The Tax Summit

Session 5.1: Australian beneficiaries of foreign trusts

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1. Overview

In this session we will explore the key Australian tax considerations that arise in relation to foreign trusts with Australian resident beneficiaries, including:

- an overview of Australian and international tax residency principles as they apply to individuals, trusts and corporations;
- the tax implications of foreign trust distributions made to Australian resident beneficiaries focusing on the operation of section 99B; and
- an outline of the relevant anti-deferral regimes, including the application of the transferor trust rules and controlled foreign company rules.

This paper is not intended to provide an exhaustive analysis of all of the issues at great length. Instead, this paper aims to outline the key principles and frameworks that apply to the taxation treatment of Australian resident beneficiaries of foreign trusts, which will be explored in greater depth through the use of focused case studies during our session. Through use of these case studies, we intend to illustrate how these rules apply in practice and highlight common compliance pitfalls and challenges and practical strategies to assist in managing them.

In this paper, legislative reference are to *Income Tax Assessment Act 1936* (Cth) (**1936 Act**) and the *Income Tax Assessment Act 1997* (Cth) (**1997 Act**), unless otherwise indicated.

2. Tax residency

The Australian taxation law and principles that apply to determine trust residency are complicated and very fact dependent, so must be worked through carefully.

The starting point for many of the issues discussed in this paper (including section 99B) is that the offshore trust is in fact a 'foreign trust', being one which is not (and not deemed to be) a resident of Australia for tax purposes. The mere fact a trust has been established overseas, or even has a non-Australian resident trustee, is not in all cases sufficient to mean that the trust is a non-Australian resident trust.

If you are advising offshore clients who have a residency connection with Australia, or who intend to become Australian resident (see below at Part 2.2 of this paper), understanding the Australian law governing trust residency is critical. Regrettably, such clients are often (unpleasantly) surprised to learn that their migration to Australia can very easily cause trusts which they control to become Australian resident trusts. If the client has only sought advice after they have migrated to Australia, it can be that 'the horse has bolted' and the opportunity to pre-plan and 'control' the tax outcomes has passed.

2.1 Trusts

General definition - Division 6

For the purposes of Division 6 of Part III of the 1936 Act, a trust estate is a '**resident trust estate**' for a given income year if it meets **either** of the following tests:[1]

1. a trustee was a resident of Australia at any time during the income year; or
2. the central management and control (**CM&C**) of the trust estate was in Australia at any time during the income year.

The term 'trustee' is given a broad definition for the purposes of Division 6. [2] Importantly, it goes well beyond the 'named' trustee in the trust instrument and, more broadly, looks to any role through which an individual may control, direct or influence the actions or affairs of the trustee. The statutory definition states:

> **trustee** in addition to every person appointed or constituted a trustee by act of parties, by order, or declaration of a court, or by operation of law, includes:
>
> (a) an executor or administrator, guardian, committee, receiver, or liquidator; and
>
> (b) every person having or taking upon himself the administration or control of income affected by any express or implied trust, or acting in any fiduciary capacity, or having the possession, control or management of the income of a person under a legal disability or other disability.

[1] Section 95(2), 1936 Act.
[2] Section 6(1), 1936 Act.

The term 'central management and control' describes activities of a material and strategic nature that go to the heart of an entity's operation, administration or governance. This concept is less concerned with day-to-day activities of an administrative nature.[3]

CM&C is also relevant in relation to corporate tax residency. While majority of cases consider this concept in the context of company tax residency, the same principles can apply more broadly to trusts.[4] We have addressed CM&C in the context of company tax residency at part 2.3 of this paper.

In relation to trusts, these are some key observations:

a. the CM&C of a trust estate is generally exercised by individuals who act in the trust's key governance and administrative roles, including individuals who act in such roles both formally and constructively - beyond the 'trustee', this could include for example, a person acting in the role or capacity of a appointor, protector or guardian, or in the role or capacity of a trust administrator or investment manager (which one will often see in offshore trusts, especially where an independent trustee or fiduciary has been appointed to administer the trust);[5]

b. identifying who exercises CM&C is a question of fact. It cannot be determined solely by identifying who has the power or authority (either formally or informally) to control and direct the matters of a trust;[6] and

c. the fact that an Australian resident individual is, formally or informally, empowered to exercise the central management and control of an entity, does not, without more, mean that CM&C is exercised in Australia. For this to be the case, there must be evidence that key decisions which go to the CM&C of the trust were made within Australia.

It is also relevant to note that:

d. the statutory definition of a 'resident trust estate' emphasises the singular tense ['a trustee' cf. all or the majority of trustees] - where there are multiple trustees, it is only necessary that **one** trustee be an Australian resident at any time during the year of income. By contrast, a company with an Australian director will only be a resident of Australia if that director exercises CM&C of the company (refer to part 2.3 of this paper); and

e. there is no requirement for a trust estate to carry on business in Australia for it to be a resident trust estate [*cf*. a company];

f. a trust estate will be a resident trust estate if it has an Australian trustee, even if that entity abrogates its decision-making power in relation to the trust in favour of a non-resident person (for example, an offshore trust administration or fiduciary service).

*Definition in the Capital Gains Tax (**CGT**) rules*

[3] Australian Taxation Office Ruling TR 2018/5 (**TR 2018/5**) and Australian Taxation Office Practical Compliance Guideline PCG 2018/9 (**PCG 2018/9**).
[4] See, *Fundy Settlement v Canada* [2012] 1 SCR 520; *Bywater Investments Ltd v Federal Commissioner of Taxation* [2016] HCA 45.
[5] TR 2018/5; PCG 2018/9.
[6] PCG 2018/9.

The CGT rules in Chapter 3 of the 1997 Act also contain a definition of the term '**resident trust for CGT purposes**'. In relation to trusts that are not 'unit trusts', the definition largely mirrors the definition that applies for the purposes of Division 6. However, there are specific rules and requirements that apply to a trust that is a 'unit trust'. There are, in offshore jurisdictions, trusts that are, or analogous to, unit trusts or have the features of a unit trust, as it would be understood under Australian legal concepts.

Under the CGT rules, a trust will be a 'resident trust for CGT purposes' in relation to a year of income if, at any time during the income year:[7]

a. for a trust that is not a unit trust, a trustee is an Australian resident or the CM&C of the trust is in Australia; or

b. for a unit trust, one of the requirements in column 2 and one of the requirements in column 3 of the following table are satisfied.

Requirements for unit trust		
Item	***One of these requirements is satisfied***	***And also one of these***
1	*Any property of the trust is situated in Australia*	*The central management and control of the trust is in Australia*
2	*The trust carries on a * business in Australia*	*Australian residents held more than 50% of the beneficial interests in the income or property of the trust*

Proposed changes

In 2021, the Federal Government announced it would consult on broadening the proposed amendments to the corporate residency test to include trusts and corporate limited partnerships, although these proposals have not progressed beyond an initial consultation phase.

2.2 Individuals

A detailed consideration of the statutory and judicial principles applying to individual residency is beyond the scope of this paper. Again, the law is complex and very heavily fact-dependent.

Statutory provisions

[7] Section 995-1(1), 1997 Act.

Under the statutory definition of residency at section 6(1) of the 1936 Act, as it applies to individuals, an individual will be a resident of Australia if they meet any one of the following four tests:[8]

1. **Ordinary concept of 'residency':** The individual 'resides in Australia', which requires consideration of the ordinary meaning of 'resides', as guided by principles established in case law, which looks to an individual's intention and the objective circumstances of their day-to-day living arrangements and behaviours).

2. **Domicile:** The individual's 'domicile' is in Australia, unless the Commissioner is satisfied that the person's 'permanent place of abode' is outside Australia. This draws into question the concepts of 'domicile' (a basic legal standard against which ones residency can be determined, based on place of birth or ancestry) and 'permanent place of abode' (a more factual based analysis which, like the 'ordinary' residency concept, looks at the objective circumstances of an individual's day-to-day living arrangements and behaviours).

3. **Physical presence in Australia:** The individual has actually been in Australia, continuously or intermittently, during more than one-half (183 days) of the year of income, unless the Commissioner is satisfied that the person's 'usual place of abode' is outside Australia and that the person does not intend to take up residence in Australia. This draws into question the meaning of actually being in Australia 'continuously or intermittently' for one-half of a year, the meaning of 'usual place of abode' (see previous) and the implications of the requirement for the Commissioner's satisfaction as to the individual's intention.

4. **Public Sector Superannuation:** The individual is a member, or spouse or child of a member, of the Public Sector Superannuation Scheme or the Commonwealth Superannuation Scheme.

Administrative guidance

The Commissioner sets out his administrative views on the application of the individual tax residency tests in Tax Ruling TR 2023/1 (**TR 2023/1**). At paragraph 20 of TR 2023/1, the Commissioners states that the ordinary concept of residency test is asking whether an individual's presence in Australia is 'usual and settled in contrast to temporary and casual'. Similar to the legal principles established in decided cases, this question can be informed by 'both the nature, duration and quality of the person's physical presence and an intention to treat Australia as home'.[9]

Factors that commonly inform the relevant association with Australia include:

- period of physical presence in Australia;
- intention or purpose of presence;
- behaviour while in Australia;
- family, and business or employment ties;

[8] Section 6(1), 1936 Act; section 995-1(1), 1997 Act.
[9] TR 2023/1, paragraph 20 citing Addy appeal at [76] per Derrington J; Hafza at [449] per Wilcox J.

- maintenance and location of assets; and
- social and living arrangements.[10]

Proposed changes

In 2021, the Federal Government announced proposed changes to Australia's individual tax residency rules based on the Board of Taxation's report to the Treasurer. The proposed new rules, which are not yet enacted, proposed the introduction a 'bright line' test, under which individual residency can be determined with reference to prescribed and objective factors.

2.3 Companies

Again, a detailed consideration of the statutory and judicial principles applying to corporate residency is beyond the scope of this paper. As is the case with all residency questions, the law is complex and very heavily fact-dependent.

Legislative provisions

Under the statutory definition of residency at section 6(1) of the 1936 Act, as it applies to companies, a company will be a resident of Australia if it meets one of the following three tests:[11]

a. **Incorporation**: if the company is incorporated in Australia; or

b. **Carries on business and CM&C**: if the company carries on business in Australia and has its CM&C in Australia, it is taken to be Australian resident.

c. **Voting power control:** The company is incorporated offshore and carries on business in Australia, and has its voting power controlled by shareholders who are residents of Australia.

Administrative guidance

TR 2018/5 (together with Practical Compliance Guide PCG 2018/9 - *Central management and control test of residency: identifying where a company's central management and control is located* (**PCG 2018/9**)) was released by the Commissioner regarding CM&C of foreign companies. It sets out the Commissioner's view on how to apply the CM&C test of company residency following *Bywater Investments Limited*[12] (***Bywater***).

The ruling states that the following matters are relevant in considering the CM&C test:

a. Whether the company carries on business in Australia. The ruling states that it is not a requirement of carrying on a business in Australia that any of the trading or investment profit-making operations take place in Australia. Rather, carrying on a business in Australia merely requires that the CM&C be in Australia because that is factually part of carrying on the business.

[10] TR 2023/1, paragraph 20.
[11] Section 6(1), 1936 Act; section 995-1(1), 1997 Act.
[12] *Bywater Investments Limited & Ors v. Commissioner of Taxation*; *Hua Wang Bank Berhad v. Commissioner of Taxation* [2016] HCA 45

b. The meaning of 'central management and control'. The ruling states that the key element in CM&C is 'the making of high-level decisions that set the company's general policies, and determine the direction of its operations and the type of transactions it will enter'. This is distinguished from the day-to-day conduct of the company's operations or the mere ability of a majority shareholder (or person with such power) to appoint those who control the company.

c. What constitutes high-level decision making of a company is a question of fact and the nature of the company's business is a relevant consideration. The more extensive a company's activities, the more likely it is that high-level decisions are an exercise of CM&C and control will be distinct from day-to-day operational decisions. The smaller the scale of a company's activities, particularly where there is no division between those who make high-level decisions and those who execute them, the more likely it is that high-level decisions will overlap with, or be the same as, the company's decisions to undertake a particular business operation or transaction.[13]

d. Who exercises central management and control? The identity of the person who exercises CM&C is not determined by who has the legal power, but rather who directs a company's operations in reality. Mere legal power or authority to manage a company is neither sufficient, nor necessary, for a finding that a person is exerting CM&C. Regardless of formal appointment, a person who is more than merely influential and in reality dictates or controls the decisions made by the directors will exercise CM&C.

e. Where the central management and control is exercised. The ruling states that a company is controlled and directed where the decision making occurs as a matter of fact and substance, rather than where the decisions are recorded or formalised. The Court in Bywater considered a range of factors in its determination including: the location of meetings; where dividends are declared and paid, where the company register and books are located, where the registered office is located, the residence of those controlling and directing operations; the residence of the shareholders; and where formal documents are made. Although it may transpire infrequently, the Commissioner has also recognised that CM&C may occur in two locations where a substantial part of the control and direction occurs in each place.

Proposed changes

In 2020, the Federal Government announced proposed changes to Australia's corporate residency rules. The proposed amendments are to provide that a company incorporated offshore will be treated as an Australian tax resident if it has a 'significant economic connection to Australia'. This would be satisfied where both the company's core commercial activities are undertaken in Australia and its CM&C is in Australia.

This measure, if enacted, is intended to have effect from the first income year after the date of royal assent of the enabling legislation.

[13] Paragraphs 15 to 16, PCG 2018/9.

2.4 Tie-breaker rules

Oftentimes, a trust, individual or company will be a tax resident under the application of the domestic tax law of Australia and another country (therefore, potentially dual resident). Australia has a wide network of double tax agreements (**DTAs**) with over 40 countries, including its key trading partners. Where there is a DTA is in place between Australian and another country, the DTA will typically provide for a 'tie breaker' provision, which will provide primary taxing jurisdiction to either Australia or the other country. In practice, these tests can again be heavily fact dependent, and sometimes their application to trusts (or trustees) can be unclear. Where no DTA is in place, taxation may apply in more than one jurisdiction, and a Foreign Income Tax Offset may be available in Australia, to allow foreign tax paid on income assessable in Australia to be offset against Australian tax on that income.

3. Distributions from foreign trusts to Australian beneficiaries

Where Australian resident beneficiaries receive amounts from foreign trusts, the relevant provisions and principles which may apply to subject Australian residents to tax on the income of foreign trust include the following:

3.1 Australian resident beneficiaries presently entitled to foreign trust income

Under section 97 of the 1936 Act, the beneficiary of a trust estate is taxed on a 'share' of the 'net income of a trust estate' to which they are 'presently entitled'.

Application to beneficiaries of non-Australian resident trusts

An Australian resident that is 'presently entitled' to an amount of the net income of a **non-Australian resident trust** will be assessed under section 97, irrespective of whether that income has an Australian source or a non-Australian source. This is consistent with the basic principle that an Australian tax resident is taxed in Australia on income from all sources, foreign or domestic.

The phrase 'presently entitled' is not statutorily defined for the purposes of section 97[14], but has been the subject of judicial consideration and interpretation. In the case of a non-Australian resident trust which applies income or capital for the benefit of an Australian resident beneficiary, it can be inferred that the general principles that cause a 'present entitlement' to arise (that is, the beneficiaries entitlement is vested in interest and in possession[15]) would apply. However, there is the added complication of needing to apply these principles through the terms of a trust deed that is governed by the laws and drafting customs of the country in which the trust has been established.

Another key concept on which Division 6 of the 1936 Act operates is the 'net income' of the trust estate. The 1936 Act defines 'net income' and prescribes a methodology for determining this amount.[16] The definition of 'net income' requires two assumptions to be made:

a. First, that the trustee of the trust is a taxpayer in relation to the trust's income (i.e. its true legal capacity is effectively ignored); **and**

b. Second, that the trustee is a tax resident of Australia (i.e. its true tax residency status is ignored) in determining the assessable income of the trust less allowable deduction.

[14] Subject to the extensions contained in section 95A.
[15] Inter alia, *Harmer v Federal Commissioner of Taxation* (1991) 173 CLR 264
[16] Section 95(1), 1936 Act.

Applying the ‘net income’ definition in section 95 and making the Australian residency assumption required would mean that the ‘net income’ of a non-Australian resident would include its income from all sources, Australian and foreign. Moreover, it will require a re-stating of the non-Australian resident trust’s income position to account for differences in tax recognition of income (as assessable) and expenses (as deductible) under Australian law and the law of the country in which the trust is a resident for tax purposes.

The residency assumption creates the potential for complexity, and even conflict, in terms of the interaction of Australian tax law and the tax law of other countries - and even between the interaction of various provisions within the Australian tax law. This is illustrated by Taxation Determination TD 2017/23, where the Commissioner comments on the application of the ‘residency assumption’ required to be made by a non-resident trustee in applying section 95, and its interaction with section 855-10 of the 1997 Act, in.

In TD 2017/23, the ATO considers that the usual application of the residency assumption, and how it has modified application in its interaction with section 855-10 of the 1997 Act. The Commissioner states the following:

> “8. **Subsection 95(1)** of the ITAA 1936 requires the trustee of a trust estate to calculate the net income of the trust for a year of income as if the trustee were a resident taxpayer (the residency assumption). Residents are required to include capital gains and capital losses from all sources in the calculation of their net capital gain (which forms part of the net income of the trust).
>
> 9. **Section 855-10** of the ITAA 1997 provides that the trustee of a trust that is a foreign trust for CGT purposes disregards a capital gain or a capital loss if the relevant CGT event happens in relation to a CGT asset that is not 'taxable Australian property'.
>
> 10. An issue arises as to how section 855-10 of the ITAA 1997 interacts with the residency assumption in the definition of net income in subsection 95(1) of the ITAA 1936.
>
> 11. If the assumption in subsection 95(1) of the ITAA 1936 were applied for the purposes of section 855-10 of the ITAA 1997, **the provisions would be in conflict**. Section 855-10 would have no operation at all in relation to foreign trusts, despite its express reference to them. This cannot have been the intention of the legislature. It is a general (though rebuttable) rule of statutory interpretation that, where there is a conflict between general and specific provisions, the specific provision prevails.
>
> 12. Subsection 95(1) of the ITAA 1936 is a general provision dealing with the calculation of the net income of a trust estate. In contrast, section 855-10 of the ITAA 1997 contains more specific rules in relation to capital gains made by a trustee of a trust that is a foreign trust for CGT purposes. In this context, it is considered that the reference to the trustee of a foreign trust in section 855-10 of the ITAA 1997 prevails over the assumption in subsection 95(1) of the ITAA 1936.
>
> 13. Therefore, **the trustee of a trust that is a foreign trust for CGT purposes disregards a capital gain or loss from a CGT event happening to an asset that is not 'taxable Australian property'. Accordingly, such a gain or loss is not reflected in the net income of the trust for the purposes of subsection 95(1) of the ITAA 1936**” (emphasis added)

The Commissioner's view in TD 2017/23 has significant implications for the way in which capital gains made by a non-Australian resident trust estate on assets that are not Taxable Australian Property (**TAP**) and distributed to an Australian resident beneficiary will be treated for tax purposes in the Australian resident beneficiary's hands. This is explained below, as part of our discussion about the application of section 99B.

3.2 Section 99B

With greater global mobility of people and wealth, section 99B of the 1936 Act matters are becoming more common than ever. And when you consider that more high-wealth individuals, who tend to have complex affairs and offshore arrangements, have migrated to Australia in the last 20 years than almost any other country in the world, its relevance to Australian trust and estate practitioners cannot be ignored.

Section 99B can apply to many common scenarios, including previous foreign employment earnings in a foreign pension fund, pre-migration wealth held in trusts, foreign gifts and inheritance and intergenerational wealth transfers.

As Hill J observed in *Traknew Holdings*[17], the 'extreme width' of section 99B has long been recognised, raising questions as to whether its operation may in some cases extend beyond the original legislative intent. Accordingly, where you have an Australian resident client who is a beneficiary of an offshore trust, or has a financial interaction with wealth held by relatives or associates in offshore structures including trusts, consideration must be given to the application of section 99B of the 1936 Act.

3.2.1 Background to section 99B

Section 99B is ostensibly an anti-avoidance provision. Section 99B was introduced in 1978 and the legislature's intent was to include an amount paid or applied by a foreign trust to an Australian resident in the Australian resident's assessable income, if the amount '*represents trust income of a class which is taxable in Australia but which has not previously been subject to Australian tax in the hands of either the beneficiary or the trustee*'. Expressed another way, section 99B is a provision which was (generally) intended to capture the accumulated foreign income of a foreign trust which was not previously subject to Australian tax (usually accumulated in a low or no tax jurisdiction) from being returned to an Australian resident beneficiary in a non-assessable form (e.g. trust corpus).

Section 99B is couched in very expansive terms. The primary assessing provision is subsection 99B(1): this provides that where an amount of property of a trust estate is paid to or applied for the benefit of a beneficiary of the trust estate who was a resident at any time during the year of income, the beneficiary's assessable income will include that amount.

This broadly expressed taxing provision is subject to a number of limiters which set out in subsection 99B(2), which provides that the following amounts are excluded from the application of subsection (1):

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[17] *Traknew Holdings Pty Ltd v Commissioner of Taxation* [1991] FCA 125.

a. Amounts representing corpus of the trust. But beware the 'exclusion to the exclusion' - if the 'corpus' is attributable to income derived by the trust which, if it had been derived by an Australian resident taxpayer, would have been included in the Australian resident taxpayer's assessable income, that amount will not be excluded from the operation of section 99B(1). This is intended to combat an offshore trust accumulating its income in a no or low tax jurisdiction and distributing it to a beneficiary in a later income year, purportedly as an amount of corpus of the trust, and therefore tax free.

b. Amounts that would not have been included in an Australian resident taxpayer's assessable income if they had been made by them.

c. Amounts that have already been included in the assessable income of a taxpayer under section 97 of the 1936 Act, assessed to the trustee of the trust under Division 6 of the 1936 Act or attributed to a taxpayer under the transferor trust rules.

In this sense, section 99B is therefore intended to apply as a provision of last resort.

Three additional matters to keep in mind are:

a. Section 99B(1) applies "*Where, **at any time during a year of income***, an amount, being property of a trust estate, is paid to, or applied for the benefit of, a beneficiary of the trust estate ***who was a resident at any time during the year of income***…" (emphasis added). That means that if an amount is distributed to an individual at a time when they are an Australian resident, it will be assessed to the individual, even if the income predates the time they became Australian resident. For example, if an individual receives a distribution from a non-resident trust in March 2022 and then becomes an Australian resident in April 2022, the distribution comes within the scope of section 99B(1) and all or part of the distribution may be included in the beneficiary's assessable income, subject to the exclusions provided by section 99B(2).

b. If section 99B operates to include an amount in a beneficiary's assessable income, a special interest charge may also apply to the extent that the distribution is attributable to:

   - eligible designated concession income derived in an income year when the trust was a resident of a listed country; or
   - profits that were not subject to tax in a listed country and were derived in an income year when the trust was a resident of an unlisted country. [18]

c. Complexities arise in situations involving multiple layers of trusts - that is, where a beneficiary receives an amount of property from a non-resident trust (the first trust) and that property has its source in property received by the first trust from another trust (the second trust). In this situation, a tracing exercise must be undertaken, to determine whether the exclusion at section 99B(2)(a) applies. This particular fact pattern has been considered by the Federal Court in *Howard's* case[19], where the court said:

[18] Section 102AAM, 1936 Act.
[19] *Howard v FCT* [2012] FCAFC 149.

- In the basic case of a non-resident trust (**Trust A**) distributing property to an Australian resident beneficiary, section 99B(2)(a) requires one to assume a hypothetical scenario whereby Trust A is an Australian resident trust estate, then consider whether and to what extent Trust A (as a resident taxpayer) would have been required to include the relevant amount in its assessable income when it was derived by Trust A.
- Where the relevant property has its source in property received by Trust A from a separate trust estate (**Trust B**), this hypothetical analysis goes a step further. One must then assume that Trust B is an Australian resident trust estate and consider whether and to what extent Trust B (as a resident taxpayer) would have been required to include the relevant amount in its assessable income when it was derived by Trust B.
- Section 99B will apply in this manner as many times as there are interposed layers of trusts, 'cascading up back up to the original (genuine) resident taxpayer'.

While this application of section 99B may lead to real practical difficulties in gathering the evidence required to undertake this necessary tracing, on one view it has policy integrity. Otherwise, the application of section 99B could be avoided quite simply by establishing a 'clean skin' non-resident trust, having the existing trust distribute all of its capital and accumulated income to the new trust as a distribution of capital, then having the new trust distribute this amount in full to the beneficiary as an amount of corpus. Such an outcome would be clearly inconsistent with the intent of section 99B.

Limited to foreign trusts?

Section 99B was enacted primarily to target 'accumulated foreign source income of a non-resident trust estate'. [20] However, the relevant statutory provisions are not expressly stated as applying only to foreign trusts estates, so may potentially impact Australian resident trust estates, and may apply in unexpected ways.

3.2.2 Case law and evidentiary burden

In the practical world, the real challenge in applying section 99B, or formulating a 'reasonably arguable position' that it does not apply, is in establishing the facts and evidence which support the application of an exclusion: most particular, the 'trust corpus' exclusion. In this regard, it is important to keep in mind that in tax matters, taxpayers bear the burden of proof[21].

Consider for example the case of *Campbell*[22]. In this case, the taxpayer received distributions from a New Zealand-based trust estate totalling $463,200 in the 2013 and 2014 income years, which were not returned by the taxpayer as income in Australia. The Administrative Appeals Tribunal ultimately determined that distributions were assessable pursuant to section 99B.

[20] Explanatory memorandum to the *Income Tax Assessment Amendment Bill (No 5) 1978*.
[21] Section 14ZZO(b), *Tax Administration Act 1953*.
[22] *Campbell v Commissioner of Taxation* [2019] AATA 2043

The lack of appropriate evidence to support the taxpayer's assertion that the amounts distributed had their source in trust corpus was decisive in this case. In particular:

a. The taxpayer provided two different sets of trust accounts for the relevant years. One set showed a negative capital balance, which would indicate there was no corpus available for distribution, while the other set showed a net positive capital balance and distributions of capital to the taxpayer. The taxpayer claimed that the differences were necessary in order to accommodate the Australian accounting standards but could provide no evidence to substantiate this claim.

b. There was no record of the trustee ever resolving to distribute any corpus of the trust in the relevant years. The trustee distribution minutes for the relevant years reflected a decision to accumulate all trust income and not make any distributions of income or capital.

Ultimately, the Administrative Appeals Tribunal concluded that the trust accounts and the trust minutes were unreliable as evidence due to their inconsistency, and the taxpayer was unable to establish that the distributions received were in fact the corpus of the trust subject to the exclusion in section 99B(2).

There are three important practical lessons that can be taken out of Campbell's case:

a. Particular care needs to be taken when communicating with advisers for non-resident entities to ensure that accounts are prepared accurately and consistently.

b. Those seeking to claim that a distribution represents 'corpus' of the trust must ensure that these distributions are accurately recorded in the trustee minutes and trust accounts, with supportive source documents and materials.

c. AUSTRAC and the ATO (and other government authorities) will readily share information about international and domestic transactions. Taxpayers should expect that any income received from oversees will come to the attention of the ATO and may be queried.

Again, the importance of evidence for taxpayers seeking to rely on the section 99B(2) exclusions cannot be over-emphasised. In the practical world, identifying or having access to information and supportive documentation can prove to be difficult, especially if the offshore trustee is uncooperative or restricted in sharing information about the trust with beneficiaries due to local laws governing tax secrecy or confidentiality. Sourcing or tracing the payment to tax-free corpus or a non-assessable amount may initially start with a good set of accounts which clearly differentiates and presents trust capital (and a dissection of the amounts in the equity section between 'originating' corpus and accretions to corpus through accumulated earnings). Some foreign trusts do not maintain financial accounts, so a forensic reconstruction of historical data (if possible) may be required. Other documents, such as the requirements of the trust deed (including whether the beneficiary can be entitled to corpus), trustee resolutions, and 'source' documents to substantiate additions to, or disbursements from, the trust, will also be important to support the accounting treatment adopted.

3.2.3 The ATO's guidance on s 99B

Recent ATO guidance has set out the Commissioner's administrative views on how section 99B of the 1936 Act should be applied, particularly in relation to the 'hypothetical resident taxpayer' test (as a component of the trust corpus exclusion at section 99B(2) of the 1936 Act) and evidentiary requirements. On 27 November 2024, the ATO released finalised guidance on section 99B, being Tax Determination TD 2024/9 and Practical Compliance Guideline PCG 2024/3.

TD 2024/9

TD 2024/9 provides the Commissioner's interpretative views on section 99B, which are illustrated with a number of examples.

<u>The 'hypothetical resident taxpayer' - applying the exemption</u>

TD 2024/9 discusses at length the 'hypothetical resident taxpayer' tests from subsection 99B(2)(a) and 99B(2)(b), which is a component of the limiter which may apply to exclude certain amounts of trust property paid to, or applied for the benefit of, resident beneficiaries representing trust corpus from being assessed under subsection 99B(1).

Revisiting the statutory text, subsection 99B(2)(a) provides (relevantly):

> *(2) 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*);*
>
> *…* (emphasis added)

a. The 'hypothetical resident taxpayer' concept set out in TD 2024/9 refers specifically to the recreative assumption or hypothesis required by subsection 99B(2)(a), that: The trustee is a taxpayer that derives income and incurs expenses on its own account; and

b. The trustee is an Australian resident subject to Australian tax law.

With regards to the 'hypothetical resident taxpayer', the ATO states in TD 2024/9:

a. the only characteristic of the hypothetical taxpayer is that they are an Australian resident. It cannot be assumed that they have any other characteristics or specific legal character - that is, as an individual, trustee or company. A consequence of this is that tax concessions and treatment that are dependent on the specific character of the taxpayer do not apply to the 'hypothetical resident taxpayer': an example of this is the 50% CGT discount (which is available to individuals and trustees but not to companies);

b. to determine whether an amount would be assessed, it is necessary to consider the circumstances that gave rise to the relevant amount in the hands of the trustee. This element of the test does give consideration to the particular form of income and the circumstances in which it has been incurred. It is for this reason that, for example, pre-CGT status in assets will be preserved as this is a characteristic of the particular type of income and the circumstances in which it was derived [Example 1], as will the application of the market-value substitution rule. On the other hand, an event that happens to the trustee after the time the assets are acquired, and which may affect the tax character of the asset, is not an attribute imputed to the hypothetical resident taxpayer: the example provided by the Commissioner is a change of residency of the trustee (for example, becoming Australian resident) that occurs after the time the asset has been acquired [Example 7].

c. the source of the amount paid or applied to the beneficiary is considered in determining whether it is 'attributable to' what would or would not be assessed in the hands of a hypothetical resident taxpayer. This requires a determination of what the amount received is attributable to and involves looking beyond the distribution by the trustee to consider how the trust property became a trust asset and the means by which its acquisition was funded. An example provided of how this may apply is where an amount currently represented as trust corpus (or a trust asset) but which has been funded or acquired with funds which have their source in interest income under a lending arrangement which (presumably) has not been previously assessed (cf. if the acquisition had been funded by property settled on the trust) [Example 8].

PCG 2024/3

PCG 2024/3 includes a discussion of several common scenarios where s 99B applies and an examination of the ‘low-risk arrangements’ where the ATO will refrain from exercising its auditing powers.

The common examples considered by PCG 2024/3 are:

- Example 1 - non-resident migrates to Australia
- Example 2 - resident trustee receives a distribution from non-resident trust
- Example 3 - resident beneficiary receives a gift from non-resident trust
- Example 4 - resident beneficiary receives a loan from non-resident trust
- Example 5 - trustee allows resident beneficiary to use non-resident trust property
- Example 6 - resident beneficiary receives an amount from a non-resident deceased estate
- Example 7 - beneficiary who changes tax residency and receives an amount from non-resident trust in the same income year

PCG 2024/3 also outlines two scenarios which it considers ‘low-risk arrangements’: where the trust property is provided by means of a commercial arrangement and certain distributions of trust property from non-resident deceased estates.

<u>Commercial arrangement</u>

For commercial arrangements, the provision of trust property by a non-resident trust to a resident beneficiary is considered low risk where an arrangement for the use of trust property, including monetary loans:

a. is the subject of a written or verbal agreement;

b. the agreement is on ‘commercial terms’, which can be substantiated; and

c. the resident beneficiary makes a ‘physical payment’ to the non-resident trust, which can also be substantiated.

For arrangements involving the use of trust property (for example, recreational or lifestyle assets owned by the trust - the PCG uses art, yachts and holiday home as examples), market terms and rates applied for interest, use and/or hire in similar circumstances are used as the benchmark for determining ‘commercial terms’. For arrangements involving a loan, a safe harbour is applied for loans which use the Division 7A benchmark interest rates and loan terms.

Deceased estates

For non-resident deceased estates, a distribution by the executor of trust property to a resident beneficiary are considered low risk where:

a. the trust assets or proceeds of sale are distributed by the executor to the resident beneficiary within 24 months of the date of death;

b. the total value of the trust property distributed, whether in a lump sum or multiple payments, is less than AUD$2 million; and

c. there is appropriate evidence to substantiate the origin of the funds and the entitlement under the estate.

Record keeping and substantiation requirements

The PCG 2024/3 outlines the Commissioner’s record-keeping and substantiation expectations for taxpayers relying on an exemption to s 99B and provides a list of documents and sources of information that resident beneficiaries seeking to apply for an exemption under s 99B may use as evidentiary material.

3.2.4 Practical insights

Section 99B, like its close cousin, 100A - takes the ‘lazy fisherman’ approach: it throws the net widely and indiscriminately to catch most distributions from a foreign trust to an Australian beneficiary as assessable, and it is for the taxpayer to escape the net, by showing the corpus or non-taxable exclusions apply. However, these exclusions may prove too onerous to evidence, in which case the distribution will be treated as being assessable in any case - not because it should be but because it cannot be proven otherwise. So good recordkeeping will be essential and where possible.

The best solution is always proactive pre-migration planning as there is little that can be done once section 99B applies. There is no safety switch in section 99B – it is self-executing and can apply even in the absence of anti-avoidance motive. As such, it can apply even to genuine family or commercial dealings, as can be seen from the deeming in section 99C. This deeming provision expands the scope of section 99B by treating certain benefits as distributions – including loans, loan repayments, debt forgiveness, and even the use of trust property such as overseas holiday homes. Gifts from a foreign person to an Australian resident may also be caught if sourced from trust property. This reach is not necessarily confined to contrived or artificial arrangements, and in practice can capture ordinary dealings unless carefully evidenced.

Another practical challenge is evidencing the corpus and non-taxable exceptions. The Commissioner recognises that it may be difficult to obtain all relevant documents and information from a foreign trustee (including due to the relationship or overseas laws). Nevertheless, the onus remains on the Australian beneficiary to establish that an exception applies. The core documents expected include the foreign trust deed, trustee minutes and resolutions confirming corpus distributions, and financial accounts. Depending on circumstances, further supporting materials may be required such as property transfer records, market valuations, bank statements, deceased estate documentation, professional advice and even foreign tax returns.

Perhaps most concerning is the imposition of the ‘throw-back interest’ charge under section 102AAM. This can trace back decades to when the income was first derived by the trustee, and anecdotal experience suggests that the tax, penalties and throw-back interest can exceed the actual distribution received.

4. Transferor trust and controlled foreign company rules

Having considered the treatment of distributions under section 99B, it is also important to note the broader anti-deferral regimes that may apply to offshore structures involving Australian residents. Broadly, the transferor trust and controlled foreign company (**CFC**) rules are designed to prevent tax deferral through the accumulation of income in offshore entities and may attribute income to Australian resident taxpayers even where no distribution is received. Unlike section 99B, which generally applies to actual trust distributions, the transferor trust and CFC rules operate on an accruals basis.

4.1 Transferor trust rules

4.1.1 Purpose and operation

The transferor trust rules target offshore trusts, both discretionary and non-discretionary, and seek to tax Australian resident taxpayers on un-repatriated offshore income attributable to them.

The rules were designed to prevent Australian residents from transferring funds, property or value to trusts established in low or no-tax jurisdictions, where income could be accumulated without Australian tax. In such circumstances, the taxpayer is the ‘transferor’ to the offshore trust.

The rules operate to attribute the income generated in an offshore trust to Australian resident taxpayers on an ‘accruals’ basis (i.e. as it is generated, rather than as it is paid out), irrespective of whether it has been repatriated to Australia. Complicated rules apply to calculate the amount that is required to be assessed to the Australian resident taxpayer.

4.1.2 Scope and exemptions

The transferor trust rules do not apply equally to offshore trusts in all jurisdictions, as they are designed to specifically target income that has been accumulated in low or no-tax jurisdictions. To give effect to this intended difference in application, the rules differentiate between ‘listed’ countries, being a group of prescribed jurisdictions with tax systems broadly comparable to Australia (including Canada, New Zealand, France, the United Kingdom, Germany, the United States of America and Japan), and ‘unlisted’ countries, which encompass all other jurisdictions.

As a broad principle, but subject to complicated rules, where a transferor trust is established in a listed country, there will only be the potential for attribution and accruals taxation if the trust has earned a designated form of concessionally taxed income in that country. In an unlisted country, *all* income will be subject to potential attribution. However, where income has been accumulated in either a listed or unlisted country, an adjustment will be made for any income which is subject to Australian tax (e.g. because it has been distributed to a presently entitled Australian beneficiary).

The rules will not apply if the requirements of one of following three statutory exemptions have been satisfied:

a. *'Non-resident family trusts' exemption*: A trust only qualifies as a 'non-resident family trust' if it is:

- a trust established on marriage dissolution and only benefits non-residents who are relatives of the transferor; or
- it is a foreign trust established to provide relief to non-resident persons who are in 'necessitous circumstances' (i.e. are in need of benevolent relief).

b. Transfer made to a foreign trust by the executor or trustee of an Australian resident individual's deceased estate: This exception is quite limited and will not be available if any of the following apply:

- the transfer is made through the exercise of the power of appointment or of a discretion by the trustee or any other person, rather than in accordance with a specific testamentary direction;
- the trustee or executors transfer property or services to a non-resident trust estate, but the transfer was caused by an entity other than the deceased person; or
- under a scheme, the trustee transfers property or services to an entity, and another entity transfers property or services to the trust. In this case, the trustee is treated as having transferred the property or services to the trust.

c. *Offshore trust has been in existence since before 12 April 1989 (the date of the introduction of the rules)*: For this exception to apply, the Australian resident transferor must prove to the Commissioner's satisfaction that they have not had control of the trust at any time after this date. This is a high evidentiary burden.

4.1.3 Practical implications

Importantly, the transferor trust rules do not operate to re-tax principal that has already been subject to Australian taxation. Rather, they focus on income generated offshore which may otherwise escape assessment in Australia.

The rules are, however, highly complex and impose significant compliance challenges. In particular, taxpayers face a high evidentiary burden, such as the need to prove an absence of control in order to access certain exemptions. These complexities mean that careful compliance, documentation and record-keeping are essential. There are numerous traps for the unwary, and specialist advice should always be sought in relation to the application of the rules to an individual's circumstances.

4.2 Controlled foreign company rules

4.2.1 Purpose and framework

Where a client owns or controls foreign companies, the CFC rules must be considered. As with the transferor trust rules, the CFC rules seek to tax Australian resident taxpayers on un-repatriated offshore income that is attributable to them.

Broadly, the effect of the CFC provisions is to require an Australian resident that is an ‘attributable taxpayer’ in relation to a CFC to return and be assessed on the ‘attributable income’ of a CFC on an accruals basis: that is, as the income is derived by the CFC and not when it is returned to the Australian resident taxpayer in the form of a dividend or other distribution.

The CFC provisions are primarily designed to target passive forms of income that are generated and accumulated in comparatively low tax jurisdictions (‘unlisted countries’). Other forms of income that are preferentially taxed in a particular country may also be taxed on an accruals basis in Australia, even where they are generated in a country which has a tax system comparable to Australia (‘listed countries’).

The CFC rules generally do not apply to income that has been derived from carrying on an active business, whether in a listed or unlisted country, through a permanent establishment in that country. Where a CFC has derived both ‘active’ and ‘passive’ income in an unlisted country, the CFC’s passive income may be attributed and assessed to an Australian resident attributable taxpayer where the CFC fails the ‘active income test’. An entity’s compliance with the active income test must be determined on an annual basis.

4.2.2 When a foreign entity is a CFC

A CFC is a company that is a resident of a listed country or an unlisted country where at least one of the following three situations applies at any time:

a. a group of five or fewer Australian ‘1% entities’, together with their associates, owns or is entitled to acquire a control interest of at least 50% in the foreign company, noting:

   - an Australian 1% entity is an Australian entity that holds an interest of at least 1% in the foreign company; and

   - an associate-inclusive control interest of an entity in a company is the sum of the direct and indirect control interests held by the entity and its associates;

b. there is a single Australian entity with direct and indirect control interests totalling more than 40%; or

c. there is a group of five or less Australian entities that, in any manner, control the company.

For a company to be a CFC, it must not be a resident of Australia (by being deemed as such under Australian law). The particular treatment of the company as a CFC will depend on whether it is resident in a listed or unlisted country.

4.2.3 When an Australian resident is an 'attributable taxpayer' in respect of a CFC

An Australian resident may be required to include an amount of attributable income from a CFC in their assessable income if they are an attributable taxpayer in relation to the CFC.

An Australian resident will be an attributable taxpayer if:

a. they have an associate-inclusive control interest of 10% or more in a CFC; or

b. all of the following apply:

- the CFC is a CFC because of the application of one of the three situations described above; and
- the Australian resident:
- is an Australian 1% entity; and
- is part of a group of five or fewer Australian entities who, alone or with associates, controls the CFC.

For the purposes of the CFC rules, 'control' is determined by reference to the ability to exercise voting power in respect of the CFC or to participate in distributions of the CFC's income or paid-up capital.

Where an Australian resident entity is an attributable taxpayer in relation to a CFC, they may be subject to tax in Australian for the relevant statutory accounting period[23] on an accruals basis based on their 'attribution percentage' of the CFC's attributable income. Other than in limited circumstances, an Australian resident entity's 'attribution percentage' will equate to their individual ownership interest in the CFC.

4.2.4 Determining the 'attributable income' of a CFC

The attributable income of a CFC is calculated in accordance with Division 7 of Part X of the 1936 Act as follows.

a. A CFC's attributable income is the amount that would be its taxable income for a statutory accounting period is certain assumptions were made to determine its 'notional assessable income', 'notional deductions', notional allowable deductions' and 'notional exempt income'.[24]

b. The basic assumptions required to be made are that the CFC were an Australian resident company for a statutory accounting period and that the statutory accounting period is assumed to be a year of income.[25]

[23] This term is defined in section 319 of the 1936 Act as a 12-month period finishing on the 30th of June. However, an entity may elect for a different or substituted statutory accounting period to apply.
[24] Section 382, 1936 Act.
[25] Section 383, 1936 Act.

Other assumptions apply based on whether the CFC is resident in a listed or unlisted country, passes or fails the active income test, and to the way in which other provisions of the Australian tax legislation would apply.

c. Having determined the CFC's 'notional assessable income' in this way, it is then necessary to consider whether any of the income derived by the CFC falls within the definition of 'adjusted tainted income', which is defined to be an amount that is:

- *Passive income*: this is defined and set out in section 446 and generally includes amounts earned in the nature of rent, dividends, annuities or interest;
- *Tainted sales income*: this is defined and set out in section 447 and generally includes income on sales made to related-party that is an Australian resident entity; or
- *Tainted services income*: this is defined and set out in section 448 and generally includes income made from services provided to a related party that is an Australian resident entity.

d. Amounts that do not fall into the definition of adjusted tainted income are treated as 'active income', save for particular types of income (called 'Eligible Designated Concession Income') which is automatically attributable.

e. Having determined the CFC's adjusted tainted income and active income through this process, the next step is to determine whether the entity satisfies the 'active income test'. A company will satisfy the active income test if:

- The ratio of the company's 'gross tainted turnover' (a measure of its adjusted tainted income) to its 'gross turnover' (which includes active income) (the 'tainted income ratio') is less than 5%; and
- The evidence shows that:
- The company is in existence at the end of its statutory accounting period;
- The company is a resident of a listed or unlisted country at all times during its statutory accounting period;
- The company has maintained accounts according to acceptable accounting standards and practice; and
- The company carries on a business through a permanent establishment in the country in which it is treated as a resident for tax law purposes (the concept of 'permanent establishment' is explained further below).

f. Relevantly for the present analysis, where a CFC is resident in an 'unlisted country':

- if the active income test is not satisfied, the CFC's attributable income will include its adjusted tainted income (but not its active income); and

- if the active income test is satisfied, the CFC will have no attributable income.

4.2.5 Consequences if the CFC rules apply

If the CFC rules apply such that an Australian resident taxpayer is an attributable taxpayer in respect of a CFC's attributable income, the income which is assessed on an accruals basis is reduced by the amount of any actual dividend which is paid by the CFC and assessed to the Australian resident taxpayer in Australia. However, the Australian resident taxpayer will still need to undertake all the relevant compliance steps to determine the active income test has been satisfied and the CFC's attributable income.

If the CFC rules apply such that there is no CFC 'attributable income', on the basis that the active income test is satisfied by the CFC and there is consequently no amount of adjusted tainted income which is attributable and assessed to an Australian resident taxpayer, the Australian resident taxpayer will be assessed on any distribution (by way of dividend or otherwise) made by the CFC to the Australian resident taxpayer at the time it is made.