Structuring cross-border transactions: part 1

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

TD 2019/D6 and TD 2019/D7 raise important considerations in international tax planning and the structuring of Australian investments, as all capital gains (whether foreign-sourced or not) that are attributed to a foreign resident beneficiary of an Australian resident trust are now assessable to that beneficiary, unless the trust is a fixed trust. The draft determinations are contentious due to a disconnect between the relevant legislative provisions and the ATO's interpretation of them, and as they do not address Australia's double tax agreements. Further, they lead to differing tax outcomes for foreign residents assessed on capital gains from the disposal of non-taxable Australian property, depending on the structure through which they derive that gain. Consequently, foreign resident taxpayers require more clarity on this aspect of Australian tax law.

Introduction

The Australian Taxation Office's release of draft taxation determinations TD 2019/D6 and TD 2019/D7 (collectively, the DTDs) in September 2019 has generated much controversy. The DTDs have been widely criticised by tax practitioners for being inconsistent with the policy intent of, and imposing an incorrect interpretation of, the legislative context for the assessment of foreign resident beneficiaries (FRBs) of Australian resident trusts.[1]

The combined effect of the DTDs is that capital gains (regardless of source) attributed to an FRB of an Australian resident trust are assessable to that FRB, unless the trust is a fixed trust. The DTDs therefore raise important considerations for international tax planning, illustrating how the ownership structure of investments can significantly impact the tax outcomes for FRBs if held directly or through a fixed trust, instead of being held through discretionary trusts.

In this article, we consider the proposed changes with each taxation determination in the context of relevant provisions of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) and the *Income Tax Assessment Act 1997* (Cth) (ITAA97), and in part 2, we consider the potential impact of the changes on international tax planning.

The taxation of capital gains for foreign residents

The following key concepts and provisions of the ITAA36 and the ITAA97 are relevant, and provide context, for the discussion below.

The assessable income of a foreign resident includes ordinary and statutory income derived, directly or indirectly, from Australian sources, and statutory income which the ITAA36 and the ITAA97 includes based on other than an Australian source.[2] In contrast, the assessable income of an Australian resident includes ordinary and statutory income from *all* sources.[3]

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 a 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] For an FRB, a trustee is liable to be assessed and pay tax on the net income of the trust attributable to that FRB at the applicable tax rate.[5]

Assessable income includes net capital gains, and the ITAA97 provides a method statement for the purposes of calculating those gains.[6] When applying this method statement to calculate the net capital gains of a trust, Subdiv 115-C ITAA97 treats a beneficiary (resident or FRB) as having an "extra" capital gain (even though no CGT event has happened directly to the beneficiary) calculated by reference to s 115-215, so that the beneficiary can apply capital losses and the appropriate discount percentage (if any) to those gains.[7] For an FRB, the trustee must "gross up" the FRB's attributable capital gains for any discount capital gains and franking credits.[8]

A foreign resident who directly holds non-taxable Australian property (TAP) and the trustee of a foreign trust holding non-TAP can both disregard a capital gain or a capital loss from a CGT event in relation to the non-TAP.[9]

Similarly, a capital gain that an FRB of an Australian resident trust makes is disregarded where the trust is a "fixed" trust.[10] A trust is a fixed trust if beneficiaries have fixed entitlements to all of the income and capital of the trust.[11] A fixed entitlement is determined by reference to a vested and indefeasible interest in a share of the income or capital of a trust pursuant to the terms of its trust deed.[12] The Commissioner has the discretion to treat an interest as a fixed entitlement in certain circumstances; however, this discretion cannot be exercised in relation to default beneficiaries and mere objects of discretionary trusts.[13]

The DTDs

TD 2019/D6

In TD 2019/D6, the ATO states that Subdiv 855-A ITAA97 does not disregard a capital gain that an FRB (or a temporary resident beneficiary) of a resident non-fixed trust makes because of s 115-215(3) ITAA97. Once finalised, the taxation determination is to operate retrospectively.

The ATO distinguishes between fixed trusts and non-fixed trusts, stating that a capital gain attributed to an FRB under s 115-215(3) is disregarded only if the trust is an Australian resident *fixed* trust — the consequence of which is that an FRB is assessable on capital gains on non-TAP that is distributed by an Australian-resident non-fixed trust.

The ATO explains its reasoning and the interaction of the relevant legislative provisions on the basis that favourable taxation treatment is warranted as:[14]

- a foreign resident is "investing" and bringing funds into Australia (whether directly or through a fixed trust), which does not occur with the object of a non-fixed or discretionary trust;
- the specific exemption in s 855-40 ITAA97 for fixed trusts is a strong indicator that beneficiaries of non-fixed trusts are not included in the application of the "general" exemption in s 855-10 ITAA97 which allows a capital gain to be disregarded if the taxpayer is a foreign resident (or the trustee of a foreign trust) and the CGT asset is not TAP; and
- a capital gain that an FRB makes because of s 115-215(3) is not a capital gain from a CGT event that happens to the beneficiary, but rather an event that happens to the trustee — if s 855-10(1) could disregard trust capital gains attributed to FRBs generally, it would do so without regard to whether the trust is fixed or not, thereby making s 855-40 redundant.

TD 2019/D7

In TD 2019/D7, the ATO states that the concept of "source" is not relevant:

- to determining whether an amount of a trust's capital gain is assessable to the FRB or trustee; and
- in relation to an FRB's share of TAP gains of a non-resident trust and a trustee's share of a capital gain to which s 115-222 ITAA97 applies.

TD 2019/D7 is intended to apply to capital gains included in the net income of a trust estate for Australian tax years ending 30 June 2020 and onwards.

The ATO explains its disregard of the source concept in TD 2019/D7 as follows:[15]

- the phrase "source concept'" refers to the limitation in Div 6 ITAA36 on the assessment of non-residents (or trustees) to amounts "attributable to sources in Australia" and cites ss 98A(1)(b) and 98(2)(e) ITAA36;[16]
- the capital gains and losses of a resident trust are determined without regard to whether they arise from TAP, or whether the trust has non-resident beneficiaries;
- s 115-220 ITAA97 increases the amount assessable to the trustee under s 98 without regard to whether the beneficiary's attributable gain satisfies the conditions in s 98 ITAA36 — the effect of which is to make the amount drawn from Subdiv 115-C ITAA97, without regard to source, assessable and taxable to the trustee under s 98;
- while s 6-10(5)(a) ITAA97 requires non-residents to include only Australian-sourced statutory income in their assessable income, s 6-10(5)(b) also includes other statutory income where a provision assesses it on some basis other than it having an Australian source; and
- s 99D ITAA36 (which can provide an FRB with a refund of tax paid by the trustee under s 99A ITAA36 on income from non-Australian sources) is subject to the discretion of the Commissioner in s 99D(2) to refuse a refund where there was a purpose of enabling the beneficiary to obtain the refund.

What does this mean?

As a consequence of the DTDs, capital gains (regardless of source) attributed to an FRB of an Australian resident trust would be assessable to that FRB, unless the trust is a fixed trust for s 855-40 ITAA97 purposes. Generally, s 855-40 provides a CGT exemption to an FRB for a capital gain or loss on an interest in a fixed trust that is not TAP.

The DTDs have been widely criticised by tax practitioners for misinterpreting the application of, and policy intent behind, Div 855 and Subdiv 115-C ITAA97 and Div 6 and Div 6E ITAA36. These criticisms have been widely reported and appear in a number of technical submissions made by professional services firms to the ATO since the release of the DTDs, and it is unnecessary to restate them here.

In the authors' opinion, there are two key repercussions of the DTDs:

- it is difficult to reconcile the relevant legislative provisions with the interpretation extended to them by the ATO in its discussion of the intended operation of the DTDs. If the DTDs are finalised in their present form, legislative changes are required to address this disconnect; and
- the DTDs also create concerns from an international tax planning perspective, as:
  - the DTDs both specifically state that they do not deal with the application of Australia's double tax agreements (DTAs). This creates considerable uncertainty as to how the ATO's interpretation of the relevant provisions would affect, and be affected by, Australia's obligations under the DTAs; and
  - the tax treatment of gains derived from the disposal of non-TAP assets will vary for a foreign resident, depending on whether the gain is attributable to the foreign resident:
    - through direct ownership;
    - as an FRB of a fixed Australian resident trust;
    - as an FRB of a non-fixed Australian resident trust; or
    - as a trustee of a foreign trust.

The international tax aspects of the DTDs are discussed in part 2 of this article.

Disconnect between the DTDS and the ITAA36 and the ITAA97

How do we reconcile the DTDs with s 98A and Div 6E ITAA36?

Section 98A(1)(b) ITAA36 states:

> "98A(1) *Where the trustee of a trust estate is assessed and is liable to pay tax* in respect of the whole or a part of a share of the net

income of a trust estate of a year of income in pursuance of subsection 98(3), *the assessable income of the beneficiary who is presently entitled to that share of the income of the trust estate shall include*:

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

(b) *so much of the individual interest of the beneficiary in 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*." (emphasis added)

This would clearly seem to indicate that an FRB's share of the net income of a trust should only include that which is referable to *Australian sources*.

The explanatory memorandum to the Income Tax Assessment Amendment Bill 1983 (EM), which inserted s 98A into the ITAA36,[17] states:

"Clause 18: Liability of Trustee

This clause proposes the amendment of section 98 of the Principal Act to include two new sub-sections …The new sub-sections of section 98 will provide, broadly, that the trustee of a trust estate is to be assessed and liable to pay tax in respect of the relevant share of the trust income to which a beneficiary who is a non-resident at the end of the year of income is presently entitled …

Subject to the tests provided, proposed new sub-section 98(4) will apply where the beneficiary is an individual …

If all of the above tests are satisfied, *the trustee will be taxed on behalf of the beneficiary* in respect of the trust income from any source that is attributable to a period when the beneficiary was a resident (paragraph 98(4) (c)) *and in respect of the trust income from Australian sources that is attributable to a period when the beneficiary was a non–resident* (paragraph 98(4) (d)). The trustee will be so taxed at the rates of tax applicable to individuals …

Clause 19: Non-resident beneficiaries assessable in respect of certain income

By this clause, it is proposed to insert a new section 98A in the Principal Act to provide for a non-resident beneficiary, on whose behalf a trustee has been taxed under new sub-section 98(3) or (4), to be also taxed on the particular trust income — with an appropriate credit being allowed for the tax paid by the trustee. The proposed new section will also provide for a refund of any excess of the tax paid by the trustee over that assessed to the beneficiary …

The new sub-section will also apply where the trustee is taxed under new sub-section 98(4) on behalf of an individual beneficiary. Apart from providing a means of second recourse in respect of the tax involved, this will ensure, on one hand, that an individual beneficiary's total income is brought to account and the tax calculated accordingly and, on the other hand, that the beneficiary is not disadvantaged in relation to any deduction and/or rebate from which he or she would have benefited if he or she continued to be taxed directly under section 97, and which will not be allowable in the assessment on the trustee under sub-section 98(4) …

Where the proposed new sub-section applies, *the beneficiary will be taxed on the trust income* from any source that is attributable to any period when the beneficiary was a resident (paragraph (a)) and on that income *from Australian sources that is attributable to a period when he or she was a non–resident* (paragraph (b)).

Proposed new sub-section 98A(2) will provide that where sub-section 98A(l) applies — that is, where a trustee is taxed under sub-section 98(3) or (4) and the beneficiary also is taxed under sub-section 98A(l) — the tax paid by the trustee is to be offset against that assessed to the beneficiary." (emphasis added)

The ATO seems to dismiss this point in TD 2019/D7, stating:

"15. In other words, *the effect of section 115–220 is merely to make the amount drawn from Subdivision 115–C, without regard to source, both assessable and taxable to the trustee under section 98 of the ITAA 1936*. This applies even if there is no other amount (based on the Division 6E net income) assessable to the trustee ...

16. *Similarly, the conditions in subsection 98A(1) of the ITAA 1936 have no application to determine the beneficiary's capital gains, as this is done by section 115–215 and other provisions within Subdivision 115–C.*

17. Division 6E of Part III of the ITAA 1936 (Div 6E) … prevents double taxation by ensuring capital gain amounts are disregarded in determining the trust income and net income that may be assessed through the ordinary operation of Division 6 of the ITAA 1936." (emphasis added)

However, the relevant provisions of Div 6E state:

"Section 102UX

(1) Make the assumptions in the following subsections for the purposes of working out in accordance with Division 6 an amount:

(a) *included in the assessable income of a beneficiary of a trust estate under section 97, 98A* or 100; or

(b) *in respect of which a trustee of a trust estate is liable to pay tax under section 98*, in relation to a beneficiary of the trust estate; or

(c) in respect of which a trustee of a trust estate is liable to pay tax under section 99 or 99A.

…

(2) Assume that the income of the trust estate were equal to the Division 6E income of the trust estate.

(3) Assume that the net income of the trust estate were equal to the Division 6E net income of the trust estate.

(4) Assume that the amount of a present entitlement of a beneficiary of the trust estate to the income of the trust estate were equal to the amount of the beneficiary's Division 6E present entitlement to the income of the trust estate.

Section 102UY

…

(2) The ***Division 6E income***, of the trust estate, is the income of the trust estate worked out on the assumption that *amounts attributable to the things mentioned in paragraph 102UW(b) were disregarded*. The Division 6E income of the trust estate cannot be less than nil.

(3) The ***Division 6E net income***, of the trust estate, is the net income of the trust estate worked out on the *assumption that the things mentioned in paragraph 102UW(b) were disregarded*. The Division 6E net income of the trust estate cannot be less than nil.

(4) A beneficiary of the trust estate has an amount of a *Division 6E present entitlement to the income of the trust estate* that is equal to the amount of the beneficiary's present entitlement to the income of the trust estate, decreased by:

(a) for each capital gain taken into account as mentioned in paragraph 102UW(b) — so much of the beneficiary's share of the capital gain as was included in the income of the trust estate; and

(b) for each franked distribution taken into account as mentioned in paragraph 102UW(b) — so much of the beneficiary's share of the franked distribution as was included in the income of the trust estate …" (emphasis added)

Section 102UW(b) ITAA36 mentions the following, which is to be disregarded for s 102UY ITAA36 purposes:

"This Division applies if:

(a) the net income of a trust estate exceeds nil; and

(b) any of the following things are taken into account in working out the net income of the trust estate:

(i) a *capital gain* (to the extent that an amount of the capital gain remained after applying steps 1 to 4 of the method statement in subsection 102-5(1) of the Income Tax Assessment Act 1997);

(ii) a *franked distribution* (to the extent that an amount of the franked distribution remained after reducing it by deductions that were directly relevant to it);

(iii) a *franking credit*." (emphasis added)

It would seem that Div 6E would only operate to disregard a capital gain *already included* in the net income of the trust estate and to which (for example) a beneficiary was assessable under s 98A and the trustee was liable to pay tax for under s 98 — and which, at the threshold level, would *exclude*, in the case of an FRB, capital gains attributable to CGT assets which do not have an Australian source.

"… the ownership structure of investments can significantly impact the tax outcomes for FRBs."

Residency and source: common law, the ITAA36 and the ITAA97, and ATO interpretation

Common law

The concept of "source" has its origin in common law and can vary depending on the type of income that is subject to assessment, with the focus being on the origin of the income. For example, in *Nathan v FCT*,[18] the High Court stated that the source of dividends was to be determined by the "real source of production of the dividend" which the court attributed to the company's operations which generated the profits for the payment of the dividends. This concept was reiterated by the Full High Court in *Esquire Nominees Ltd v FCT*:[19]

"… the place where the distributed profits were made is the geographical source of the fund out of which the dividend itself is declared: therefore it may be said that that place is the geographical source of the dividend."

Similarly, the place where the intellectual property from which the right to receive royalties arose was held to be the source of the royalties in decisions such as *FCT v United Aircraft Corporation*.[20] With interest, in *FCT v Spotless Services Ltd*,[21] the Full Federal Court upheld Lockhart J's conclusion in the Federal Court that the loan contract which bound the parties was concluded with the delivery of the check in the Cook Islands, such that the interest income was sourced there.

The ITAA36, the ITAA97 and the DTAs

What the legislative provisions discussed above illustrate is that, when determining liability to taxation, the considerations applicable to a taxpayer are, first, their *residency* and, then, the *source* of that income.

The residency–source dichotomy has been incorporated in the Australia–United States income and capital tax treaty (treaty),[22] with the taxing rights being primarily attributed based on the residency of the taxpayer and with (secondary) withholding tax rights being allocated to the country of source.[23]

For example, the treaty states:

"Article 10 Dividends

(1) Dividends paid by a company which is a resident of one of the Contracting States for the purposes of its tax, being dividends to which a resident of the other Contracting State is beneficially entitled, may be taxed in that other State.

(2) However, those dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident for the purposes of its tax, and according to the law of that State, but: …

Article 11 Interest

(1) Interest arising in one of the Contracting States, being interest to which a resident of the other Contracting State is beneficially entitled, may be taxed in that other State.

(2) However, that interest may also be taxed in the Contracting State in which it arises, and according to the law of that State, but the tax so charged shall not exceed 10 percent of the gross amount of the interest …

Article 12 Royalties

(1) Royalties from sources in one of the Contracting States, being royalties to which a resident of the other Contracting State is beneficially entitled, may be taxed in that other State.

(2) Such royalties may be taxed in the Contracting State in which they have their source, and according to the law of that State, but the tax so charged shall not exceed 5 percent of the gross amount of the royalties …"

The ATO

The ATO's approach with the DTDs (at least in this context, where residency and source converge) is to *eliminate* the concept of source when it comes to taxing capital gains attributed to an FRB by adopting a "formulaic" approach to statutory interpretation. This approach is also seen in TD 2019/D10 which was released in October 2019 (soon after the release of TD 2019/D6 and TD 2019/D7) and which discusses the foreign income tax offset (FITO) limit calculation. The ATO states that net capital gains are to be excluded from the ambit of the income captured for the purposes of the FITO calculation as they do not have a source:

> "4. The FITO limit calculation involves a comparison between Australian tax actually payable and the Australian tax that would be payable if certain income, and deductions reasonably related to that income, were disregarded …
>
> 6. Generally, the higher the amount of income captured under paragraph 770-75(4)(a), the higher the FITO limit …
>
> 9. Amounts are included under subparagraph 770-75(4)(a)(ii) if they are amounts of 'ordinary income' or 'statutory income' from a 'source other than an Australian source'.
>
> 10. A net capital gain is an amount of statutory income. Each capital gain is not an amount of 'statutory income'.
>
> 11. *A net capital gain does not have a source. It is a product of capital gains and capital losses made during the income year from Australian and non–Australian sources, the application of unapplied net capital losses from earlier income years and applicable discounts.*
>
> 12. Subparagraph 770-75(4)(a)(ii) does not allow you to disaggregate a net capital gain (the singular amount of 'statutory income') to identify capital gains that have been included in working out your net capital gain." (emphasis added)

As with TD 2019/D6 and TD 2019/D7, TD 2019/D10 has been criticised as being contrary to policy and statute:[24]

> "It is contrary to this policy [relief against double taxation] to suggest that foreign sourced capital gains can never be taken into account in determining this limit merely because the capital gains tax regime aggregates multiple capital gains and losses and applies concessions to determine one assessable amount being a net capital gain. It would lead to artificial differences if a taxpayer could obtain a better outcome because a foreign sourced gain is assessable as ordinary income on revenue account and therefore assessable in its own right."

Further, TD 2019/D10 does not provide any support for the ATO's assertion that a net capital gain inherently cannot have a source, with this point being what the ATO's conclusion ultimately turns on in TD 2019/D10. The authors believe that the context of the income tax legislation leads to a contrary conclusion in this regard.

Conclusion

There is a disconnect between the DTDs and the relevant provisions of the ITAA36 and the ITAA97 and ATO clarification would be helpful to address these matters. Otherwise, accompanying legislative change is required if the DTDs are to be finalised in their present form. The DTDs also create international tax structuring issues. These are discussed in part 2 of this article.

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

Peter Harper
CEO and Managing Director
Asena Advisors, LLC

References

1 Being Subdiv 115-C ITAA97, Div 6 ITAA36, Div 6 ITAA97, and Div 855 ITAA97.
2 Ss 6-5(3) and 6-10(5) ITAA97.
3 Ss 6-5(2) and 6-10(4) ITAA97.
4 S 97(1) ITAA36.
5 S 98(2A) and (3) ITAA36.
6 S 102-5 ITAA97.
7 S 115-215(1) and (4A) ITAA97.
8 Ss 115-220 and 115-225 ITAA97.
9 S 855-10 ITAA97.
10 S 855-40 ITAA97.
11 S 995-1 ITAA97.
12 S 272-5(1), Sch 2F ITAA36. See also PCG 2016/16.
13 S 272-5(3), Sch 2F ITAA36.
14 Paras 11 to 21 of TD 2019/D6.
15 Paras 12 to 21 of TD 2019/D7.
16 Para 2 of TD 2019/D7.
17 By Act No. 14 of 1983.
18 [1918] HCA 45.
19 [1973] HCA 67 per Barwick CJ at [13].
20 ([1943] HCA 50. See also *Curtis Brown Ltd (as Agents for Stella Benson) v Jarvis* (1929) 14 TC 744 and *International Combustion Ltd v IR Commrs* (1932) 16 TC 532
21 95 ATC 4775.
22 *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.
23 See arts 10 to 12 of the treaty which address the taxing rights in respect of dividends, interest and royalties.
24 Chartered Accountants ANZ submission on TD 2019/D10 dealing with capital gains and the calculation of the foreign income tax offset limit, 27 November 2019. Available at www.charteredaccountantsanz.com/news-and-analysis/advocacy/policy-submissions/submission-on-td-2019-d10-dealing-with-capital-gains-and-foreign-income-tax-offset-limit.