Structuring cross-border transactions: part 2

by Renuka Somers, Senior Tax Advisor, US–Australia Tax Desk, and Peter Harper, CEO and Managing Director, Asena Advisors, LLC

In part 1 of this article, we noted that draft taxation determinations TD 2019/D6 and TD 2019/D7 raise important considerations in international tax planning and the structuring of Australian investments, with capital gains (whether foreign-sourced or not) attributed to a foreign resident beneficiary of an Australian resident trust being assessable to that beneficiary unless the trust is a fixed trust. In part 2, we delve into the international tax planning issues that the draft taxation determinations create, particularly in relation to Australia's international tax treaty obligations, and the potential impact that these determinations could have in how cross-border investments are structured.

Introduction

The Australian Taxation Office's draft taxation determinations TD 2019/D6 and TD 2019/D7 (collectively, the DTDs), which were released in September 2019, generated much controversy and criticism. The DTDs purport to extend the reach of the Australian capital gains tax rules to capital gains of a foreign resident beneficiary (FRB) of an Australian resident non-fixed trust, regardless of the source of those gains.

In part 1 of this article, we considered the changes proposed by the DTDs and the disconnect between the changes and relevant provisions of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) and the *Income Tax Assessment Act 1997* (Cth) (ITAA97). In part 2, we discuss the potential impact of the DTDs on international tax planning, and particularly how the ownership structure of Australian investments could significantly impact the tax outcomes for FRBs.

International tax planning

As noted in part 1 of this article:

- generally, under Div 855 ITAA97, foreign residents and trustees of a foreign resident trust (FRT) for CGT purposes may disregard the capital gains and losses in relation to CGT assets which are not "taxable Australian property" (TAP);[1]
- TAP includes direct or indirect interests in Australian real property, certain mining, quarrying or prospecting rights, and business assets (other than Australian real property) of an Australian permanent establishment;[2]
- an FRT is a trust that does not satisfy the requirements for being an Australian resident trust for CGT purposes. A trust is an "Australian resident trust for CGT purposes" at any time during the year:[3]
  - if the trust is not a unit trust: either the trustee is a resident or the central management and control of the trust is in Australia; or
  - if the trust is a unit trust: (1) either any property of the trust is situated in Australia or the trustee carries on business in Australia; and (2) either the central management and control of the unit trust is in Australia or residents held more than 50% of the beneficial interests in the income or property of the trust;
- the assessable income of a beneficiary of a trust who is not under any legal disability, and who is presently entitled to a share of the income of the trust, includes their share of the net income of the trust attributable to the period when the beneficiary was a resident, and their share of the net income of the trust attributable to a period when the beneficiary was not a resident and which is also attributable to sources in Australia;[4]
- an FRB (individual or company) which makes a capital gain or loss on an interest in a fixed trust which is not TAP is exempt from CGT pursuant to s 855-40 ITAA97. Additional conditions must be satisfied if the interest is TAP.[5] The trustee of a fixed trust is not liable to pay tax in respect of an amount which has been disregarded for such an FRB;[6] and
- based on the ATO's statements in TD 2019/D6, these provisions do not extend to exempting the extra capital gain recognised under Subdiv 115-C ITAA97 where an FRB derives a capital gain from a *non-fixed trust*.

For international tax planning purposes, the DTDs create some unique concerns as:

- they specifically avoid commenting on how the application of Australia's double tax agreements (DTAs) would be addressed. This creates uncertainty as to how the ATO's interpretation of the law can affect, and be affected by, Australia's treaty obligations; and
- the effect of the DTDs is that the Australian tax consequences will vary for gains derived from the disposal of non-TAP assets, depending on whether the gain is derived:
  - through direct ownership by the foreign resident;
  - as an FRB of a fixed Australian resident trust;
  - as an FRB of a non-fixed Australian resident trust; or
  - as an FRT.

The DTAs

Australia's DTAs aim to allocate taxing rights between Australia and treaty countries with respect of income movements between the countries.

In this section, we review the allocation of income rights under the Australia–United States income and capital tax treaty (the treaty)[7] in the context of the DTDs.[8]

"Residents" of the US or Australia who are "qualified persons" are entitled to the benefits available under the treaty.[9] The term "qualified persons" includes individuals, government bodies and listed entities, as well as unlisted entities that satisfy both an ownership test and a base erosion test.[10]

These tests require that:

- 50% or more of the aggregate voting power and value (of a company) or beneficial interest (in trusts or partnerships) is owned, directly or indirectly, on at least half the days of the company's taxable year by qualified persons;[11] and
- less than 50% of the entity's gross income for the tax year is paid or accrued, directly or indirectly, to persons who are not residents of either Australia or the US in the form of tax deductible payments for the taxes covered by the treaty.[12]

The beneficial interests in a trust are considered to be owned by its beneficiaries in proportion to each beneficiary's actuarial interest in the trust, with the interest of a remainder beneficiary being 100% less the aggregate percentages held by income beneficiaries. If it is not possible to determine the actuarial interest of any beneficiaries in a trust, the ownership test will not be satisfied unless all possible beneficiaries are qualified persons.[13]

For the purposes of the treaty, a person is a "resident of Australia" if the person is an Australian corporation, or "any other person (except a company as defined under the law of Australia relating to Australian tax) who, under that law, is a resident of Australia".[14] This is subject to the proviso that in relation to any income, a person who is subject to Australian tax on income from sources in Australia, or is a partnership, an estate of a deceased individual, or a trust, "shall not be treated as a resident of Australia except to the extent that the income is subject to Australian tax as the income of a resident, either in the hands of that person or in the hands of a partner or beneficiary, or, if that income is exempt from Australian tax, is so exempt solely because it is subject to United States tax".[15]

Similar provisions apply with respect to the term "resident of the United States".[16]

The treaty specifically covers Australian capital gains[17] and provides that:

- capital gains from the alienation of real property are generally taxed by the country of source,[18] and gains from business assets and shares in property holding companies are subject to specific rules.[19] These types of assets would constitute TAP for Australian purposes and are outside of the changes proposed in the DTDs;
- income from dividends, interest and royalties may be taxed in the country of residence of the recipient, with the source country applying a withholding tax of between 5% and 15%, depending on the percentage of shareholding (for dividends) and whether amounts arise in connection with a permanent establishment or fixed base, in the source country.[20] These types of income, while potentially deriving from non-TAP assets, are passive income streams and unrelated to the gains from non-TAP interests referred to in the DTDs; and
- gains from non-TAP assets could be characterised as "other income" for the purposes of the treaty, and, based on art 21 of the treaty, would be taxable by the country of residence, unless sourced in the other country:[21]

> "ARTICLE 21 Other Income
>
> (1) Items of income of a resident of one of the Contracting States, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.
>
> (2) The provisions of paragraph (1) shall not apply to income, other than income from real property as defined in paragraph (2) of Article 6 (Income from Real Property), derived by a resident of one of the Contracting States where that income is effectively connected with a permanent establishment or fixed base situated in the other Contracting State. In that case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.
>
> (3) Notwithstanding the provisions of paragraphs (1) and (2), items of income of a resident of one of the Contracting States not dealt with in the foregoing Articles of this Convention from sources in the other Contracting State may also be taxed in the other Contracting State."

Therefore, under art 21(3) of the treaty, as "the other Contracting State", Australia would *not* have taxing rights in respect of the income of an FRB (residing in the US) that is derived from non-TAP assets, and which is not sourced in Australia. Under the terms of the treaty, it is the US that has those rights. Consequently, this could lead to double taxation for the FRB, by being subject to tax in both countries.

Generally, where income is taxed in both countries, treaty relief may be provided by the country of residence crediting the tax paid or payable in the source country against the tax payable in the country of residence.[22] However, in this case, Australia is technically not the "source country". Further, query whether the income may be deemed to be sourced in Australia if it is not the country which is actually given the taxing rights under the treaty.[23] The only connection to Australia is via the residency (Australian), and form of (non-fixed), the trust from which the income was distributed. So the likelihood of the US providing a foreign tax credit in respect of the income attributed to the (US resident) FRB could be limited by this technicality.

An FRB taxpayer in this situation may need to resort to invoking the mutual agreement procedure in the treaty as a remediation measure, and would need to prove that the tax imposed on income attributed to them results, or would result, in taxation not in accordance with the provisions of the treaty.[24] This would require an FRB who is a resident of the US to present their case to the US Internal Revenue Service (IRS) within three years of an ATO assessment and for the IRS to then seek to come to an agreement with the ATO.[25]

How structure impacts tax

What the DTDs illustrate is that, in an international setting, holding interests in non-TAP assets either directly, or through a fixed trust, is far more tax-effective than holding such assets in an Australian resident discretionary trust.

We examine four potential ownership structures in examples 1 to 4 below:

- example 1: interests in non-TAP held through a discretionary (non-fixed) Australian resident trust;
- example 2: interest held directly by a foreign resident individual or company;
- example 3: interest held by an Australian resident fixed trust; and
- example 4: interest held through an FRT.

Interests in non-TAP assets held through Australian resident discretionary trusts

Example 1 demonstrates that, if the DTDs operate in the manner proposed by the ATO, the tax cost of holding non-TAP in an Australian discretionary trust structure would be prohibitive.

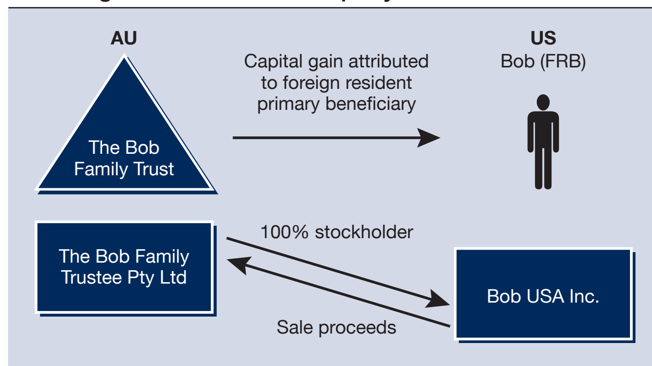
Example 1. The Bob Family Trust

An Australian resident discretionary trust (The Bob Family Trust) owns shares in a US corporation (Bob USA Inc.). Bob USA Inc. is not a "US real property holding corporation". Bob is the primary beneficiary of the trust and relocates from Australia to California, becoming a tax resident of the US and a non-resident of Australia. The Bob Family Trust remains an Australian resident trust and Bob is an FRB. The Bob Family Trust sells the stock in Bob USA Inc. (non-TAP). The gain is distributed to the Bob Family Trust and, in turn, to Bob (see Diagram 1).

In this scenario, the global effective tax rate could be as high 62.10% (if the US allows the foreign tax credit) (see Tax Matrix 1 below):

- as the sale involves the sale of shares in a US corporation that is not a US real property holding corporation, The Bob Family Trust would only be subject to CGT in Australia;
- as a consequence of the DTDs:
  - Bob would now be taxable on the gain in Australia under s 115-215(3) ITAA97, at non-resident tax rates;
  - s 855-10 ITAA97 is not applicable as the non-TAP assets are not held by Bob directly or by a company or an FRT;
  - s 855-40 ITAA97 is not applicable as the trust is not an Australian resident fixed trust; and

Diagram 1. Australian resident discretionary trust owning shares in a US company



Tax matrix 1. Sale of Bob USA Inc. → Capital gain (US) by AU non-fixed trust → Distribution to FRB (AU and US)

Tax in the US: trust		
Gain on sale of Bob USA Inc.		$100.00
Total US tax paid		–
US effective tax rate		0.00%
Tax in Australia: FRB		
Net income of the trust		$100.00
Gross-up of US tax paid		–
Gross income in Australia		$100.00
Australian CGT general discount	50%	$(50.00)
Net capital gain		$50.00
Beneficiary tax payable by trustee (s 98(3) ITAA36) (non-resident beneficiary)		
Distribution to beneficiary (net capital gain)		$50.00
Gross-up of discount capital gain		$50.00
Distribution to beneficiary		$100.00
Less: discount capital gain		–
		$100.00
Tax payable by trustee (non-resident rates)	45%	$(45.00)
Net distribution		$55.00
Total AU tax paid		$45.00
AU effective tax rate		45%
Tax in the US: FRB		
Distribution to beneficiary (net capital gain)		$100.00
Federal income tax (@ 37%)	37%	$(37.00)
California state income tax (@ 13.3%)	13.3%	$(13.30)
US federal NIIT (3.8%)	3.8%	$(3.80)
Less: AU foreign tax credit (if allowed by the US)		**$37.00**
Distribution to beneficiary		$82.90
Total US tax payable by beneficiary		$17.10
US effective tax rate		17.10%
Global effective tax		$62.10
Global effective tax rate		62.10%

  - as Bob is an FRB, the trustee would be assessed under s 98(3) ITAA36 on the attributed capital gain; and
- as a US tax resident, Bob would be liable to pay taxes in the US on his worldwide income[26] and would be assessable on the gain in the US. It is questionable whether, under the DTA, the US would grant a foreign tax credit in respect of the taxes paid in Australia (see discussion above), potentially creating a global tax rate of 99.1% (through a combined tax rate of US federal 37%, US net investment income tax (NIIT) 3.8%, California state 13.3%, and Australian 45%, disregarding exchange rate differentials). If the US did allow the Australian foreign tax credit, it would be limited to the US federal tax payable on the distribution,[27] leaving an 8% differential (between the Australian rate of 45% and the US federal rate of 37%), leaving a global effective tax rate of 62.10%.

Interests in non-TAP assets held through other structures

In contrast:

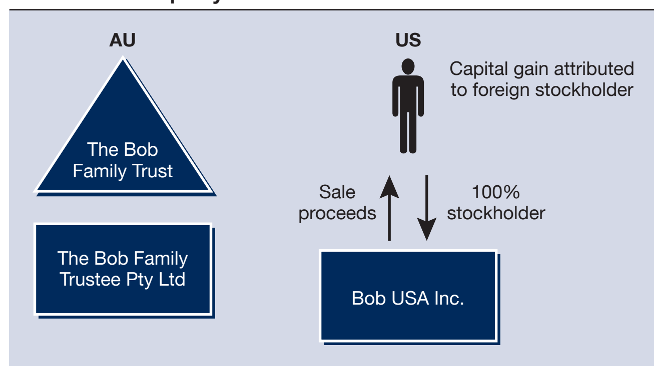
- if the shares in Bob USA Inc. were held directly by Bob and Bob USA Inc. did not hold any TAP, no tax would be payable in Australia under s 855-10 ITAA97; and
- if the shares (non-TAP assets) were held by an Australian resident fixed trust, the capital gain attributed to Bob would be exempt from tax in Australia under s 855-40 ITAA97.

In each of these scenarios, this would create a global effective tax rate of 37.10% (see examples 2 and 3, and Diagrams 2 and 3). These results create tax planning opportunities for Australian entrepreneurs who are expanding overseas, to hold their interests in a US structure either personally or through Australian resident fixed trusts.

It also means that, if an interest in non-TAP was held by an FRT, the gain would be exempt from tax in Australia under s 855-10. So, if in the above example, Bob controls a US trust and is the "grantor" of the trust for the purposes of the US grantor trust rules,[28] a gain on non-TAP assets would be attributed to him for US tax purposes and would be taxable at the rate of 37.10% (see example 4 and Diagram 4).

Example 2. Interest held through direct ownership by a foreign resident individual or company

Diagram 2. Foreign resident individual owning shares in a US company

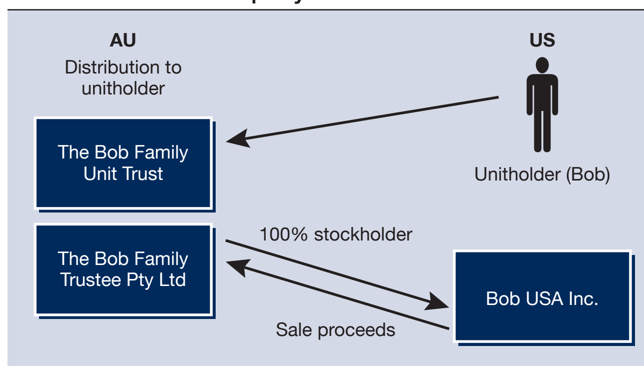


Tax matrix 2. Sale of Bob USA Inc. → Capital gain by US person (US)

Tax in the US: Bob		
Gain on sale of Bob USA Inc.		$100.00
US federal corporate tax (@ 20%)	20%	$(20.00)
US federal NIIT (3.8%)	3.8%	$(3.80)
California state CGT (@ 13.3%)	13.30%	$(13.30)
Net		$62.90
Total US tax paid		$37.10
US effective tax rate		37.10%
Tax in Australia: non-resident, non-tap asset		
Gain derived by foreign resident		–
Tax payable by beneficiary (non-resident rates)	45%	–
		–
Total AU tax paid		–
AU effective tax rate		0%
Global effective tax		$37.10
Global effective tax rate		37.10%

Example 3. Interest held by an Australian resident fixed trust

Diagram 3. Australian resident fixed trust owning shares in a US company

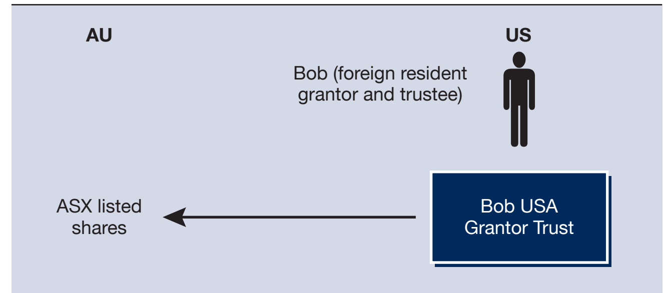


Tax matrix 3. Sale of Bob USA Inc. → Capital gain (US) by AU fixed trust → Distribution to foreign resident unitholder (AU and US)

Tax in the US: AU fixed trust		
Gain on sale of Bob USA Inc.		$100.00
Total US tax paid		–
US effective tax rate		0.00%
Tax in Australia		
Net income of the trust		$100.00
Gross-up of US tax paid		–
Gross income in Australia		$100.00
Australian CGT general discount	50%	$(50.00)
Net capital gain		$50.00
Tax payable by trustee (s 98(3) ITAA36) (non-resident beneficiary)	45%	–
Net distribution		$50.00
Unitholder		
Distribution to unitholder		$50.00
Gross-up of tax paid by trustee		–
Gross-up of discount capital gain		$50.00
Distribution to beneficiary		$100.00
Less: discount capital gain		–
Net distribution		$100.00
Tax payable by unitholder (non-resident rates)	45%	–
Less: tax paid by trustee		–
Tax payable by beneficiary (non-resident rates)		–
Total AU tax paid		–
AU effective tax rate		0%
Tax in the US: foreign resident unitholder		
Distribution to unitholder (net capital gain)		$100.00
US federal CGT (@ 20%)	20%	$(20.00)
California state income tax (@ 13.3%)	13.3%	$(13.30)
US federal NIIT (3.8%)	3.8%	$(3.80)
Less: foreign tax credit		–
Net		$62.90
Total US tax payable by foreign resident unitholder		$37.10
US effective tax rate		37.10%
Global effective tax		$37.10
Global effective tax rate		37.10%

Example 4. Interest held through an FRT

Diagram 4. Foreign resident trust owning Australian non-TAP assets



Tax matrix 4. Sale of Bob USA Inc. → Capital gain (US) by FRT → Distribution to FRB (US)

Tax in the US: US grantor trust		
Gain on sale of Bob USA Inc.		$100.00
Gain assessed to grantor		$100.00
US federal corporate tax (@ 20%)	20%	$(20.00)
US federal NIIT (3.8%)	3.8%	$(3.80)
California state CGT (@ 13.3%)	13.30%	$(13.30)
Net		$62.90
Total US tax paid		$37.10
US effective tax rate		37.10%
Tax in Australia		
Not applicable — FRBs and FRTs may disregard the capital gains and losses in relation to non-TAP CGT assets (s 855-10 ITAA97)		

Conclusion

As presently worded, the DTDs will have a significant impact on the FRBs of Australian resident non-fixed trusts, subjecting them to CGT in Australia, even on gains which do not have an Australian source. As discussed in part 1 of this article, it is difficult to reconcile the proposed operation of the DTDs with the current legislative framework within which the DTDs seek to operate. It is also difficult to reconcile them with the intent and operation of the DTAs.

The DTDs could make it compelling for Australian entrepreneurs to restructure the assets held by their Australian trusts *before* they leave Australia for the US, or to return to Australia before a significant sale or other disposal of non-TAP held in an Australian resident non-fixed trust. We may also see the use of unit trusts becoming more prevalent in such cases.

Renuka Somers
Senior Tax Advisor
US–Australia Tax Desk
Asena Advisors, LLC

Peter Harper
CEO and Managing Director
Asena Advisors, LLC

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References

1 S 855-10 ITAA97.
2 Ss 855-15 and 855-20 ITAA97.
3 S 995-1(1) ITAA97.
4 S 97(1) ITAA97.
5 At least 90% (by market value) of the underlying assets of the trust must not be TAP. Alternatively, at least 90% (by market value) of the assets held by other fixed trusts in which the first trust has a direct or indirect interest must not be TAP (s 855-40(5) to (8) ITAA97).
6 S 855-40(3) ITAA97.
7 *Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, 1982, as amended by the United States Protocol (No.1) 2001.
8 The treaty substantially reflects the basis of allocating income rights in Australia's other DTAs.
9 Art 16(1) of the treaty.
10 Art 16 of the treaty.
11 Art 16(2)(g)(i) of the treaty.
12 Art 16(2)(g)(ii) of the treaty.
13 *The US Treasury Technical Explanation of the Protocol between the Government of the United States of America and the Government of Australia signed at Canberra on September 27, 2001, amending the Convention between the United States of America and Australia with respect to taxes on income signed at Sydney on August 6, 1982*. Available at www.treasury.gov/resource-center/tax-policy/treaties/Documents/teaustra.pdf.
14 Art 4(1)(a)(i) to (ii) of the treaty.
15 Art 4(1)(a)(iii) to (iv) of the treaty.
16 Art 4(1)(b) of the treaty.
17 Art 2(1)(b)(i) of the treaty.
18 Arts 6 and 13 of the treaty.
19 Art 13 of the treaty.
20 Arts 10 to 12 of the treaty.
21 Art 21 of the treaty.
22 Art 22 of the treaty.
23 Art 27 of the treaty.
24 Art 24(1)(a) of the treaty.
25 Art 24(1)(b) of the treaty.
26 S 7701(a)(30) of the US *Internal Revenue Code* (IRC).
27 S 904 IRC.
28 A "grantor trust" is taxed under ss 671 to 679 of the IRC as if it is owned in whole or in part by the "grantor", with the income of the trust being attributed to the grantor to the extent to which the grantor is considered to "own" the trust, ie if they have created the trust, or directly or indirectly made a gratuitous transfer of property to a trust, or retain power to control or direct the trust's income or assets. For a further discussion on grantor trusts see "Is your Australian trust a "grantor trust" for US tax purposes?". Available at https://asenaadvisors.com/blog/is-your-australian-trust-a-grantor-trust-for-us-tax-purposes.

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