the payment is made, the trust satisfies the widely-held requirements in s 12-402 in relation to the income year the trust satisfies the licensing requirements in s 12-403 in relation to the income year, at the time the payment is made the trust is not required to be registered in accordance with s 601ED of he *Corporations Act* 2001 (Cth) because no product disclosure statement is required or because it is operated or managed by a Crown entity.

A trading trust or other trust carrying on a trading business cannot be a MIT. This includes a trust that controlled, or was able to control, directly or indirectly the affairs or operations of another person in respect of the carrying on by that other person of a trading business.

For withholding to apply, the recipient of the fund payment must have a relevant connection outside Australia. This will occur if either:

a. According to any record in the trust's possession, the recipient has an address outside Australia; or

b. The trust is authorised to make payment at a place outside Australia.

If the MIT does not have an obligation to withhold at that time, it may have an obligation to give notice to the recipient to make certain information available on a website in respect of the payment. The obligation to give a notice or to make information available on a website will continue through a chain of entities until the obligation to withhold is triggered.

Where a foreign resident invests in a MIT through an interposed entity (e.g. a custodian), the custodian is require to withhold from a payment it makes where:

a. The payment is reasonably attributable to a payment received by the custodian that was covered by a notice or information that was made available on a website; and

b. The recipient of the payment has a relevant connection outside Australia.

Withholding is not required in respect of a payment made by a corporate custodian unless the custodian is acting in the capacity of a trustee or as an agent for a principal. For this purpose, bot a public trading trust and a corporate unit trust is a company.

A non-custodian is required to withhold an amount where:

a. The non-custodian receives a payment, all or part of which is covered by a notice or information made available on a website; and

b. A foreign resident is, or becomes entitled to, an amount attributable to the payment received by the non-custodian.

If the place, address or country of residence is in a jurisdiction with which Australia has effective exchange of information on tax matters, withholding is required at 15%. In any other case, withholding is require at the rate of 30%. The amount that is required to be withheld is calculated by reference to the withholding rate that corresponds to the income year of the MIT to which the fund payment relates, not the resident trust's income year in which the beneficiary's entitlement arises: *Interpretative Decision* ATO ID 2013/63.

Information exchange countries are specified in TAR regulation 44E as:[50] Anguilla, Antigua and Barbuda, Argentina, Aruba, the Bahamas, Belize, Belgium, Bermuda, the British Virgin Islands, Canada, the Cayman Islands, China, the Cook Islands, Czech Republic, Denmark, Fiji, Finland, France, Germany, Gibraltar, Guernsey, Hungary, India, Indonesia, Ireland, the Isle of Man, Italy, Japan, Jersey, Kiribati, Republic of Korea, Macau, Malaysia, Malta, Mauritius, Mexico, Monaco, the Netherlands, Netherlands Antilles, New Zealand, Norway, Papua New Guinea, Poland, Romania, Russia, San Marino, Singapore, Slovakia, South Africa, Spain, Sri Lanka, St Christopher and Nevis, St Vincent and the Grenadnies, Sweden, Taipei, Thailand, Turks and Caicos Islands, United Kingdom, United States of America and Vietnam.

9.7 TFN Withholding for Non Residents

Under the Tax File Number ('**TFN**') System, an investment body is required to withhold tax from any income that it has been liable to pay in connection with certain investments in respect of which the investor has not quoted a TFN.

In relation to trusts in particular, the TFN withholding arrangements apply to closely held trusts, including family trusts: s 202DN to 202DR of the 1936 Act. The beneficiary is require to quote a TFN to the trustee who must then report the TFN to the Commissioner. Such trusts will need to withhold amounts from trust distributions at the top marginal rate (which includes the budget repair levy) plus Medicare if the TFN has not been provided to the trustee. Taxpayers who have tax withheld by trustees can claim a credit for the tax in their tax returns.

However, non-resident investors are exempt from the TFN quotation rules provided the investment body is required to withhold tax from the relevant interest or dividend payments: s 202EE(1) of the 1936 Act.

9.8 Agency of the Non-Resident

Every person in Australia – including those acting as trustees of trusts – holding monies due to a non-resident who derives Australian source income or capital gains, is deemed to be the non-resident's agent: ss 254 and 255 of the 1936 Act.[51] This ensures the collection of tax due by non-residents, particularly where they do not carry on business or furnish returns in Australia.

[50] An exchange agreement was signed with Uruguay on 10 December 2012 but has not yet entered into law.

[51] Interestingly, a banker may be treated as the agent of a non-resident in respect of monies in the non-resident's account: s 257 of the 1936 Act.

10 Adverse Tax Implications of an Asset Passing to a Non-Resident

Where the trustee of an Australian trust is distributions cash, or its equivalent, to a non-resident beneficiary converting the funds into the currency of the beneficiary's home jurisdiction is the main issue.

However, other issues arise where the asset itself is passing to a non-resident beneficiary. It is presumed, in analysing the tax issues of this matter, that the relevant trust deed permits an in specie distribution.

10.1 CGT Issues: Section 106-50 – But Not for Real Property

Section 106-50 of the 1997 Act is relevant, as it provides that for the purposes of Parts 3-1 and 3-3 of that Act (being the capital gains tax provisions), where a taxpayer is absolutely entitled to a CGT Asset you can disregard any CGT consequences that occur at the trustee level. The section states:

> If you are absolutely entitled to a *CGT asset as against the trustee of a trust (disregarding any legal disability), this Part and Part 3-3 apply to an act done by the trustee in relation to the asset as if you had done it.

That is, the beneficiary for whom the interest(s) are held on bare trust is treated as the owner of the CGT asset – for CGT purposes they are considered to own the interest from the time the property was acquired.

Although the Commissioner agrees that a beneficiary can be absolutely entitled to certain assets, he does not include in this land if there is more than one beneficiary: *Taxation Ruling* TR 2004/D25.[52]

This is a draft ruling that, for over 10 years now, has not been finalized. It is doubtful whether the Commissioner's reasoning would be accepted by a court or the Administrative Appeals Tribunal, as there seems no difference between land and a share in a company (which may not strictly be fungible as they are separately numbered and separately identifiable).

The Commissioner's reasons, so far as is relevant for present purposes, is as at paragraphs 10, 20 to 25, 54 and 55:

> **Core Principle**
>
> 10. The core principle underpinning the concept of absolute entitlement in the CGT provisions is the ability of a beneficiary, who has a vested and indefeasible interest in the entire trust asset, to call for the asset to be transferred to them or to be transferred at their direction. This derives from the rule *Saunders v. Vautier* applied in the context of the CGT provisions (see Explanation paragraphs 41 to 50). The relevant test of absolute entitlement is not whether the trust is a bare trust (see Explanation paragraphs 33 to 40).
>
> …

[52] *Income Tax: capital gains: meaning of the words 'absolutely entitled to a CGT asset as against the trustee of a trust' as used in Parts 3-1 and 3-3 of the Income Tax Assessment Act 1997.*

Core principle: applying it practice

20. The most straight forward application of the core principle is one where a single beneficiary has all the interests in the trust asset.

…

One beneficiary with all the interests in a trust asset

21. A beneficiary has all the interest in a trust asset if no other beneficiary has an interest in the asset (even if the trust has other beneficiaries).

22. Such a beneficiary will be absolutely entitled to that asset as against the trustee for the purposes of the CGT provisions if the beneficiary can (ignoring any legal disability) terminate the trust in respect of that asset by directing the trustee to transfer the asset to them or to transfer it at their direction (see Explanation paragraphs 76 to 79).

More than one beneficiary with interests in a trust asset

23. If there is more than one beneficiary with interests in the trust asset, then it will usually not be possible for any one beneficiary to call for the asset to be transferred to them or to be transferred at their direction. This is because their entitlement is not to the entire asset.

24. There is, however, a particular circumstance where such a beneficiary can be considered absolutely entitled to a specific number of the trust assets for CGT purposes. This circumstance is where:

- the assets are fungible;
- the beneficiary is entitled against the trustee to have their interest in those assets satisfied by a distribution or allocation in their favour of a specific number of them; and
- there is a very clear understanding on the part of all the relevant parties that the beneficiary is entitled, to the exclusion of the other beneficiaries, to that specific number of the trust's assets.

25. Because the assets are fungible, it does not matter that the beneficiaries cannot point to particular assets as belonging to them. It is sufficient in these circumstances that they can point to a specific number of assets as belonging to them. See Explanation paragraphs 80-126.

…

54. Therefore, the requirements for absolute entitlement within the context of the CGT provisions cannot be satisfied if there are multiple beneficiaries in respect of a single asset such as land. While each beneficiary may have an interest in, and therefore be entitled to, a share of the land, the asset to which the provisions refer is the land and no beneficiary in this case is entitled to the whole of it.

55. Even if the asset to which the provisions refer is a beneficiary's undivided share in the land (and, as discussed, we do not agree that it is), the beneficiary could not insist upon having that undivided share transferred to them. To do so may prejudice the other beneficiaries because the sale of the remaining undivided share may not realize the same amount as if the whole of the land had been sold and the proceeds distributed: see *Re Horsnaill* [1909] 1 Ch 631 and *Wilson v Wilson* (1950) 51 SR (NSW) 91.

In this regard the Commissioner may also seek to take, but it does not seem that he has taken, further comfort from more recent cases of:

a. *Attorney General of New South Wales v Homeland Community Ltd & Ors*[53] at [63] per Windeyer AJ;

b. *Michael Victor Henley, in the Estate of Hedy Jadwiga Weinstock and Leo Arie Weinstock*[54] at [46] and [65] per Slattery J; and

c. *Feeney v Feeney*[55] at [21] per White J.

But these cases deal with the real property and trust law considerations, not the fact that the relevant underlying asset, for CGT purposes, is the CGT asset. As made clear above, each separate part of a post-partition lot, which a registered holding co-owner holds for another co-owner, is a separate CGT asset.

Therefore, there are numerous trusts with one trustee and one beneficiary, not fewer trusts with one trustee and numerous beneficiaries. In relation to the specific CGT asset that is held for a particular co-owner, that co-owner could call for the CGT asset. It seems, therefore, that partitions involving three or more participants can involve absolute entitlement.

It is also unsatisfactory that *Taxation Ruling TR 2004/D25* remains in draft form. In the National Tax Liaison Group meeting of December 2010 (at item 9 of the minutes[56]) the Australian Taxation Office representatives made clear that:

a. the status of the ruling remains unclear; and

b. the ATO considers the finalization of the ruling as intricately linked to how it will deal with bare trusts, which also remains an unresolved issue.

[53] [2013] NSW 748.
[54] [2013] NSWSC 975.
[55] [2008] NSWSC 890.
[56] Arising in the context of insurance proceeds trusts and self-managed superannuation funds.

10.2 Unintended Tax Consequences

There are two relevant CGT Events that may apply where an interest in a trust is dealt with or where an asset is provided to a non-resident beneficiary by a testator / testatrix who was resident at the time of their death. They are respectively considered in headings 12 and 13.

11 The CGT Provisions for Australian Property & Non Residents

A foreign resident's liability for CGT is based on whether the relevant asset is "taxable Australian property". The following assets are taxable Australian property pursuant to s 855-15 of the 1997 Act:

a. taxable Australian real property;

b. an indirect interest in Australian real property;

c. a business asset of a permanent establishment in Australia;

d. an option or right to acquire any of the GST assets in (a) to (c); or

e. a CGT asset that is deemed to be Australian taxable property where a taxpayer, on ceasing to be an Australian resident, makes an election under s 104-165 of the 1997 Act.

From 8 May 2012 non-residents are not eligible for the general discount in Division 115 of the 1997 Act.

A non-final withholding tax was also introduced on 1 July 2016 to increase the recovery of CGT from foreign residents. This is discussed in more detail at heading 11.3 below.

11.1 Taxable Australian real property

Taxable Australian real property not only includes real property situated in Australia, it also extends to a lease of Australian land and mining, quarrying or prospecting rights where the materials are situated in Australia: section 855-20 of the 1997 Act and *Taxation Determination* TD 2009/18.

11.2 Indirect real property interest

Taxable Australian real property also includes an interest in Australian real property that is held indirectly through a chain of interposed entities. An indirect Australian real property interest exists where a foreign resident has a membership interest in an entity and that interest passes two tests: see s 855-25 of the 1997 Act.

The first is the *Non-portfolio Interest Test* that is passed where an interest held by an entity (the holding entity) in another entity (the test entity) and the sum of the direct participation interests held by the holding entity and its associates in the test entity is 10% or more: s 960-195 of the 1997 Act. A direct participation interest is the total interest that an entity directly holds in another entity: s 960-190 of the 1997 Act. The test time is at the time of the relevant GCT Event or any twelve-month period in the previous two years.

The second is the *Principal Asset Test* that is used to determine when an entity's underlying value is principally derived from Australian real property. A membership interest held by a foreign resident (the holding entity) in another entity (the test entity) passes the principal asset test if more than 50% of the value of the test entity's assets is attributable to Australian real property: s 855-30 of the 1997 Act. For these purposes an asset of an entity is anything recognised in commerce and business as having economic value to the entity at the time of the relevant CGT Event for which a purchaser of the entity's membership interest would be willing to pay: *Interpretative Decision* ATO ID 2012/4.

11.3 CGT Withholding Tax on Foreign Residents

The government announced on 14 May 2013 that it would introduce a 10% non-final withholding tax on payments made to foreign residents that dispose of certain taxable Australian property. The Bill for this measure, the *Tax and Superannuation Laws Amendment (2015 Measures No. 6) Act* 2015 (Cth) received Royal Assent on 25 February 2016.

The new withholding regime will apply to contracts entered into on or after 1 July 2016.

Broadly, where a foreign resident disposes of certain taxable Australian property, the purchaser will be required to withhold 10% of the purchase price[57] and pay that amount to the ATO.

While the withholding regime will protect the integrity of the foreign resident CGT regime, it also applies where the disposal of such taxable Australian property by a foreign resident generates gains on revenue account and, as a result, is taxable as ordinary income, rather than as a capital gain.

11.3.1 How is it administered?

The provisions introduce a 10% non-final withholding on payments made to foreign residents under contracts entered into on or after 1 July 2016 to dispose of certain taxable Australian property.

Three online forms are available. These are:

1. Clearance certificate application for Australian residents;

2. Rate Variation application for foreign residents and other parties; and

3. Purchaser payment notification.

These items are discussed below.

11.3.2 Assets affected

This withholding is limited to taxable Australian property, which is discussed at heading 11 above.

11.3.3 Exclusions

There are a number of exclusions. If the foreign resident vendor falls within one of these categories then the 10% withholding is not applicable:

1. Real property transactions with a market value[58] under $2 million, ensuring that the vast majority of residential house sales will be unaffected by this measure;

2. Transactions listed on an approved stock exchange; and

[57] The legislation specifies that the 10% withholding is actually on the "first element of the cost base". However, as purchase price is understood by vendors and purchasers, and in many instances will equate with the "first element of the cost base", we have used the term purchase price for simplicity.

[58] If a purchase price negotiated between a purchaser and vendor is on an arm's length basis, then the purchase price may be used as a proxy for market value.

3. The foreign resident vendor is under external administration or in bankruptcy.

11.3.4 Clearance certificates

The clearance certificate confirms that the withholding tax is not to be withheld from the transaction. For real property transactions with a market value of $2 million or above, the purchaser must withhold 10% of the purchase price unless the vendor shows the purchaser a clearance certificate from the ATO. This certificate can be provided to the purchaser on or before the settlement of the transaction. Where a clearance certificate is provided, the purchaser is not required to withhold an amount from the purchase price.

If the vendor fails to provide the certificate by settlement, the purchaser would be required to withhold 10% of the purchase price and pay this to the ATO. This means Australian resident vendors of real property with a market value of $2 million or above will need to apply for a clearance certificate and provide this to the purchaser before settlement to ensure no funds are withheld from the sale proceeds.

The vendor may apply for a clearance certificate at any time they are considering the disposal of real property. This can be before the property is listed for sale. The clearance certificate will be valid for 12 months and must be valid at the time the certificate is given to the purchaser prior to settlement.

The ATO is implementing an 'automated' process for issuing a clearance certificate. This would involve:

1. the vendor (or their agent) completing an online 'Clearance certificate application for Australian residents' form;
2. the information on the application being automatically checked against information held by the ATO to assess if the vendor should be treated as an Australian tax resident for the purposes of the transaction; and
3. the automatic issuance of a clearance certificate which removes the need for the purchaser to withhold the 10% from the sale proceeds.

In straightforward cases where the ATO has all the required information, it is expected that clearance certificates will be provided within days of being submitted.

However, where there are data irregularities or exceptions, some manual processing may be required and the clearance certificates will be provided within 14–28 days. Higher risk and unusual cases may also require greater manual intervention which could take longer.

11.3.5 Variation application

Where the vendor is not entitled to a clearance certificate, but believes a withholding of 10% is inappropriate, the vendor can apply for a variation. The vendor completes an on-line 'Variation application for foreign residents and other parties' form requesting a lesser withholding rate be determined by the ATO. In the majority of cases (where the ATO has all the required information), the variation will be provided within 28 days.

The notice of variation should be provided to the purchaser before settlement to ensure the reduced withholding rate applies.

11.3.6 Paying and reporting withholding amounts

Where a withholding obligation exists, the purchaser must withhold the relevant amount at settlement and pay it to the ATO. This should be done promptly as general interest charge may apply to late payments. The penalty for failing to withhold is equal to the amount that was required to be withheld and paid. An administrative penalty may also be imposed.

11.3.7 Purchaser payment notification

Where an amount is withheld, the purchaser is required to complete an online 'Purchaser Payment Notification' form to provide details of the vendor, purchaser and the asset being acquired to the ATO.

The purchaser will then automatically receive a payment reference number, and a payment slip which includes a barcode for use if paying in person at Australia Post. The purchaser needs to pay the withholding on or before settlement. The ATO's preference is electronic payment (funds transfer), however the purchaser can choose to pay the withheld amount at a post office with the barcode, or they can mail a cheque to the ATO with the payment reference number.

11.4 Exemption if Interest in Fixed Trust

A CGT exemption is available under section 855-40 of the 1997 Act where a foreign resident makes a capital gain or loss on an interest in a fixed trust (including a managed fund) and that interest is *not* taxable Australian property.

The exemption applies where the a fixed trust has a CGT Event happen to it and at least 90% of the trust's assets (by market value) are not taxable Australian property.

11.5 DTAs and CGT

Australia has entered into comprehensive DTAs with many countries. The articles of a DTA with particular relevance for CGT purposes are those dealing with business profits and the alienation of property.

11.5.1 Business Profits

The broad effect of the business profits articles is that the business profits of an enterprise of one of the Contracting States is exempt form tax in the other Contracting State unless the enterprise carries on trade or business in the other Contracting State through a permanent establishment. A reference to the profits of a business or activity should be read, where the context so permits, as a reference to taxable income derived from that business or activity: s 3(2) of the *International Tax Agreements Act* 1953 (Cth). In this context, an isolated adventure in the nature of trade may constitute an enterprise carried on for the purposes of Article 7 of the Australia-Swiss DTA: *Thiel v FCT.*[59] However, that case supports a view that only business profits are exempted, and that profits in the nature of trade (i.e. from a purely passive income) are not covered.

11.5.2 Alienation of Property

[59] 90 ATC 4717.

Not all agreements contain an alienation of property article and the articles in the various agreements differ in scope. For example, some agreements deal only with the alienation of land and interests in land, while others also deal with the alienation of other forms of property.

Some of the more recent DTAs contain a "sweep up" provision (e.g. Article 13.5 of the Australia-Thailand DTA) that preserves the application of a law of a Contracting State relating to the taxation of gains of a capital nature derived from the alienation of property which is not specifically covered elsewhere in the DTA.

Strictly these provisions require an actual alienation of property and relate only to property. Consequentially, capital gains arising from all the CGT Events may not be covered.

11.5.3 Application of CGT Where No DTA Applies

Where a DTA was negotiated before the enactment of the CGT provisions generally applicable to a particular CGT Event (usually events happening on or after 20 September 1985), Australia's right to tax capital gains in Australia exclusively under the CGT regime is limited by the DTA.

In *Virgin Holdings SA v FCT*[60] the court held that the Australia-Swiss DTA operated to deny Australia the right to impose CGT on a capital gain made by a Swiss resident company on the sale of share sin an Australian company. This decision was subsequently confirmed in relation to a sale of share sin Australian companies by companies resident in the United Kingdom and the Netherlands pursuant to the pre-CFT DTAs for those countries: see *Undershaft No 1 LTd; Understahft No 2 BV v FCT*.[61]

These decision are contrary to the Commissioner's former view, now withdrawn, in *Taxation Ruling* TR 2001/12.

11.6 CGT and Temporary Residents

Capital gains and losses made by a temporary resident will be treated as if they had been made by a non-resident: s 768-960 of the 1997 Act. In addition, special rules apply where there is a change of residence status. These changes reflect the policy of treating temporary residents as if they were a non-resident for CGT purposes. Therefore, from 8 May 2012 temporary residents are also not eligible for the general discount in Division 115 of the 1997 Act.

Ignoring employee shares or rights, the tax treatment of capital gains or capital losses realised by a temporary resident is determined as if the temporary resident were a foreign resident: s 768-915 of the 1997 Act. However, this only applies to capital gains and losses made by a temporary resident in their personal capacity, not in their capacity as trustee of a trust: *Interpretative Decision* ATO ID 2009/88.

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[60] 2008 ATC ¶20-051.
[61] 2009 ATC ¶20-091.

12 CGT Event E8

CGT Event E8 happens pursuant to s 104-90 of the 1997 Act. It happens if the beneficiary of a trust, including a non-resident beneficiary:

a. disposes of all or part of the beneficiary's interest in trust capital to someone other than the trustee of the trust;

b. did not acquire the interest by assignment; and

c. did not give any money or property to acquire the interest.

However, CGT Event E8 does not happen if the trust is a unit trust or a deceased estate. Nor does it operate in relation to a life interest, as this is not considered to be a capital interest in the trust: see *Private Binding Ruling* PBR 60092 (2006).

To be an interest in trust capital for these purposes, the interest must be a vested and indefeasible interest in a share of trust capital. In this regard, a taker in default does not have the required interest in the trust capital: *Taxation Determination* TD 2009/19.

If the trust interest is disposed of under a contract, the time of the CGT Event E8 is when the beneficiary enters into the contract (similarly to what happens for CGT Event A1). If there is no contract for disposal of the trust interest, CGT Event E8 happens when the beneficiary stops owning the relevant trust interest (again, as with CGT Event A1). If the trust interest is acquired by the a taxpayer as a result of CGT Event E8, it is acquired at the tie of the CGT Event.

If the taxpayer is the only beneficiary with an interest in the trust capital, a capital gain arises from CGT Event E8 if the capital proceeds from the disposal are more than the net asset amount: s 104-95 of the 1997 Act. The net asset amount is found by adding the:

a. sum of the cost bases of the trust's CGT assets acquired on or after 20 September 1985;

b. sum of the market values of the trust's CGT assets acquired before 20 September 1985; and

c. the amount of money that formed part of the trust capital at the time of disposal.

A capital loss arises from CGT Event E8 if the capital proceeds from the disposal are less than the reduced net asset amount. The reduced net asset amount is worked out in the same way as the net asset amount, except the reduced cost bases of the trust's post-CGT assets are used.

Where there is more than one beneficiary having an interest in the trust capital or a beneficiary is disposing of only a part of such an interest, capital gains and losses from CGT Event E8 are worked out in the same way, except that the net asset amount and reduced net asset amount are reduced by reference to the proportion of the trust interest being disposed of.

A capital gain or capital loss from CGT Event E8 is disregarded if the trust interest was acquired before 20 September 1985. However, if CGT Event K6 apples and pre-CGT interests are treated as post-CGT interest, CGT Event E8 will operate: see subsection 104-95(6) and the legislative note to subsection 104-100(6) of the 1997 Act.

13 CGT Event K3

CGT Event happens pursuant to section 104-215 of the 1997 Act. It happens if a taxpayer dies and a CGT asset passes to a beneficiary that is an exempt entity, is the trustee of a complying superannuation fund, a complying ADF or a PST or is not an Australian resident.

However, if the asset passes to a beneficiary that is not a resident, CGT Event K3 only happens if the taxpayer was a resident and the asset (in the hands of the beneficiary) is not taxable Australian property. "Taxable Australian property" is discussed at heading 11 above. It is also considered, in this context, in *Private Binding Ruling* PBR 78077 (2008).

The time of the CGT Event K3 is just before the taxpayer dies. If an asset is acquired by a tax-advantaged entity as a result of CGT Event K3, it is acquired at the time of the CGT Event.

A taxpayer makes a capital gain from CGT Event K3 if the market value of the asset on the day the taxpayer dies is more than its cost base. If the market value of the asset is less than its reduced cost base, a capital loss is made.

A capital gain or capital loss from CGT Event K3 is disregarded if the asset was acquired before 20 September 1985. Capital gains or losses are also disregarded if they are from a testamentary gift that would have been deductible under the normal rules if made during the taxpayer's lifetime: s 118-60 of the 1997 Act.

14 Streaming to a Non Resident Beneficiary

Where a trust estate has a net capital gain, a franked distribution or a franking credit for an income year, the position before the income year ending 30 June 2011 was that these amounts were brought into the calculation of the net income (s 95 of the 1936 Act) of the trust estate for the income year and that net income was attributed to the beneficiaries proportionately according to the presently entitled share of the trust income of the trust estate. That is no longer the position.

14.1 **Capital Gains**

Where a trust estate has a net capital gain in the income year ending 30 June 2011 or later, the *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth) applies. In very broad terms, where a trust estate has a net capital gain and 'net income' for an income year, a capital gain that is not reduced to nil by the application of the method statement in s 102-5 of the 1997 Act[62] is taken out of the operation of Division 6 of Part III of the 1936 Act: Division 6E of that Part. Instead, its treatment is governed by the provisions of Division 115 of the 1997 Act, and in particular Subdivision 115-C of that Act.

The position is that:

(a) to the extent to which a beneficiary is 'specifically entitled' to an amount of the capital gain (before applying the method statement), an appropriate part of the gain (after applying the method statement) is attributed to the beneficiary as a capital gain.

(b) to the extend to which there is no beneficiary 'specifically entitled' to an amount of the capital gain (before applying the method statement), beneficiaries have an appropriate part of the gain (after applying the method statement) attributed to them on a pro rata basis according to their share of the distributable income of the trust estate. If there is no distributable income of the trust estate for that income year (or there is part of the distributable income to which no beneficiary is presently entitled), the trustee is taxed on the amount of the capital gain (or the appropriate part of the capital gain) after applying the method statement.

(c) where the trust estate was entitled to the CGT discount capital gain concession (Division 115 of the 1997 Act) and or the CGT small business active asset reduction (Division 152 of the 1997 Act), a beneficiary's (or the trustee's) attributed capital gain is grossed up appropriately.

(d) a beneficiary's attributed capital gain (grossed up if necessary) is taken into account in the calculation of the net capital gain (or loss) of the beneficiary. When calculating the net capital gain, the beneficiary may apply the CGT discount capital gain concession and the CGT small business concessions to which the trust estate was entitled.

This regime speaks of a beneficiary being 'specifically entitled'. Section 115-228 of the 1997 Act provides:

> **Specifically entitled to an amount of a capital gain**

[62] That is, but offsetting any capital losses and net capital losses and applying any relevant CGT concessions.

(1) A beneficiary of a trust estate is ***specifically entitled*** to an amount of a * capital gain made by the trust estate in an income year equal to the amount calculated under the following formula:

$$^{*}\text{Capital gain} \times \frac{\text{Share of net financial benefit}}{\text{Net financial benefit}}$$

where:

"net financial benefit " means an amount equal to the * financial benefit that is referable to the * capital gain (after any application by the trustee of losses, to the extent that the application is consistent with the application of capital losses against the capital gain in accordance with the method statement in subsection 102-5(1)).

"share of net financial benefit " means an amount equal to the * financial benefit that, in accordance with the terms of the trust:

(a) the beneficiary has received, or can be reasonably expected to receive; and

(b) is referable to the * capital gain (after application by the trustee of any losses, to the extent that the application is consistent with the application of capital losses against the capital gain in accordance with the method statement in subsection 102-5(1)); and

(c) is recorded, in its character as referable to the capital gain, in the accounts or records of the trust no later than 2 months after the end of the income year.

Note: A trustee of a trust estate that makes a choice under section 115- 230 is taken to be specifically entitled to a capital gain.

(2) To avoid doubt, for the purposes of subsection (1), something is done in accordance with the terms of the trust if it is done in accordance with:

(a) the exercise of a power conferred by the terms of the trust; or

(b) the terms of the trust deed (if any), and the terms applicable to the trust because of the operation of legislation, the common law or the rules of equity.

(3) For the purposes of this section, in calculating the amount of the * capital gain, disregard sections 112-20 and 116-30 (Market value substitution rule) to the extent that those sections have the effect of increasing the amount of the capital gain.

Preferably the trust deed would provide for the trustee to be able to make a beneficiary 'specifically entitled' to an amount of capital.

In order to allow streaming of capital gains, however, the trust deed must give the trustee that power.

The Commissioner of Taxation has determined that it is possible (depending on the circumstances) for a beneficiary of a trust estate to be reasonably expected to receive an amount of a financial benefit referable to a capital gain for the purposes of s 115-228(1) of the 1997 Act, despite the making of the capital gain not being established until after the end of the income year: *Taxation Determination* TD 2012/11.

this has more significance since 8 May 2012, when non-residents were not longer able to access the general discount in Division 115 of the 1997 Act.

14.2 **Franking Credits**

Specific streaming provisions for franked distributions received by a trust estate in the income years ending 30 June 2011 or later were made by *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth). Where a trustee with discretion holds shares in a company as an asset of the trust and a franked distribution is made by the company to the trustee, the assessable income of the trust for the income year includes the amount of the franking credit on the distribution in addition to the franked distribution itself: s 207-35(1) of the 1997 Act.[63]

As stated above, as a result of the amendments made by that amending Act, where a trust estate receives a franked distribution, in broad terms, Division 6E of the 1936 Act takes the distribution outside the operation of Division 6 of Part III and renders it subject to Division 207 of the 1997 Act (and in particular Subdivision 207-B thereof).

As with the capital gains issues discussed, the way the streaming of a franked distribution, and the associated franking credits, is achieved is by a beneficiary or beneficiaries being made 'specifically entitled' to the franked distribution.

The concept of specific entitlement for these purposes is set out in s 207-58(1) of the 1997 Act, which provides:

> **Specifically entitled to an amount of a franked distribution**
>
> (1) A beneficiary of a trust estate is ***specifically entitled*** to an amount of a * franked distribution made to the trust estate in an income year equal to the amount calculated under the following formula:
>
> $$^{*}\text{Franked distribution} \times \frac{\text{Share of net financial benefit}}{\text{Net financial benefit}}$$
>
> where:

[63] For the situation where the trustee is assessable under ss 98, 99 or 99A of the 1936 Act, see s 207-35(5) and (6) of the 1997 Act.

"net financial benefit " means an amount equal to the * financial benefit that is referable to the * franked distribution (after any application by the trustee of expenses that are directly relevant to the franked distribution).

"share of net financial benefit " means an amount equal to the * financial benefit that, in accordance with the terms of the trust:

(a) the beneficiary has received, or can be reasonably expected to receive; and

(b) is referable to the * franked distribution (after application by the trustee of any expenses that are directly relevant to the franked distribution); and

(c) is recorded, in its character as referable to the franked distribution, in the accounts or records of the trust no later than the end of the income year.

(2) To avoid doubt, for the purposes of subsection (1), something is done in accordance with the terms of the trust if it is done in accordance with:

(a) the exercise of a power conferred by the terms of the trust; or

(b) the terms of the trust deed (if any), and the terms applicable to the trust because of the operation of legislation, the common law or the rules of equity.

Where no beneficiary is specifically entitled to a franked distribution or part of it, the beneficiaries' respective shares of the distribution, and the associated franking credit, are determined by reference to the adjusted Division 6 percentages of the beneficiaries. The starting point of that percentage is the beneficiary's share in the trust estate's net income for that income year.

There can be no streaming of franked distributions where:

(a) the trust deed does not confer an adequate power on the trustee;

(b) the trust estate does not have a positive 'net income' for the income year; or

(c) expenses that are directly relevant to the franked distribution exceed the franked distribution,

and it is not possible to stream a franking credit independent of the franked distribution to which it attaches.

14.3 Anti-Streaming Rules

However, so far as dividends are concerned, there are anti-streaming rules in Division 204 of the 1997 Act. These rules are designed to prevent such practices as circumventing the benchmark rule by exploiting the benchmark franking percentage of another entity, streaming franked distributions and tax-exempt bonus shares, or streaming imputation benefits to a member who could benefit to a greater degree than another member.

14.4 **Absence of streaming provision**

If the trust deed contains no provision which would allow the streaming of categories of income (for example, foreign sourced income) and, having regard to the Commissioner of Taxation's view on streaming following *FCT v Bamford* [2010] HCA 10, it would seem that the Commissioner would not regard the streaming of any category of income or capital gains (other than capital gains and franked distributions in accordance with the statutory provisions) as being effective for tax purposes. The Commissioner's interpretation of *FCT v Bamford* was confirmed in *FCT v Greenhatch* [2012] FCAFC 84.

14.5 **Terms to be Provided for in a Trust Document**

Given the changes in the taxation of trusts, it is recommended that trust deed (or any other constituent documents) be reviewed so as to determine:

(a) How income, capital gains and outgoings are accounted for and determined; and
(b) How income, capital gains and outgoings are to be distributed.

Some of the powers which may be advantageous to have within a trust instrument include:

(a) an accounting policy which is sufficiently broad and allows the trustee to exercise maximum discretion;
(b) the discretion to reclassify and allocate income and capital gains;
(c) the discretion to reclassify and allocate outgoings;
(d) the discretion not to recoup losses (whether income or capital in nature);
(e) the ability to allocate and stream classes of income and capital and their related tax attributes;
(f) ensure that any unpaid present entitlement / loan provisions are removed, and an ability to hold amounts subject to a sub-trust.

Some additional powers to be considered include:

(a) whether the trustee has the power to distribute income and / or capital at any time within a tax year;
(b) whether any determination of income (or capital) can be made within the income tax year; and
(c) whether the trustee has a power to determine entitlements with respect to an income tax year after the relevant year.

14.5.1 Accounting policy

Essential is ensuring that the trust deed provides guidance with respect to an accounting policy that should be used by the trustee. Such an accounting policy should provide sufficient flexibility for the trustee, so that it may depart from generally accepted accounting standards in the event that the trustee considers that it is appropriate to do so.

14.5.2 Reclassifying and allocating income and capital

As the High Court in *FCT v Bamford* accepted that the tax law income of a trust is dependent upon (amongst other things) the definition of that term in the trust deed, regard should be given to the definition of the 'income' as contained in the trusts constituent documents.

An issue to consider is whether attributed amounts (e.g. franking credits) should be included within the definition of trust income. An issue that arises is that if attributions are included in trust income (and which are not physically 'paid' by a trustee – but which follow certain amounts of income), whether by being included in trust income, and thereby providing that a trustee creates a 'present entitlement' in a beneficiary to an amount that is never received by a trustee, the trustee will be exposed to a claim in relation to amounts that are not actually received by the trustee.

It is submitted that amounts such as franking credits should be prima facie carved-out of the definition of income. However, the definition should contain discretionary elements to allow a trustee to cause such 'attributed' amounts to fall within the definition of income.

An approach which may be considered is, in defining trust income:

(a) Provide that it prima facie equals the amount provided for in s 95(1) of the 1936 Act (less any franking credits);
(b) If the tax law approach is not warranted for a particular tax period, then:
    (i) According to an accounting policy adopted by the trustee; or
    (ii) Any other basis as determined by the trustee; or

(c) In the trustee's absolute discretion, the gross income of the trust.

14.5.3 Reclassifying and allocating outgoings

In *Cajkusic v FC of T (No 2)* [2006] ATC 4752 deductions allowable to a family discretionary trust for payments that were made under an employee benefits trust arrangement in the income tax years ending 30 June 1997 and 30 June 1998 caused there to be a loss within the trust estate.

As a result of the losses, there was no distributable income of the trust. As a result, the Full Court of the Federal Court held that the lack of distributable income meant that there could be no beneficiary of the trust (for the relevant income tax years) to be "... *presently entitled* ...'"pursuant to s 97 of the 1936 Act to any amount.

It should be noted that the Commissioner's subsequent application for special leave to appeal to the High Court was rejected.

Cajkusic v FC of T (No 2) stands for the proposition that the 'distributable income' of a trust is determined by reference to proper accounting principles, as well as the terms of a trust deed. In this context distributable income is income determined according to accounting principles, and which is distributable amongst the beneficiaries. It does not alter either the income as calculated under accounting principles, of the 'net income' as determined under s 95(1) of the 1936 Act – rather, only gives a trustee the power to determine the distributable amounts.

As a result of the decision in Cajkusic, it is submitted that a trust deed should give a trustee the power to reclassify, and allocate outgoings, so that there can be 'distributable income' to which beneficiaries are presently entitled.

14.5.4 Discretion not to recoup losses (whether income or capital in nature)

It is recommended that a trustee have a discretion not to recoup losses (whether of an income or capital nature). That is, a power not to recoup losses which have arisen in the past.

15 Estate Planning

A number of tax issues arise where a beneficiary of a deceased estate is a non-resident for tax purposes. In particular, CGT may apply to the transfer of assets in a deceased's estate to a non-resident beneficiary (see the discussion of CGT Event K3 at heading 13 above). The gain arises in the deceased's final tax return and is paid by the deceased's estate.

In considering estate planning issues it important to distinguish between assets that are:

a. ***movable property*** that is property which is (generally) capable of being moved physically. An immovable property can become a movable property being sold and converted to cash or another form of investment located within Australia.

b. ***immovable property*** that is property which (generally) cannot be moved. It includes land and other tangible property that cannot be physically relocated. Intangible property rights in land are immovable, but a debt secured over land is movable.

Estate planning issues can then be teased out by way of an example.

15.1 Example

By way of example, in a situation where a deceased estate includes shares in a publicly listed company and Australian real estate and a non-resident is the sole beneficiary of the estate, then:

a. CGT is imposed on the estate upon the transfer of the shares to the non-resident. This is even though these shares are no "taxable Australian property" in the hands of the non-resident beneficiary and will not be subject to Australian taxation on the subsequent disposal by the non-resident; and

b. no CGT will be imposed on the estate upon transfer of the Australian real estate to the non-resident beneficiary. For the estate the normal CGT rollover on death will apply in relation to transfer of assets that are "taxable Australian property". The non-resident, however, will be subject to Australian tax on the subsequent disposal of the Australian real estate on the basis that the asset is "taxable Australian property".

Where the beneficiary is a non-resident, tax is paid by the estate unless the will provides otherwise. This has obvious implications when drafting the will.

15.2 For Shares in a Testamentary Trust

As shares are not "taxable Australian property" the planning requirement is to have them pass to a resident beneficiary and, thereby, avoid CGT Event K3 happening.

The easiest way to achieve this outcome is to bequeath them to a testamentary trust with the intended recipient as a beneficiary thereof, rather than bequeathing them directly to the resident beneficiary.

If the trustee of the testamentary trust later sold the shares the CGT regime would apply in the usual way. As mentioned throughout this paper, however, from 8 May 2012 there will be no discount in the capital gain made on those shares a non-resident beneficiary is made presently entitled to it.

All of the other advantages of establishing a testamentary trust would also apply in the usual way.

15.3 With Real Estate and Non-Resident Beneficiaries

There are number of planning options open in relation to real estate, which is "taxable Australian property".

First, the real property should be valued as at 7:29pm on 8 May 2012 so that the CGT discount in Division 115 of the 1997 Act can be applied to the capital gain that has accrued on the properties prior to that time.

Second, an Australian resident testamentary trust might again prove a solution. The testator / testatrix could establish an Australian resident testamentary trust under their will to hold the real estate. When it is subsequent sold (by an Australian resident entity, being the trustee) the general discount would apply. It would, however, be subject to higher marginal tax rates after that discount is applied.

16 Section 99B

It is convenient to consider s 99B of the 1936 Act in this context.

Although the purpose of s 99B of the 1936 Act was to assess trust income that had been accumulated overseas and not subject to Australian tax (as expressed in *Union Fidelity Trustee Co of Aust Ltd v FCT*[64]), its literal terms are much wider than this. In my experience the Commissioner does not apply the provision as widely as its literal terms would permit.

Subsections 99B(1) of the 1936 Act would apply to the distribution of the revaluation reserve. The operation of s 99C of the 1936 Act confirms this position. It is important, however, to set out the relevant passage of s 99B(2) of the 1936 Act in full. It provides:

> The amount that, but for this subsection, would be included in the assessable income of a beneficiary of a trust estate under subsection (1) by reason that an amount, being property of the trust estate, was paid to, or applied for the benefit of, the beneficiary shall be reduced by so much (if any) of the amount, as represents:
>
> (a) corpus of the trust estate (except to the extent to which it is attributable to amounts derived by the trust estate that, if they had been derived by a taxpayer being a resident, would have been included in the assessable income of that taxpayer of a year of income);
>
> (b) an amount that, if it had been derived by a taxpayer being a resident, would not have been included in the assessable income of that taxpayer of a year of income; …

The operation of s 99B(2)(a) of the 1936 Act was recently considered by the Full Court of the Federal Court in *Howard v FCT*.[65] The Court[66] held a resident taxpayer received over $6 million from a Jersey-based trust, the Esparto Trust. The Esparto Trust had received this amount as part of a share buy-back from another Jersey trust, the Juris Trust. The taxpayer asserted that the amount was a distribution of the corpus of the trust estate and was therefore a capital receipt. The Commissioner of Taxation did not take issue with this assertion, but said the amount was nevertheless assessable under s 99B of the 1936 Act to the extent that it was not assessable under s 97 of that legislation. The Full Court agreed, finding that the amount was caught by s 99B as it would have been assessable if derived by a resident taxpayer (i.e. the exception to the corpus exception in s 99B(2)(a) applied). This was because the distribution represented the proceeds of an off-market share buy-back, which would have been deemed (by s 159GZZZP of the 1936 Act) to be assessable dividends (under s 44 of the 1936 Act).

The Full Federal Court explained the "simple" application of s 99B(2)(a) to the complex facts of the case as follows (at [41]):

[64] (1969) 119 CLR 177.
[65] [2012] FCAFC 149.
[66] Middleton, Perram and Dodds-Streeton JJ.

> In this case, having penetrated two layers of trusts – first the Esparto Trust; then the Juris Trust – one encounters for the first time a non-trust relationship. The trustee of the Juris Trust received non-trust distributions from another Jersey company called Esparto Ltd. Although the process of conjoining Mr Howard to the amounts paid by Esparto Ltd seems complicated, in reality it is not. Section 99B(2)(a) will simply apply as many times as there are interposed layers of trusts. Each application of s 99B(2)(a) leads to a hypothetical question about whether the amounts received by the trust estate would have been assessable income if they had been earned by a resident taxpayer. Once an answer to that question is known at the level of the deepest trust the answer cascades back up to the original (genuine) resident taxpayer. To unpick that slightly: if the Juris Trust estate had been a resident taxpayer and the amounts received by it had been assessable income, then the amounts received by the Esparto Trust, although corpus, would have fallen within the parenthetic excision in s 99B(2)(a) and would have been assessable income in its hands. This, in turn, provides the affirmative answer to the question posed by s 99B(2)(a) as to whether the amounts received by the Esparto Trust estate would have been assessable income on the hypothesis that the Esparto Trust estate was a resident taxpayer. But it is that answer on that hypothesis which applies to Mr Howard himself. What is revealed therefore is not complexity but repetition.

The issue therefore becomes whether the distribution of the revaluation reserve would be assessable to an Australian resident taxpayer. This is so because it is the question for the exception in s 99B(2)(a) and it is the question itself in s 99B(2)(b).