International Clients and Investors

Written and Presented by:

John Balazs
Partner
Balazs Lazanas & Welch LLP

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1 INTRODUCTION

Most mornings, my dog and I watch the sunrise as we stare out to sea. The sea is often choppy and an inky black colour, full of uncertainty. But it is the rocks close to the edge that most grab your attention as the waves wash onto them.

As metaphors go, that may be fairly ordinary, but it does encapsulate a truth about taxation when an individual chooses to come to or leave Australia. It is always at the edges that one sees the many dangers and uncertainties of a system of taxation.

The boundary – between residency and non-residency of an individual – is one of the great fault lines in Australian income tax. It is also a topic of remarkable complexity and subtlety. So I have chosen to largely avoid the issue in the paper, which has been written on the assumption that the relevant inbound individual becomes a resident on the first day he or she arrives and the relevant outbound individual ceases to be a resident on the day or departure.

Whilst the former is very often the case, the latter is rarely true, or, at least, not without the benefit of hindsight. However, issues about when does someone "reside" in Australia, where is a person "domiciled" and when does domicile change and what is the difference between a "permanent place of abode" and a "usual place of abode", are, when added to the issues that arise in relation to the residency article in the many double tax agreements, such that they would overwhelm what I wish to do with this paper.

Correspondingly, I have not dealt with individuals who are "temporary residents" (***TRs***) as defined in section 995-1[1]. However, I do address some issues that relate to TRs and matters concerning the residency of entities related to our hypothetical individual.

For obvious reasons, I cannot address the non-Australian issues. But I do note the obvious point that the non-Australian issues may well dwarf the Australian ones and will often shape the decisions that are made, especially when the United States (the ***US***) is involved.

The natural division is between inbound and outbound. Part A deals with inbound. Part B with outbound.

2 REFERENCES

In an effort to make this paper readable, it is assumed that the reader understands from which of the two key Acts the sections, divisions and other such provisions come and, unless indicated otherwise, all references to legislation are to either to the *Income Tax Assessment Act 1936* (the ***1936 Act***) or *the Income Tax Assessment 1997* (the ***1997 Act***) (as the case may be).

PART A INBOUND

In dealing with an inbound individual, I have chosen to address the following matters:[2]

1 Residency of related entities.

2 The "cost base" of assets and liabilities.

3 Controlled foreign companies (***CFCs***), trusts and foreign accumulation funds (***FAFs***).

4 Unwinding offshore structures in advance.

5 Elections.

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1 *Income Tax Assessment Act 1997*.

2 There are many issues that are well beyond the scope of this paper. For example, issues such as thin capitalisation and transfer pricing are not dealt with. Those are the sorts of issues that can, of course, arise once one gets into a structure which stretches across borders, but are too specific and too complex to be part of this paper.

3 RESIDENCY OF RELATED ENTITIES

Having passed up the issue of residency for our hypothetical individual, we cannot ignore the residency issues that arise for the entities (as defined in section 960-100) with which he or she is connected.

The starting premise is that the individual is a resident. Thus, even if our individual is a TR, the protection given to a TR from the many adverse consequences of our rules for offshore structures, does not extend to a related entity so as to prevent it from becoming a resident.

3.1 Companies

3.1.1 Residency

The tests for residency for those companies incorporated outside Australia remains trapped in the late 19th century/early 20th century. Familiarity with the wording in section 6(1) has led to a glossing over of the issues. The relevant statutory tests are:

> ***Resident*** or ***resident of Australia*** means:
>
> …
>
> (b) a company … which not being incorporated in Australia carries on business in Australia, and has either its central management and control in Australia, or its voting power controlled by shareholders who are residents of Australia.

The Commissioner has interpreted these provisions in TR 2004/15 as establishing a need to satisfy two requirements[3] when the company is not incorporated in Australia:

1 That the company carries on business in Australia.

2 Either (i) the central management and control is in Australia or (ii) the company's voting power is controlled by shareholders who are residents of Australia.

The decision in *Malayan Shipping v FCT* (1946) 71 CLR 156 has often been interpreted as laying down a rule that a company is a resident if its central management and control is in Australia as, by definition, a company that has its central management and control in Australia carries on business in Australia. Whilst that is a misreading of the decision, the risk is obvious.

A common approach is to rely on nominee directors to avoid having central management and control in Australia, although case law tells us that that approach does not always achieve the desired outcome. As always, the issue comes down to the facts; see for example: *Wood v Holden* [2006] EWCA Civ 26, *Esquire Nominees Limited v FCT* (1973) 129 CLR 177 and *HMR&C v Smallwood* [2010] EWCA Civ 778.

In *Smallwood*, Lord Justice Patten adopted the useful summary of Lord Justice Chadwick in *Wood v Holden*. Patten LJ said at [59]:

> The importance of the case for present purposes lies in the analysis by Chadwick LJ of what is capable of constituting management and control of a company by persons who are not its directors. Referring to the treatment of this issue by Park J at first instance, he said this:
>
> > "[26] At para [26] of his judgment the judge had examined four cases in which (as he said) the courts had recognised the considerations to which he had just alluded. Those cases were *Re Little Olympian Each Ways Ltd* [1995] 1 WLR 560, *Esquire Nominees Ltd v Comr of Taxation* (1973) 129 CLR 177, *New Zealand Forest Products Finance NV v Comr of Inland Revenue* [1995] 2 NZLR 357 and *Untelrab Ltd v McGregor* (*Inspector of Taxes*) [1996] STC (SCD) 1. He accepted, of course, that each of those cases was decided on its own facts; but 'they do have some common features which … are relevant to the present case'. He identified those features at para [27]… They all involved persons based in one

[3] Perhaps there is a third requirement, that of incorporation which seems to have been glossed over.

> jurisdiction (commonly a high tax jurisdiction) causing companies to be established in other jurisdictions (commonly low or no tax jurisdictions). In all the cases the companies so established were intended to fulfil particular purposes which were ancillary to the activities of the persons who caused them to be established. In all the cases the local managements did not take initiatives, but responded to proposals (described in some passages in the judgments as instructions) which were presented to them. In all the cases they did implement the proposals, and it is obvious that, when the foreign companies had been established, the confident expectation was that they would implement the proposals. In general, although large amounts of money may have been involved, the functions which the companies were established to fulfill did not involve much regular activity, so there was no great need for frequent exercises of central management and control. …
>
> [27] In my view the judge was correct in his analysis of the law. In seeking to determine where 'central management and control' of a company incorporated outside the United Kingdom lies, it is essential to recognise the distinction between cases where management and control of the company is exercised through its own constitutional organs (the board of directors or the general meeting) and cases where the functions of those constitutional organs are 'usurped'—in the sense that management and control is exercised independently of, or without regard to, those constitutional organs. And, in cases which fall within the former class, it is essential to recognise the distinction (in concept, at least) between the role of an 'outsider' in proposing, advising and influencing the decisions which the constitutional organs take in fulfilling their functions and the role of an outsider who dictates the decisions which are to be taken. In that context an 'outsider' is a person who is not, himself, a participant in the formal process (a board meeting or a general meeting) through which the relevant constitutional organ fulfils its function."

3.1.2 Section 457

If a company incorporated outside of Australia (which is resident in an "unlisted country") does become an Australian resident, then, in addition, to the traditional issues regarding the cost/cost base of assets discussed below, there is the need to consider whether section 457 applies so as to give rise to an amount of assessable income.

The section provides as follows:

> Where at any time (in this section called the ***residence-change time***) a company that:
>
> (a) is a CFC; and
>
> (b) has an attributable taxpayer;
>
> ceases to be resident in an unlisted country and becomes:
>
> (c) … ; or
>
> (d) a Part X Australian resident
>
> then the attributable taxpayer's assessable income of the year of income in which the residence-change time occurs includes the amount calculated under subsection (2).

The key aspect of section 457, if it is triggered, is the taxing of a limited amount. Previously, tax was potentially payable in respect of all of the ***distributable profits*** of the former CFC. Since 2004, the section has been limited in its application to (essentially) *adjusted tainted income* of the period from the start of the statutory accounting period to when the change in residence occurs.

3.1.3 Foreign hybrid companies

Section 830-15 sets out the rules that determine when a foreign company is a foreign hybrid company. It is simply noted that for a foreign company[4] to be a foreign hybrid company, it must not be an Australian resident – section 830-15(1)(c) – at any time in an income year.

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4 Section 830-15 is limited to Limited Liability Companies (***LLCs***) formed in the United States (***US***), possibly an S Corporation (a US concept) and Limited Liability Partnerships (***LLPs***) formed in the United Kingdom (***UK***) – see Regulation 830.15.01 (which perhaps mistakenly brings a UK LLP into section 830-15 on the assumption that a UK

3.2 General partnerships

When a partner becomes an Australian resident that does not alter the status of the general partnership of which he is a partner for the purposes of Division 5 of Part III (***Division 5***).

However, it is worth noting that, from the perspective of the CFC rules in Part X, the partnership becomes an Australian partnership (see section 337) and an Australian entity (see section 336). That means that the partnership can be an attributable taxpayer (see section 361) for the purposes of the CFC rules.

3.3 Corporate limited partnerships (CLPs)

This is a reference to Division 5A of Part III (***Division 5A***) and, in particular, to the impact of section 94T which provides that a CLP is:

(a) a resident;

(b) a resident within the meaning of section 6 of the 1936 Act;

(c) a resident of Australia; and

(d) a resident of Australia within the meaning of section 6 of the 1936 Act;

if and only if:

(e) the partnership was formed in Australia; or

(f) either:

(i) the partnership carries on business in Australia; **or**

(ii) the partnership's central management and control is in Australia.

Clearly paragraph (f) raises threshold questions as to what amounts to the "carrying on of business in Australia" and what is the meaning of "central management and control" in the context of a partnership – is it, for example, the same as the test for a company?

However, as a general proposition, whether the offshore limited partnership or limited liability partnership is carrying on business in Australia **or** is centrally managed and controlled in Australia, is likely to be apparent as a matter of fact, especially if the hypothetical individual is the decision maker.

A related provision, section 94J says:

> A reference in the income tax law (other than the definition of dividend, resident or resident of Australia, in section 6 of this Act) to a company or to a body corporate includes a reference to the partnership.

Curiously, these and the other related sections do not explicitly say that the CLP is a person, although that does not appear to be significant because the CLP is often a body corporate by virtue of the place of its creation (e.g. Delaware).

Moreover, because of the way the definition of Australian resident, person and company in section 995-1 are drafted, a CLP that is a resident because of section 94T, will:

(a) be an Australian resident (as defined in section 995-1) and taxed as a resident company pursuant to Division 5A for the whole of the income year; and

(b) fall outside of Subdivision 830-A – i.e. not be a foreign hybrid for that income year if it is a resident at any time in the income year.

LLP falls outside of section 830-10). In relation to a UK LLP, go to: http://www.hmrc.gov.uk/manuals/bimmanual/BIM72115.htm for the UK position from the perspective of HMR&C, which is that it is a partnership for some tax purposes and a corporation for other tax purposes.

3.4 Trusts

3.4.1 Section 95(2)

When it comes to the residency of a trust, the Acts apply different approaches. For the purposes of Division 6 of Part III (***Division 6***), section 95(2) says:

> For the purposes of this Division, a trust estate shall be taken to be a resident trust estate in relation to a year of income if:
>
> (a) a trustee was a resident at any time during the year of income; or
>
> (b) the central management and control of the trust estate was in Australia at any time during the year of income.

Significantly, these tests apply across all "trust estates". Gordon J recently considered the meaning of the expression "trust estate" in *Leighton v FCT* [2010] FCA 1086 at [34] to [36] inclusive. Her Honour said at [35]:

> Consistent with those authorities, I accept that the expression "trust estate" in Div 6 of Pt III refers to trust property which gives rise to the income derived by the trustee.

The residency of a trustee is, of course, linked to the definition of "resident" in section 6(1) (and, of course, section 94T if the trustee is a CLP). It is conceivable that a contrary intention applies and the expression "a resident" takes its meaning by reference to the general law notions of residence (e.g. central management and control of a company), but highly unlikely.

It has been suggested that if, for example, the individual was a trustee before becoming a resident and was replaced before he became a resident, the trust may still have an issue with paragraph (a) above if the change takes place in the same income year because the individual was a trustee and is a resident. Logically, the rule should only apply if the individual was a resident at the same time as he or she was a trustee, otherwise the rule will lead to some absurd outcomes.

The second test, which speaks of the "central management and control of the trust estate", raises questions as to what is meant by "central management and control" in the context of a trust estate.

There is no local law on the issue, although many have assumed that the test is the same as that for a company. The concepts are, however, different, and it is not clear exactly how one applies old law created in respect of a company to a trust estate.

Recently, the Canadian courts have been focussed on the issue of where is a trust resident for the purposes of Canadian income tax, including the double tax treaty between Canada and Barbados. The case, *Garron v The Queen* 2009 TCC 450, known as *St Michael Trust Corp v The Queen* 2010 FCA 309 on appeal (collectively referred to as *Garron*), considered the issue by first holding that a trust may reside where the central management and control is actually exercised, notwithstanding that the trust is not a person because for income tax purposes it is treated as though it were a person.

A point to note is that the judges in *Garron* refer to the residency of a trust by reference to where it is centrally managed and controlled, whereas in section 95(2) the question posed is where is the central management and control of the <u>trust estate</u>. Perhaps there is no difference, but this writer believes that there can be.

The following extract from *St Michael* is worth noting:

> [67] Some of the factors listed above are common characteristics of ordinary trusts and, considered in isolation, would not be sufficient to locate the management and control of the Trusts anywhere but the residence of the St. Michael Trust Corp. For example, the fact that the beneficiaries have the right to appoint a protector who has the power to replace the St. Michael Trust Corp. as trustee is a common safeguard in a trust indenture and would not by itself be enough to find the beneficiaries to be in control of the property of the Trusts. The same could be said of the fact that St. Michael Trust Corp. and the beneficiaries employ common advisers, or the fact that the beneficiaries took it on themselves to advise the St. Michael Trust Corp. and even urged St. Michael Trust Corp., however strongly, to undertake a particular transaction. Indeed, the appointment of a trustee with little investment experience in a trust that

requires the property to be invested might not be significant, provided that the trustee has the power to retain others for advice and, in the end, is the one making the decisions.

> [68] However, there is a line to be drawn. On one side of the line are recommendations, even strong ones, by the beneficiaries to the trustee, leaving the trustee free to decide how to exercise the powers and discretions under the trust. In that case, the trustee is still managing and controlling the trust. On the other side of the line the beneficiaries are really exercising the powers and discretions under the trusts, managing and controlling the trusts, and displacing the appointed trustee. As mentioned above, on which side of the line a case falls is a factual question, requiring consideration of the evidence in its totality.
>
> [69] Justice Woods took into account some normally neutral facts, such as the existence of a protector and reliance on common advisers, and combined them with a considerable body of evidence of the surrounding circumstances to conclude that on the facts of this case, the line was crossed. In my view, it was reasonably open to her to reach that conclusion.
>
> [70] Indeed, what else is to be made of the common understanding of the parties, as found by Justice Woods, that decisions in relation to the sale of the Trusts' interests in PMPL, the investment of the cash proceeds received on the sale, the making of distributions to the beneficiaries, and the taking of appropriate action to minimize the tax burden of the Trusts would be made by Mr. Garron and Mr. Dunin and implemented by St. Michael Trust Corp.? What else explains the lack of documentary or other evidence that St. Michael Trust Corp. took an active role in assessing any of the important decisions relation to the disposition of the property of the Trust? What is the explanation for the professed lack of interest on the part of Mr. Garron and Mr. Dunin of the capabilities of St. Michael Trust Corp. to manage trust assets, except in relation to the work ordinarily done by someone with accounting and tax expertise? What is the explanation for the paucity of evidence as to the formation and operation of the Trusts and the failure to call key witnesses?

The main lesson to be drawn from the case is simply that foreign trustees should be left to manage the trust and the trust estate with only minimal direction from the beneficiaries or the true settlor, preferably as an adviser and no more.

The comment at paragraph [67]:

> For example, the fact that the beneficiaries have the right to appoint a protector who has the power to replace the St. Michael Trust Corp. as trustee is a common safeguard in a trust indenture and would not by itself be enough to find the beneficiaries to be in control of the property of the Trusts.

is interesting, but it does not follow that our courts will take the same approach. It remains necessary to approach the issue of who controls the trustee, be it a protector, appointor or guardian, with care and one should seek to place as much distance as possible between the individual and the control of the trustee and the trust property.

In *ASIC v Carey and Others (No 6)* (2006) 153 FCR 509, French J (as he then was) followed and extended the approach of the Family Court in holding that certain persons had contingent interests in trust property, saying:

> 38 The Full Court of the Family Court of Australia in *In the Marriage of Ashton* [1986] FamCA 20; (1986) 11 Fam LR 457 considered a case in which the husband was appointor of a family trust. He had the power to remove and appoint the trustee and could appoint himself. The trustee had the power to alter the terms of the trust at will. He was not a beneficiary of the trust but had received income from it. He was found to be 'in full control of the assets of the trust'. There were 'good grounds for saying the trust is no more than the husband's alter ego'. Strauss J said (at [14]):
>
> > *'In the result, having regard to the powers and discretions which the husband has, and having regard to what had in fact taken place, for the purposes of s 79 [of the Family Law Act 1975* (Cth)]*, the husband's power of appointment, and all the attributes it carries with it, amounts to de facto ownership of the property of the trust.'*
>
> 39 A similar trust arrangement existed in *In the Marriage of Goodwin* (1990) 101 FLR 386. The trial judge had found that the reality in that case was that no person other than the husband had any real interest in the property or income of the trust except at the will of the husband. In upholding the trial judge, the Full Court said (at 392):

> *'... we have no doubt that his Honour was entitled to find that the trust property was in reality the property of the husband in the present case. The husband had the sole power of appointment of the trustee which was a creature under his control and he was a beneficiary to whom the trustee could make payments exclusive of other beneficiaries as the husband saw fit.'*

Whilst that was said in a different context, it should, at the very least, be a pointer to how the courts may approach the issue of central management and control of a trust estate.

The Commissioner's views can be gleaned from his ruling on the meaning of "Australian superannuation fund" in TR 2008/9. Those views reflect the approach taken in *Garron* (whilst obviously pre-dating the case). The Commissioner's position is extensively discussed from [109] onwards.

If, by chance, the trust does become a resident trust estate, Division 6 approaches the matter as if the trust estate is a resident for the whole of the income year, which may have adverse ramifications unless the approach taken by the Commissioner in TD 1999/83 (discussed below) is also applied to Division 6.

Subdivision 855 (discussed below) speaks of rules that are relevant to CGT assets owned "just before the resident became a resident trust for CGT purposes". Presumably, this is a reference to the time at which the change takes place and not the start of the income year in which the change takes place, so the impact of a change in residence may differ for Division 6 purposes as against the CGT.

Finally, in this respect, it is also worth remembering that the TR rules will not exclude a trust from the consequences of the change in tax residency of the TR. In other words, because a trustee is a TR or a TR centrally manages and controls the trust estate, it does not follow that the trust is not a resident trust estate. On the contrary, if the TR is a resident under section 6(1), then there will in either case be a resident trust estate and income and gains that would otherwise have escaped tax in Australia become taxable.

3.4.2 Resident trust for CGT purposes

Section 995-1 provides that:

> ***resident trust for CGT purposes":*** a trust is a ***resident trust for CGT purposes*** for an income year if, at any time during the income year:
>
> (a) for a trust that is not a unit trust, a trustee is an Australian resident or the central management and control of the trust is in Australia; or
>
> (b) for a unit trust, one of the requirements in column 2 and one of the requirements in column 3 of this table are satisfied.

	Requirements for unit trust	
	One of these requirements is satisfied	**And also one of these**
	Any property of the trust is situated in Australia	The central management and control of the trust is in Australia
	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

Oddly, this definition differentiates between unit trusts (undefined) and other trusts, and it is possible for a unit trust to be a resident trust for section 95(2) and a foreign trust for CGT purposes. Thus a unit trust wholly owned by Australian residents and centrally managed and controlled in Australia will not be a resident unit trust for CGT purposes unless it has property "situated in Australia" – which brings into play concepts of situs of property more familiar to those who deal with stamp duty and estates[5] – or it carries on business in Australia (see *Charles v FCT* (1954) 90 CLR 598).

It follows that a unit trust may be a resident trust for the purposes of Division 6 but a foreign trust for CGT purposes so that section 885-10 applies, essentially excluding capital gains on non-taxable Australian property from the net income of the trust estate. In this respect, the Commissioner clearly accepts that Division 855 overrides Division 6 – see, for example, ATO ID 2003/231. Although the ID deals with the predecessor to Division 855, Division 136, the principle remains the same and the later, more specific, provision applies in preference to the general provision.

A further oddity is that the definition of a resident trust for CGT purposes leaves out the word "estate" and refers to the central management and control of the trust and not a "trust estate". It remains to be seen if there is a difference between central management and control of a trust and a trust estate. The answer may well depend on which approach to statutory construction holds sway at the time.[6] However, it is the writer's view that there is a difference and that the difference needs to be taken account of, especially as the rules in Division 855 differ expressly from Division 6.

3.4.3 Legal personal representatives

As an executor or an administrator of an estate is regarded as a trustee (see, for example, *FCT v Whiting* (1943) 68 CLR 199), there are two obvious considerations as regards an estate.

If the individual is already acting as the executor of a non-Australian estate, then he or she needs to consider whether it is possible to renounce or resign in the income year before becoming an Australian resident.

The other concerns the need to ensure that the future estate of a relative or friend does not become a resident trust through oversight. There is no need for a will to necessarily be changed, but, at the relevant time, the individual may need to renounce.

3.4.4 Superannuation funds

A superannuation fund is a foreign superannuation fund unless it is an "Australian superannuation fund" as defined in section 295-95(2). The Commissioner's views are set out in TR 2008/9.

On the basis that the fund was established outside Australia, it could not be an Australian superannuation fund unless one or more assets of the fund are "situated" in Australia. In this respect, the Commissioner believes that the matter is governed by common law rules regarding the situs of assets for the purposes of private international law – see [16] and [103] to [105] inclusive of TR 2008/9.

Currently, such funds will essentially not be taxed on non-Australian source income and gains from non-taxable Australian property), as they are treated as having no attributable income under Division 6AAA and should not be taxed under Division 295. The FIF rules that potentially taxed such funds to the members (assuming that they were not exempted by section 519) have, of course, been abolished. One would expect the proposed FAF rules to deal with the issue.

Moreover, in view of the penalty imposed on converting the fund to an Australian superannuation fund (see sections 295-320 and 295-330), bringing the fund onshore may not be desirable.

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5 See TR 2008/9.

6 See The Intolerable Wrestle: Developments in Statutory Interpretation Address By The Honourable J J Spigelman AC Chief Justice of New South Wales Keynote Address to the Australasian Conference of Planning and Environment Courts and Tribunals Sydney, 1 September 2010: http://www.lawlink.nsw.gov.au/lawlink/Supreme_Court/ll_sc.nsf/vwFiles/spigelman010910.pdf/$file/spigelman010910.pdf

There is, however, a further issue for the individual. The fund can conceivably be a controlled foreign trust (***CFT***) (see below) and can therefore cause the individual to be an attributable taxpayer in respect of a CFC held through the fund.

4 THE "COST BASE" OF ASSETS AND LIABILITIES

4.1 CGT

4.1.1 The individual

When an individual (other than a TR) becomes an Australian resident, section 855-45 applies in respect of each "CGT asset" owned just before the individual became an Australian resident except if the asset is "taxable Australian property", certain ESS interests or it was acquired by the individual prior to 20 September 1985.

With respect to what is "taxable Australian property", one must not forget the transitional provision in section 104-165 of the *Income Tax (Transitional Provisions) Act 1997*. The intended effect of the section is to treat a person who ceased to be an Australian resident before 12 December 2006 and who made a choice to treat assets that did not have the necessary connection with Australia as having a necessary connection with Australia as having made a choice under section 104-65(3) (of the 1997 Act) to treat those assets as taxable Australian property – see ATO ID 2009/148).

For those assets covered by the section, there is a deemed acquisition at the time of the change of residence (the ***timing rule***) at market value at that time.

The relevant section, section 855-45(3), that deals with the time when the acquisition occurs says:

> Also, Parts 3.1 and 3.3 apply to the asset as if you had *acquired it at the time you became an Australian resident.

The section that deals with the cost base/reduced cost base, section 855-45(2), says:

> The first element of the *cost base and *reduced cost base of the asset (at the time you became an Australian resident) is its *market value at that time.

The position for a TR is governed by sections 768-950 and 768-955. They effectively defer the deemed acquisition to the time at which the TR ceases to be a TR if the TR remains an Australian resident. Obviously, if the TR ceases to be an Australian resident there is no deemed acquisition and if the TR becomes an Australian resident at that time, section 768-955 applies, which is akin to section 855-45.

There is, in theory, an issue as to when someone becomes an Australian resident if, for example, the 183 day rule is the basis on which the individual is taken to be an Australian resident. The Commissioner accepts that the general test is the relevant basis if a person also resides in Australia, but it does seem possible according to the Commissioner for an individual not to reside in Australia under the general test yet be caught by the 183 day rule.

4.1.2 Companies

Essentially, the same rules apply to a company that becomes a resident, except that section 855-55 imposes a different set of rules for a CFC that becomes an Australian resident in relation to what was non-taxable Australian property. In broad terms, the section is aimed at CFCs that are brought onshore some time after they have become CFCs and are already subject to attribution. The policy is that, as its assets were already subject to tax through attribution, the CGT cost base is not reset except if the capital gains (had they been made by the CFC) would also have been taxed in a listed country.

4.1.3 Trusts

Section 855-50 speaks only about trusts that become resident trusts for CGT purposes. Again, the rules are the same as for companies and individuals. Consequently, there is no deemed acquisition at market value for a trust that becomes a resident trust for the purposes of section 95(2) but which remains a "foreign trust for CGT purposes".

There is also an exception in section 855-50(4) for a CFT (as defined in section 342) that becomes a resident trust for CGT purposes if that trust was a CFT pursuant to paragraph (a) of section 342. Paragraph (a) is concerned with an "eligible transferor" (see sections 347 and 348 and the discussion below).

It follows that a CFT that is covered by section 855-50(4) gets no step up or step down nor is it subject to the timing rule.

Section 855-50(4) would only appear to apply if the CFT becomes a resident trust at a later point in time than the individual (on the basis that if the change was contemporaneous, the trust was never a CFT).

In terms of when one determines the first element of the cost base (or reduced cost base), TD 1999/83 tells us that the Commissioner looks to when the act that causes the change of residence occurred – see example 1 in the TD.

4.1.4 General partnerships

There is no rule regarding general partnerships. This, presumably, stems from the notion that partnerships are ignored for CGT purposes.

However, section 106-5(1) says that *any *capital gain or *capital loss from a CGT event happening in relation to a partnership or one of its CGT assets is made by the partners individually*.

This is supplemented by section 106-5(2). It tells us that each partner has a separate cost base for the partner's interest in each CGT asset of the partnership.

The recent decision of the High Court in *Commissioner of State Taxation v Cyril Henschke Pty Ltd* [2010] HCA 43 – see [23] to [27] inclusive - raises questions as regards the nature of a partner's interest in the assets of a partnership and whether this look-through approach is right from a partnership law perspective, let alone the Acts.

The concern here is that whilst the individual's interest in the partnership (clearly, a CGT asset) may be rebased, the CGT assets of a partnership are not. Presumably, the Commissioner will continue to administer the CGT provisions (at a minimum) on the basis of the look-through approach and allow each partner to calculate cost base/reduced cost base of the partnership's assets on a change in residence of the partner by reference to the rules in Division 855.

4.1.5 Liabilities

The CGT rules do not deal with the rebasing of liabilities.

4.2 Forex

On 5 August 2004, the then Minister for Revenue and Assistant Treasurer, Mal Brough, announced that changes would be made to the foreign exchange rules (***FX rules***) in Division 775. One change, a technical amendment, was said to be as follows:

> **A 2.3 Calculating forex cost base and other values where a taxpayer becomes an Australian resident**
>
> As currently drafted, the foreign currency provisions may apply so that a taxpayer who becomes an Australian resident is taxed on forex realisation gains or losses that were made while the taxpayer was not an Australian resident. To the extent that the gains or losses are not Australian sourced, only changes in exchange rates that occur once a taxpayer has become an Australian resident should be taken into account in determining any gain or loss.
>
> Amendments will be made so that the cost base (or value) for a new resident of a foreign currency right or obligation that gives rise to a non-Australian sourced gain or loss is based on the exchange rate applicable at the time that the taxpayer became an Australian resident.

Timing

The amendment will take effect from 1 July 2003.

More recently, on 13 May 2008, Messrs Swan, the Treasurer, and Bowen, the then Assistant Treasurer, announced that the Government was committed to proceeding with the previously announced foreign currency amendments.

Some of the measures dealt with in the first announcement were enacted in 2010 (see *Tax Laws Amendment (2010 Measures No. 4) Act 2010*). But the change outlined above appears to remain outstanding.

The forex rules, if applicable, cause gains and losses to be treated as statutory income (see section 775-15) or allowable deductions (see section 775-30) in most instances, although one needs to be conscious of the fact that gains are not always assessable and losses are not always deductible if they are regarded as “private or domestic” or they relate to exempt income or non-assessable non-exempt income or are covered by the short term rules.

It is not clear what is regarded as “private or domestic” and it is unclear why, when the forex rules are so intimately connected with the CGT, that the test is not directly linked to whether the foreign currency is characterised as a “personal use asset” for CGT purposes (see section 108-20(2)).[7]

Section 775-15 speaks of a “forex realisation gain” made as a result of a “forex realisation event”.

Taking “forex realisation event 1” as our base case, it tells us that you make a “forex realisation gain” if you make “a *capital gain” from the event and some or all of the capital gain is attributable to a currency exchange rate effect – section 775-40(4) and a “forex realisation loss” if you make “a *capital loss” from the event and some or all of the capital loss is attributable to a currency exchange rate effect – section 775-40(6).

The expression “*capital gain” (and “* capital loss”) would appear to take you to section 995-1 where the definition of “capital gain” reads as follows:

> ***capital gain***: for each *CGT event a ***capital gain*** is worked out in the way described in that event.

The same approach applies to a “capital loss”.

In this case, the relevant CGT event is CGT event A1 (section 104-10). That tells us that a capital gain (capital loss) is made if the capital proceeds from the disposal are more (less) than the asset’s cost base (reduced cost base) (section 104-10(4)).

As foreign currency is a CGT asset (see section 108-5 and Note 1 to section 108-5(2)), the CGT cost base rules would appear to give us the cost base (reduced cost base) of the foreign currency as proposed without the need for any amendments to the rules.[8]

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7 In *FCT v Anstis* [2010] HCA 40, the High Court pointed out at [35] that the terms “private” and “domestic” are difficult to apply where *there is no available dichotomy between an essentially “private” expense and an essentially “working or business” expense*. Presumably, the approach taken and decision arrived at on the deductibility of Ms Anstis’ expenses leads to the conclusion that, aside from situations in which foreign currency is held purely as cash or travellers cheque for a holiday (which are clearly private), the foreign currency gains and losses related to a bank account, for example, will not be private or domestic.

8 That approach also leads to the view that the source of a gain taxed through Division 775 is dependent on the rules in Division 855 and not on the general test.

4.3 TOFA

4.3.1 The individual

Division 230 applies to financial arrangements, although, unless the arrangement is a "qualifying security" or the individual elects into Division 230, it will not apply to the individual.

When Division 230 was first enacted it excluded from its application an interest in a foreign investment fund (a ***FIF***) and a foreign life policy (an ***FLP***).

When Part XI was repealed by *Tax Laws Amendment (Foreign Source Income Deferral) Act (No 1) 2010,* section 230-460(12) was amended to exclude a right or obligation that arises under a "direct participation interest of an attributable taxpayer" in a CFC. This will remain the position until the new FAF rules are introduced. Presumably, the section will then be amended to exclude those rights and obligations that relate to FAFs and FLPs (as it seems that FLPs will be covered by the new FAF rules).

This change clearly narrows the application of the exclusion. Consequently, for those individuals who elect in to TOFA, FIF interests which were excluded from TOFA and which were not taxed on an attribution basis because an exclusion applied are now potentially subject to TOFA, which at the very minimum may change the character of any gain or loss from a capital gain (and therefore potentially a discount capital gain) or capital loss to a gain or loss on revenue account.

4.3.2 Change of residence

Subdivision 230-I of Division 230 deals with changes of residence to Australia as follows:

1 If the realisation method is the appropriate method, then there is a deemed disposal and reacquisition at the fair value of the financial arrangement (section 230-485(4)). Theoretically any gain would not be assessable unless it had an Australian source and any loss would not be deductible unless it related to Australian source income.

2 If the accruals method is applicable, then the rules require apportionment on a reasonable basis between periods and then one applies Divisions 6 and 8 of the 1997 Act accordingly (see [11.92] and [11.93] of the explanatory memorandum (the ***TOFA EM***) to *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008*).

If other methods are used, see TOFA EM [11.94] to [11.98] inclusive.

4.3.3 CFCs and transferor trusts

Section 389(ba) excludes the application of Division 230 in determining the attributable income of a CFC.

Until the passing of *Tax Laws Amendment (2010 Measures No 4) Act 2010*, there was no equivalent provision in relation to transferor trusts in Division 6AAA – see section 102AA(2)(aa).

The TOFA EM states at [11.28] and [11.29] that, in the case of non-resident trusts, the issue was to be dealt with by an amendment to (the now repealed) section 96C(5A), although just how that outcome was achieved was not made clear.

Just so that we are now clear on the matter, [3.79] of the explanatory memorandum to *Tax Laws Amendment (2010 Measures No 4) Act 2010* says that the amendments made by Items 1 and 2 of that Act "put the matter beyond doubt" – which they do.

4.4 Depreciable assets

Division 40 work by reference to the "start time" (section 40-60) so that the change in residence only brings the balance of the "cost" within the Acts.

4.5 Trading stock

The trading stock rules in Division 70 of Part 2-25 of the 1997 Act do not directly address the question of what happens when an entity becomes an Australian resident and has trading stock that was not, prior to the change, trading stock that was taxable in Australia.

For the trading stock rules to work rationally, section 70-30 would need to apply. The difficulty is that if the asset is already held as trading stock of a non-Australian business of the individual, it cannot start being held as trading stock. For the section to apply in this instance, words would need to be read into the section so that it dealt with trading stock that was not previously held as trading stock of a business "taxable in Australia".

4.6 Revenue assets

Whereas the Acts make some attempt to accommodate trading stock and depreciating assets, the only references to (and definition of) a "revenue asset" occur in Division 977 of the 1997 Act and in the value shifting provisions and loss integrity provisions in the 1997 Act.

Perhaps a Whitford's Beach approach (*Whitfords Beach Pty Limited v FCT* (1982) 150 CLR 355), resetting the cost to align it with the change in residence on the basis that that is akin to the contribution of the asset to the income producing activity, is the right approach. Against this is the approach taken in *Tikva v FCT* (1972) 128 CLR 158.

4.7 Deferred ESS interests

For those ESS interests that involve a deferral of the taxing point and are therefore subject to Division 83A, there is no resetting or adjustment of the "cost" to reflect the period of service undertaken outside Australia. The intended outcome (as discussed below) is that section 83A-110 will (together with sections 6-5 and 6-10) exclude from assessment that part of the benefit that relates to foreign sources and when the individual was a foreign resident.

4.8 Division 974

Division 974 is not focussed in any way on issues that arise out of a change of residence. The point, therefore, is that the characterisation of an interest from a tax perspective can, in effect, change. What is from another jurisdiction's perspective an equity interest or a debt interest, may, on a change of tax residence, be re-characterised (albeit that the re-characterisation is effectively a retrospective exercise) even though there is no material change**.**

4.9 Foreign hybrids

If there is a foreign hybrid[9] for the purposes of Division 830, then Subdivision 830-D applies. The foreign hybrid is treated as a general partnership and, interestingly, Subdivision 830-D introduces a methodology for dealing with the tax cost of assets – see sections 830-90 and 830-95 which you would expect to extend to other situations.[10] Generally speaking, a foreign hybrid will only become a foreign hybrid for Division 830 purposes in the residence change year and section 830-80 will apply rules that set out tax costs for the assets of the foreign hybrid.

5 OFFSHORE ENTITIES

When people migrate to Australia, they tend to want to bring with them an offshore structure that will consist of any one or more of the following:

1 A trust consistent with our jurisprudence.

2 A company with share capital.

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9 In other words a genuine hybrid covered by the rules and which is not an Australian resident.

10 An attempt has been made to deal with the fact that assets that are nominally outside the tax regime are dragged in. No change seems to have been made to take account of Division 230 – that is references to Division 16E of Part III remain even though it would be expected that Division 230 would apply to the "interest in the asset".

3 A foundation, anstalt, stiftung, stichting or other form of exotic "entity" that has been established to accumulate wealth.

4 Hybrids such as companies limited by guarantee, Dutch CVs, German KGs, US LLCs and US and Cayman Island LLPs.

With respect to those covered by 3 and 4, opinions will differ on where these entities sit in the context of out rules. Many papers have been written on the characterisation of entities, which is a complex and difficult area. Characterising these entities is not always straightforward and it is easy to jump to conclusions about them.

The Commissioner approach is to treat those entities as being covered by our rules, especially our "foreign source income anti-deferral rules" which currently consist of Division 6AAA of Part III (***Division 6AAA***) and Part X and which will include the FAF rules once they see the light of day.[11]

In ATO ID 2007/42, for example, the Commissioner concluded that a Dutch Stichting was a trust estate for the purposes of the transferor trust rules. In another example, PBR 77367, the Commissioner concluded that a Dutch CV was a company for the purposes of the Acts.[12]

See also the Peter Clyne litigation where it was argued, but never decided, that certain entities established in Liechtenstein were foreign companies.

Moreover, even if the entity is characterised as a company, it does not automatically follow that the rights held are properly characterised as "direct attribution interests" (section 356). Section 356 speaks of "the total paid-up share capital of the company", "the total rights of shareholders" and "its shareholders".

"Shareholder" is defined in section 6(1) as including a "member or stockholder".

"Paid-up share capital' is also defined in section 6(1). It is defined to mean 'the amount standing to the credit of the company's share capital account …", which takes you to the definition of "share capital account", which through two further definitions takes you to section 975-300 where the trail ends with a reference to "share capital" as an undefined term.

Thus it may well be that even if an entity is a CFC (through the elusive "control" test) in respect of which the individual is an attributable taxpayer, there is no "attribution percentage" and, therefore, nothing to attribute.

There are, of course, other good reasons why the Commissioner may be wrong in his views, but as the characterisation issue has been referred to by the Board of Taxation and Treasury in various consultative documents released in relation to the foreign source income anti-deferral regimes, one would expect the Government to extend the application of the existing regimes, so that when the long mooted changes are introduced, no exotic entity will fall outside of the CFC, FAF or the transferor trust rules.

Consequently, the following is based on the (brave) assumption that the Government will successfully make changes that deal with these issues.

5.1 CFCs

Again, given the breadth of the topic, this paper does not address most of the issues that arise out of Part X.

Generally speaking, if one is dealing with a traditional company, one with a share capital, it is clear when the individual is an attributable taxpayer with a substantial attribution percentage (usually 100%). If the individual has a CFC in those circumstances, and there is a wish to continue with the entity (there are potentially good reasons for doing so in some cases, especially if the entity carries on an

[11] I would also include Division 6 and section 99B, in particular, in those rules. Fortunately, the deemed present entitlement rules and Part XI have been repealed.

[12] Although this is not apparent from the ruling, Deloitte has told us that it related to a Dutch CV in a paper written for an International Masterclass run by the TIA on 18 September 2008.

active business), then one needs to consider the "interposition" of an Australian holding company. The problem with taking that step is that Part IVA will almost certainly be applied to that structure, or so it seems, in light of the decisions at first instance and on appeal in *British American Tobacco Australia Services Limited v FCT* [2009] FCA 1550 and [2010] FCAFC 130.

With respect to the application of Part X, the less commonly understood situation is one whereby the company becomes a CFC through the CFT rules in Part X.

A very common structure used offshore for wealth management involves the settlement of a discretionary trust followed by the incorporation of a wholly owned subsidiary company of the trust (speaking colloquially), and it is that structure that is focussed upon in the immediately following discussion.

The basic principle is that the CFC rules take precedence and that if an entity is a CFC through a CFT in respect of an individual, attribution will occur through Part X and not through Division 6AAA or Division 6.

The points to note, however, are that:

(a) if the trust is not a transferor trust under Division 6AAA, the trust may still be a CFT;

(b) if the trust is a transferor trust, there may be nothing to attribute under Division 6AAA because attribution has occurred pursuant to the CFC rules; and

(c) the discount CGT rules will not apply to the capital gains made by the company.

Importantly, section 347 operates in a similar but not identical way to section 102AAT in the transferor trust rules, the section which tells us who is an attributable taxpayer under Division 6AAA.

In effect, if there is an "eligible transferor" in respect of the interposed trust, then the trust becomes a CFT and a controlled foreign entity (a "CFE" in the language of Part X) and the company a CFC.

In simplified terms, section 340(a) says that a company is a CFC if Australian residents alone or together with their associates have not less than 50% of the associate-inclusive control interests in the company.

Section 342(a) says that:

> A trust is a CFT at a particular time if, at that time, the trust is not an Australian trust and:
>
> (a) there is an eligible transferor in respect of the trust; or
>
> (b) there is a group of 5 or fewer Australian 1% entities the aggregate of whose associate-inclusive control interests in the trust is not less than 50%.

For discretionary trusts (as defined in section 317), the relevant definition of "eligible transferor" is found in section 347. For non-discretionary trusts and public unit trusts, the relevant definition is in section 348.

A foreign trust in the circumstances we are contemplating will rarely be a non-discretionary trust because of the way discretionary trust is defined in section 317.

Sections 347 and 348 differentiate between transfers made before 7.30 pm on 12 April 1989 (by standard time in the ACT) and those made on or after that time (known as the "IP time").

There are subtle differences between transfers made before the IP time and those made on or after.

5.1.1 Pre the IP time

For those made before the IP time, the individual is an eligible transferor if the transfer of the property or services is not an eligible business transaction (as defined in section 346 – essentially one done in the ordinary course of a business on standard terms) and the transferor was at any time after the IP time and before the test time in a position to control the trust.

5.1.2 On or after the IP time

In this instance the control test is only relevant if the transfer was made under an arm's length transaction otherwise than in the course of carrying on a business so that the absence of control will not prevent the transferor from being an eligible transferor unless the transfer was made under an arm's length transaction.

When is a transfer to a trustee an "arm's length transaction"? Implicit in the drafting is the belief that a transfer to an independent trustee is not an arm's length transaction. It appears to assume that the transfer must be for consideration and that consideration is either market value or based on true bargaining with respect to the transfer.

5.1.3 Control

Control – or more accurately being "in a position to control a trust" - is very widely defined. It is defined in section 347(2) as follows:

> (1) An entity (in this section called the ***transferor entity***) is an eligible transferor in relation to a discretionary trust at a particular time (in this section called the ***test time***) if the trust is not a public unit trust at the test time and:
>
> (a) all of the following subparagraphs apply:
>
> (i) the transferor entity transferred property or services to the trust at a time (in this subparagraph called the ***transfer time***) at or after the IP time and before the test time;
>
> (ii) if the underlying transfer was made in the course of carrying on a business--the underlying transfer was not an eligible business transaction;
>
> (iii) if the underlying transfer was made under an arm's length transaction otherwise than in the course of carrying on a business--the transferor entity was in a position, at any time after the transfer time and before the test time, to control the trust; or
>
> (b) all of the following subparagraphs apply:
>
> (i) the transferor entity transferred property or services to the trust at any time before the IP time;
>
> (ii) the underlying transfer was not an eligible business transaction;
>
> (iii) at any time after the IP time and before the test time, the entity was in a position to control the trust;
>
> and, at the test time, the transferor entity is an Australian entity or a CFE.
>
> (2) For the purposes of this section, an entity is taken to be in a position to control a trust if, and only if:
>
> (a) a group in relation to the entity had the power by means of the exercise by the group of any power of appointment or revocation or otherwise, to obtain, with or without the consent of any other entity, the beneficial enjoyment of the corpus or income of the trust; or
>
> (b) a group in relation to the entity was able in any manner whatsoever, whether directly or indirectly, to control the application of the corpus or income of the trust; or
>
> (c) a group in relation to the entity was capable under a scheme of gaining the enjoyment or the control referred to in paragraph (a) or (b); or
>
> (d) **a trustee of the trust was accustomed or under an obligation (whether formally or informally) or might reasonably be expected to act in accordance with the directions, instructions or wishes of a group in relation to the entity**; or

(e) a group in relation to the entity was able to remove or appoint the trustee, or any of the trustees, of the trust. (emphasis added)

A reference to a group is also widely defined in section 347(3) to be a reference to:

> any of the following:
>
> (a) the entity acting alone;
>
> (b) an associate of the entity acting alone;
>
> (c) the entity and one or more associates of the entity acting together;
>
> (d) 2 or more associates of the entity acting together.

It has been said by the Board of Taxation and the Review of Business Taxation that "control" is a difficult matter to prove when it comes to a foreign trust.[13]

Experience suggests that an individual, directly or through his family (his associates), is **often** in a position to control the trust.

Interestingly, the *Elliott* litigation in relation to section 1207V of the *Social Security Act 1991* – a similar provision that is concerned with a "controlled private trust" – is an example of where there was **no** control. See *Elliot v Secretary, Department of Education, Employment and Workplace Relations* [2008] FCA 1293 and *Secretary, Department of Education, Employment and Workplace Relations v Elliott* [2009] FCAFC 37.

In that case, the trust was established as a discretionary trust by a will and involved truly independent trustees, although the trustees were required to take account of Mr Elliott's needs. The case focused on the nature of a "beneficial interest" and whether the rights of the members of the Elliott family in aggregate gave rise to "beneficial interests". The AAT (at [2006] AATA 970) had earlier concluded (wrongly) that control did exist because the Elliotts and their associates (essentially their children) had more than 50% of the beneficial interests in income and corpus. Ultimately, no consideration was given by the AAT and, therefore, the judges, to the concepts of de-facto control set out in the section.

5.1.4 Transfer

As with the transferor trust rules, what is a relevant transfer is very widely defined and, inter alia, includes a transfer of property or services to a trust (defined in section 317 to mean the trustee, the trust or the trust estate) on the creation of the trust and an acquisition by the trustee of property that did not exist before its acquisition (e.g. an equitable interest impressed on a legal estate) – see sections 344 and 345.

The fact that the transfer took place years before the transferor became a resident is irrelevant except for the distinction drawn by reference to the IP time.

Part X (like Division 6AAA) contains extensive deeming provisions as to what constitutes a transfer. In Part X, these are found in section 345. Two are noted here. The first in section 345(1) is when a person "causes" another to actually transfer property or services. The second is the back-to-back scheme in section 345(5).

The explanatory memorandum (the ***1990 EM***) to *Taxation Laws Amendment (Foreign Income) Bill 1990* tells us that:

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[13] See, for example, the Board of Taxation's Report to the Assistant Treasurer ***Review of the foreign source income anti-tax-deferral regimes*** September 2008 at page 39.

> Subsection 345(1) addresses the circumstance where an entity causes another entity to transfer property or services to a trust. The transfer is taken to have been made by the forcing entity rather than by the actual transferor. An example of this type of arrangement would be a company that directs a wholly owned subsidiary to provide services to a trust or to transfer money to the trust.

The 1990 EM also says in relation to the equivalent provision in Division 6AAA, section 102AAK(1), that a back-to-back arrangement is an example of "causes". However, that provides little guidance, especially as the same concept is covered by section 345(5) (and section 102AAK(5)).

In this respect, without seeking to give an answer as to what conduct can result in someone being found to have caused another to transfer property or services, attention is drawn to the discussion in the judgment of Spigelman CJ in *Jack Smith v Kathleen* Day [2003] NSWCCA 159.

His Honour considers other cases, including the leading case, *O'Sullivan v Truth* (1957) 96 CLR 220, and concludes **in the context** that the word is used in the "**sense of procure or bring about**" and that "cause" did not mean "sole cause". That is consistent with the example, so, in theory, section 345(1), should it ever be the subject of judicial scrutiny, may have a wider application than has been suggested and is likely to go beyond back-to-back arrangements.

In relation to section 345(5), it is simply noted that there is no requirement that the property or services transferred to the interposed entity and the transfer by the interposed entity be identical in any way.

In TR 2007/13 the Commissioner says that:

> 8. A transfer of property or services by an Australian resident entity to a non-resident company in which a non-resident trustee has a direct or indirect ownership interest is considered to be property or services applied for the benefit of the non-resident trustee.
>
> 9. Accordingly, the transfer will be treated as having been made by the resident entity to the non-resident trustee under subsection 102AAJ(3) and subsection 344(3).

This ruling is extremely odd. Taken literally, the Commissioner is seeking to apply the CFC rules and Division 6AAA to every Australian resident who transfers property or services to a foreign company owned by the trustee of a foreign trust.

The examples given in the ruling (at [16] to [21] inclusive) are also odd because the trusts and companies involved are transferor trusts and CFCs when set up and the further transfers covered by the ruling do not alter the position.

The Commissioner is misinterpreting the purpose of the sections – 102AAJ(3) and 344(3) – to deal with a perceived flaw in the transferor trust and CFC rules. In essence, if a trust is established such that there is no Australian transferor or deemed transferor, the rules do not prevent the transfer of property or services to its subsidiary.

Finally, it is noted that there are extensive tracing provisions in section 345 that enable the Commissioner to trace through other entities, including "defunct" entities.

5.1.5 CFT

Once the foreign trust is marked as a CFT, the trust is brought within the CFC rules. Firstly, as a controlled foreign entity (which means that the eligible transferor is regarded as holding the interests in any company owned by the trustee of the CFT) and secondly as an entity that gives rise to attribution in its own right under section 459A which is aimed at preventing the CFC rules being circumvented by washing the attributable income of a CFC through an Australian partnership or Australian trust.

5.2 Transferor trusts

The central provision is section 102AAZD. It is a very extensive provision and its aim is to cause an "attributable taxpayer" to be made assessable on the "attributable income" of the transferor trust or on a deemed amount if the taxpayer could not reasonably be expected to obtain the information required to determine the “attributable income” of the trust. The section is subject to a de minimis rule in section 102AAZE.

Like Part X, Division 6AAA differentiates between discretionary trusts on the one hand and non-discretionary trusts and public unit trusts on the other. Ignoring public unit trusts, it will very rarely be the case that a trust is a non-discretionary trust because of the width of the definition of discretionary trust in section 102AAB for the same reasons why a trust is a discretionary trust for the purposes of Part X.

Consequently, the following assumes that the trust is a discretionary trust as defined.

With respect to (potential) transferor trusts, it is necessary to distinguish not just by reference to the IP time but also by reference to those coming to Australia as first time residents (***First Timers***) and former residents who are returning to Australia.

5.2.1 Pre the IP time

This distinction arises through section 102AAT(1)(a)(F) because it requires the transferor to control the trust at **any** time after the IP time and before the end of the “current year of income” for section 102AAT(1)(a) to be satisfied (assuming the other sub-paragraphs are satisfied).

5.2.2 On or after the IP time

(a) First timers

Unlike the rules applicable in determining whether a foreign trust is a CFT, the transferor trust rules allow an individual First Timer a potential carve out through the operation of section 102AAT(1)(c) if the individual became a First Timer after the IP time, the transfer occurred before the individual became a First Timer and the First Timer was not in a position to control the trust at any time in the period commencing with the following income year after residency and the end of the relevant income year.

(b) Returning former residents

The point is simply that such individuals cannot defer the application of the transferor trust rules in the same way as a First Timer.

5.2.3 Section 102AAT(4)

The problem for those individuals who escape through either section 102AAT(1)(a)(F) or section 102AAT(1)(c) and those who escape through section 102AAT(1)(a)(E) – an arm’s length transaction outside of a business when there is no control of the trust - is that subsequently obtaining control of the trust estate results in retrospective taxation as if the carve outs had never applied.

5.2.4 Discount capital gains

Generally speaking, the “attributable income” of a transferor trust will be its “net income” as determined in accordance with Division 6, as adjusted by Division 6AAA.

Section 102AAZB makes it clear that in calculating the net income (of a transferor trust that is not a listed country trust estate) – the starting point for the purposes of ascertaining the “attributable income” under section 102AAU – the transferor trust is treated as a resident trust estate for CGT purposes (thereby preventing section 855-10 from applying to exclude gains and losses from non-taxable Australian property).

However, it seems that there are issues with respect to how section 102AAU inter-relates with the discount CGT provisions in Division 115.

Section 115-100 applies a 50% discount to a gain made by trust without regard to the status of the trust as a resident trust or foreign trust for CGT purposes.

Consequently, there is no reason why any discount available to the trustee cannot be applied in calculating the net income.

Section 115-210 says that Subdivision 115-B applies if a trust estate has a net capital gain for an income year that is taken into account in working out the trust estate's net income as defined in section 95 for the income year. That would suggest that the Subdivision should apply if an amount is attributed under section 102AAZD.

However, section 115-215(2) says that the section (i.e. 115-215) treats you as having an extra capital gain and a deduction if you are a beneficiary of the trust estate and your assessable income for the income year includes an amount under:

(i) section 97(1)(a);

(ii) section 98A(1) or (3); or

(iii) section 100.

It follows that because an amount is made assessable through section 102AAZD, there is no grossing up under section 115-215(3) or deduction under section 115-215(6). Presumably, this is an unintended outcome.

5.2.5 Attributable income

As noted above, the starting point is section 102AAU and "net income" determined by reference to a number of modifications.

One very important point to note is that the "attributable income" is reduced to the extent that an amount is included in the assessable income of a beneficiary under section 97.

5.2.6 Listed country trust estates

Section 102AAU limits the application of the transferor trust rules if the trust is a "listed country trust estate" in relation to the income year. It does that by limiting the net income to "eligible designated concession income".

For a trust estate to be a "listed country trust estate" in relation to an income year, it must meet a stringent test as regards each item of "income or profit derived".

The test, which is in section 102AAE, reads as follows:

> (1) For the purposes of this Division, a trust estate is taken to be a listed country trust estate in relation to a year of income if, and only if, either of the following paragraphs applies to each item of income or profit derived by the trust estate in the year of income:
>
> (a) the income or profit is either:
>
> (i) subject to tax in a listed country in a tax accounting period ending before the end of the year of income or commencing during the year of income; or
>
> (ii) designated concession income in relation to any listed country; or
>
> (b) both of the following conditions are satisfied:
>
> (i) a part of the income or profit is either:
>
> (A) subject to tax in a listed country in a tax accounting period ending before the end of the year of income or commencing during the year of income; or
>
> (B) designated concession income in relation to any listed country;
>
> (ii) the remaining part, or each of the remaining parts, of the income or profit:

(A) is subject to tax in another listed country or in different listed countries, as the case may be, in a tax accounting period ending before the end of the year of income or commencing during the year of income; or

(B) is designated concession income in relation to any listed country.

The expressions “listed country” and “subject to tax” take their meanings from Part X.

Significantly, the test is a difficult test to satisfy.

If the individual is a grantor with respect to a US trust, then this test may be satisfied if the individual has not expatriated from the US and whilst that may involve a lower rate of tax, the price payable is an effective liability for US estate tax on the grantor’s death (or possibly that of his spouse).

5.2.7 Non-complying superannuation funds

These are treated as resident trust estates (section 102AAB) under the transferor trust rules and pursuant to section 102AAU(2) the attributable income is zero.

5.2.8 Other Exceptions

Division 6AAA has a number of other exceptions, but most of them are of limited benefit.

One is for investments in public unit trusts. Another is for the delightfully misnamed “non-resident family trust” – which is in fact two exceptions. These are defined in section 102AAH and are in essence (a) trusts established and operated solely for the relief of non-resident family members who are in necessitous circumstances and (b) trusts created on a breakdown of a marriage or a de facto relationship for non-resident family members, but limited to spouses, former spouses and children.

The most interesting exception is for trusts created by will. By definition, a dead taxpayer does not have to deal with Division 6AAA if a trust is created through his or her will. Section 102AAL makes this clear, although the section is focussed primarily on the deceased’s legal personal representative.

The section extends to transfers that result from a modification of a will or codicil by a court order.

However, section 102AAL does not extend to a transfer pursuant to the exercise by anyone of a power of appointment or other discretion.

This paper ignores non-discretionary trust estates. These are rare, aside from public unit trusts. Assuming one has such a trust, the transferor trust rules may still apply if there is a transfer at an under value post the IP time. Moreover, such trusts are highly likely to be CFTs because of section 342(b) and that will almost certainly mean that any subsidiary of the trust is an attributable CFC.

5.2.9 Generally

Whilst many individuals moving to Australia are unwilling to bring their offshore structure within the transferor trust and CFC rules, there are often long term benefits in retaining the structure. One obvious factor is that both sets of rules cease to apply once the individual is dead and from that point onwards the structure may be able to achieve the individual’s aim of creating an accumulation vehicle which is not subject to tax. These days, jurisdictions, such as Jersey and Guernsey, no longer apply a rule against perpetuities so the trust can remain in existence for as long as the family wishes it. Companies are, of course perpetual until they are wound-up or deregistered, so it may be a very hasty decision to unwind or “inpatriate” the structure.

The CGT rules on death give an added incentive for continuing with the structure. CGT event K3 (section 104-215) says that a gift to a foreign resident by an Australian resident of non-taxable Australian property is a CGT event.

CGT event K3 is not replicated in either Division 6AAA or Part X. In other words, if the individual leaves a transferor trust in place, then on his or her death there is no taxing event for assets that are effectively removed from the jurisdiction.

Therefore, it may well be better to retain the structure and use section 97 (together with section 101 if necessary) or section 102AAZD to cause tax to be paid by an Australian resident beneficiary (be it a company or an individual – a matter that may well depend on the effectiveness of streaming) during the life of the individual. That may require the distribution of assets from the company to the trust before the individual moves, assuming that the discount CGT rules can be utilised efficiently in light of the decisions in *CPT Custodian Pty Limited v CSR* (2005) 224 CLR 98 and *Colonial First State Investment Limited v FCT* [2011] FCA 11.

Alternatively, it may be advisable to split income producing assets from those that are longer term growth assets and to place those in a second (transferor) trust before the individual comes to Australia.

5.3 Section 102 and non-transferor trusts

5.3.1 Section 102

It is commonplace in Australia to establish a trust using a "nominee settlor" as the creator of the trust to avoid the application of section 102. This practice, which stems from the decision of Menzies J in *Truesdale v FCT* (1970) 120 CLR 353 and which is often wrongly executed, is not the norm in the rest of the world. Normally, there is no nominee settlor, just the single individual settlor.[14]

This means that if the foreign trust[15] meets either paragraph (a) – possible - or (b) – unlikely – of section 102(1), the section will apply and the trustee will be taxed. The exception is if (and to the extent that) a transferor is assessed through section 102AAZD on the net income.

5.3.2 Non-transferor trusts

There are many reasons why non-transferor trusts exist. The most common reason is because of a will trust or a trust settled by a family member who is either dead or is not an Australian resident and has no intention of ever becoming one.

These trusts give rise to difficult issues because of the issues created by Division 6 and, if section 99B is relevant, section 102AAM. Most planning tends to be focussed on avoiding present entitlement to income and in ensuring (in so far as that is possible) that distributions to Australian residents are made from "tax-free corpus" to avoid the application of sections 99B and 102AAM.

5.4 Division 7A and section 47A

It is simply noted that Division 7A of Part III (***Division 7A***) was extended last year to include non-resident companies – see section 109BC. Section 109BC arguably narrows the application of Division 7A to non-resident companies in that the section may have no application if, for example, there is in the foreign jurisdiction no "due date for lodgement" for an income tax return.

The Note to section 109BC helpfully explains that section 109L:

> prevents amounts from being included in assessable income under this Division if the amounts are included in, or excluded from, assessable income under another provision of this Act, such as the rules relating to CFCs and FIFs.

However, if one turns to section 109L, the exclusion is not so generous and the profits of a CFC that have previously been taxed may still give rise to a deemed dividend when the person assessed under the CFC rules is not the person being assessed through Division 7A.

There is also a need to consider section 47A, as a loan from a CFC may be caught by section 47 even if it escapes taxation through Division 7A, unless the Commissioner accepts that a Division 7A complying loan is a loan made between parties "at arm's length with each other in relation to the loan". Even then, a complying Division 7A loan may fall foul of the other provisions in section 47A(7).

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14 It remains unclear why Part IVA does not apply to those trusts that would otherwise fall into section 102.
15 The section also applies if the trust has become a resident trust.

Section 47A is incredibly opaque. It applies to benefits provided by CFCs that are residents of an unlisted country under Part X and potentially taxes them as deemed dividends. It is not restricted to loans.

5.5 The FAF rules

The Government is developing these rules. At the time of writing, the Government had done nothing since releasing an Exposure Draft (the ***ED***)[16] of the new rules as *Tax Laws Amendment (Foreign Source Income Deferral) (No. 2) Bill 2010: Antirollup rule.*

For reasons best know to the Government, Part XI was repealed without proper consideration of what that entailed in the case of an FLP. At this stage, we know from the ED that someone finally understood the implications of repealing the FLP rules because there is a reference to it. But that is the extent of it: FLPs will be covered by the new FAF rules.

5.6 Source of income

It is also common for structures to be established on the basis that the foreign company or the trustee gives to the individual a power of attorney to make decisions on the entity's behalf as regards investments and, more importantly, to execute or arrange for the execution of share trades and the like.

This arrangement invariably creates issues as regards the nature of the gains (are they income or are they capital gains) and, if the gains are income (especially on the basis of *London Australia Investment Co Limited v FCT* (1977) 138 CLR 106 when it comes to a company and *Orr v Wendt* [2005] WASCA 199 when it comes to a trust[17]), then the income may be sourced wholly or partially in Australia.

If a business is being carried on, then sections 136AE(4) and 136AE(6) become relevant. They say, in broad effect, that the Commissioner may determine the source of income derived by a non-resident company or trustee if the company or trustee carries on a business in Australia at or through a permanent establishment (as defined in section 6(1) – which includes a dependent agent).

The Commissioner in making any determination is required to have regard to the matters set out in section 136AE(7), including at (c) "such other matters as the Commissioner considers relevant".

6 UNWINDING A STRUCTURE

6.1 Residency

To state the obvious, unwinding a structure is best done in the income year immediately prior to the one in which the individual is looking to become a resident.

In this respect, a returning resident who has retained his or her Australian domicile needs to be certain that a permanent place of abode still exists when unwinding the structure otherwise he or she may inadvertently find themselves taxed as a resident.

6.2 Sections 99B and 102AAM

6.2.1 Section 99B

Section 99B is a remarkably mean spirited provision.

It starts by making a resident assessable on an amount being property of a trust estate that is paid or applied for the benefit of a beneficiary of the trust estate. It does that regardless of the fact that the amount was in fact paid or applied at a time when the beneficiary was not a resident, if the beneficiary was a resident at any time during the income year in which the amount was paid or applied. It may be

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16 The ED is dated 21 April 2010.

17 The case is not a tax case, but relies on tax cases to conclude that gains on the sale of shares gave rise to income not capital.

that the courts will read this so that there needs to residency when the payment or application takes place, but that is the less likely reading of the section, especially in view of the amendment made in 2007 to add section 99B(2)(ba).

Regardless, one needs to be prudent and assume the worst case.

Section 99C significantly extends the concept of what is meant by an amount being applied for a person's benefit.

Sadly, it is only if one or more of the exclusions, set out in section 99B(2), applies that the amount is reduced or completely diminished. Even these exclusions are drafted in a mean spirited way.

Despite being added to the 1936 Act in 1979, the section has not found its way into the case law, aside from a mention in *Traknew Holdings Pty Limited v FCT* [1991] FCA 129 and *Weyers v FCT* [2006] FCA 818 where Dowsett J referred to what Hill J had said in *Traknew* but said that he did not need to deal with the section in view of his other conclusions. It is, however, the subject of numerous ATO IDs and Private Binding Rulings.

It is also the subject of a number of papers, mostly written back in the 1980s, by the luminaries of the day.

There are many unanswered questions concerning section 99B. The most obvious ones are:

1 Is the object of a bare power a beneficiary? Recently Heydon J in *Kennon v Spry* (2008) 238 CLR 366 and Brereton J in *Cypjayne v Rodskog* [2009] NSWSC 301 said an object was not a beneficiary in the context of the matters in dispute in those cases. In contrast, see Lindgren J in *Kafataris v FCT* [2008] FCA 1454. In the *Elliott* litigation referred to earlier, it was said that the objects were beneficiaries without any debate or discussion of the point.

2 How does one identify the corpus that benefits from the exception in section 99B(2)(a)? In *FCT v Clark* [2011] FCAFC 5, at [27] and [28], it is recognised that the property of a trust varies, for whatever, reason. It follows that for section 99B purposes it is more likely than not that, in the case of the usual trust instrument, the trust property will vary and, as a matter of logic, one will not be able to say what part of that property is "original" or "tax-free" corpus and what is everything else (such as undistributed current year income). It therefore seems sensible to identify what is covered by the exception by reference to the way the accounts are kept. This is supported, at least by analogy (as weak as that may be) by the cases on section 47, such as *Archer Brothers Pty Limited v FCT* (1953) 90 CLR 140.

3 How does the section deal with capital gains? They are taken to be included in the bad corpus, but the language – "amounts derived" - does not fit very well with how capital gains are taxed as net capital gains.

4 What happens to an amount taxed to the trustee through section 102? Does section 102(3) resolve the question when a subsequent distribution is made?

5 Does the section have a cascading effect? In other words, does the section apply if there is resettlement of capital (that represents accumulated income and gains of the old trust but is now corpus of the new trust) followed by a distribution from the new trust? The trustee of the new trust would not normally be described as a beneficiary. That would need to be the case for the corpus of the new trust not to be excluded by section 99B(2) when it is on-distributed. There is, of course, Part IVA to consider if one seeks to rely on this approach.

6 How literally does one read section 99C(2)(c)? That section says an amount is applied for the benefit of a beneficiary if:

> the beneficiary has received or become entitled to receive any benefit (including a loan or a repayment, in whole or in part, of a loan, or any other payment of any kind) provided directly or indirectly out of that amount or out of property or money that was available for the purpose by reason of the derivation of the amount.

Can it have been intended that a loan (especially one on commercial/arm's length terms) to a beneficiary is assessable in whole?

7 How does one identify a section 99B(2)(c) amount? The exclusion in section 99B(2)(c) presumes that there is a clear identity between an amount paid or applied and an amount that has been assessed to the beneficiary under section 97 or the trustee under section 98, 99 or 99A when the amounts that are assessed by these provisions are notional amounts that depend on what has been brought into the net income calculation.

Most of the work done in relation to section 99B is focussed on the corpus exception or, in the context of this paper, ensuring that the trust fund is, at the very least, liberated of its accumulated income and gains in the income year before the individual migrates (or ceases to be a TR – see section 768-910).

In relation to section 768-910, it may be that receipt in the same year as when a TR ceases to be a TR but paid to or applied for the benefit of the TR at a time when the individual was still a TR may be excluded from assessability on the basis that the relevant circumstance is the payment or application of the amount.

6.2.2 Section 102AAM

Section 102AAM gives an incentive for the retention of the two-tier (trust and company) structure because of the way that it works. In simple terms, section 102AAM (together with *Taxation (Interest on Non-resident Trust Distributions) Act 1990*) aims to penalise the accumulation of income and gains in a trust by imposing an additional tax charge – in effect an interest charge – on amounts made assessable pursuant to section 99B.

Relevantly, section 102AAM is drafted to take account of the fact that a trust ceased to be a non-resident trust. Thus converting the trust into a resident trust before making a distribution that is assessable under section 99B cannot defeat the section.

That, of course presupposes that section 99B applies to a resident trust. Read literally it does, and, of course, when it was added to the 1936 Act, there was good reason why it applied to resident trusts – see *Union Fidelity Trustee Company of Australia Ltd v FCT* (1969) 119 CLR 177.

The Commissioner has said that section 99B is limited to non-resident trusts, but has argued to the contrary. Justice Hill in *Traknew* suggested, without deciding, that section 99B may need to be read down, but not necessarily so that it applies only to non-resident trusts.

However, in view of the fact that an offshore trust (with one asset - Australian dollars) can easily move onshore, section 99B would need to be applicable to such trusts.

Fortunately, the section limits the additional tax so that a beneficiary never pays more than 100 cents in the dollar (see section 102AAM(6)).

Even more fortunately, the section effectively imposes no penalty if the distribution is taxed in the income year in which the individual becomes a resident, provided that the individual is a First Timer (i.e. first commences to be a resident in the income year (see section 102AAM(5)(a)).

A possible weakness in the application of the section is that it is linked solely to the year on income in which the income or profit is derived by the trustee so the two tier structure does result in a lower rate of additional tax if the amount taxed through section 99B is sourced in a dividend or deemed dividend from the company that represents accumulated income and gains over a long period of time.

6.3 Dividends

It is critical to extract profits from a foreign company prior to becoming a resident unless one is a TR.

Even if the profits are distributed prior to the individual becoming a tax resident, there is a need to consider whether there is a "retrospective" aspect to residency if the individual becomes a resident in the same income year as the distribution is made and the individual is potentially taken to be a resident for the whole of the income year under the "183 day test".

It is not uncommon to see people coming from the UK putting a company in liquidation with a view to treating any distribution as a capital distribution (*IRC v George & Burrell* [1924] 2 KB 52). The theory is that from an Australian perspective the individual has stepped up his or her cost base for CGT purposes and, as a consequence, the distribution in liquidation is tax-free or substantially tax-free.

That, of course, is not how we look at what has happened. Rather we apply sections 44 and 47 so that the "profits" distributed are potentially taxed as income – see inter alia *FCT v Brewing Investments Limited* (2000) 100 FCR 437 and the High Court's decision to reject the special leave application, *Brewing Investments Limited v FCT* [2001] HCATrans 28.

In this respect, it is important to remember that, if dividends are involved, section 44 taxes dividends that are "paid". Whilst "paid" is given an extended meaning in section 6(1) when it comes to dividends, by treating a dividend "credited" as paid, "credited" does not mean the making of a journal entry. So timing is important.

6.4 Delayed remuneration

Sometimes an individual who moves to Australia receives income as a consequence of some services undertaken when the individual was a non-resident. However, the income is received and, therefore, derived when the individual is a resident (assuming as would normally be the case that the individual is a cash basis taxpayer on that income).

There was a time when section 23AG might have assisted the individual with the resolution of this matter, but since its amendment through the addition of section 23AG(1AA), the section has a very limited field of application.

It is possible to argue that the income is not assessable, assuming that it all relates to services rendered when the individual was a non-resident. The argument depends on the extent to which the Commissioner is willing to accept the "policy" that is evident in the rules that relate to employee share schemes as a guiding policy.

If one refers to [1.105] and [1.347] to [1.366] of the explanatory memorandum to *Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009* which relates to the ESS rules introduced in 2009 and Chapter 4 of the explanatory memorandum to *New International Tax Arrangements (Foreign-Owned Branches and Other Measures) Act 2005*, one can see that the authors of the explanatory memoranda believe that there is an overriding principle that derivation of the income is apportionable over the period and if the relevant employment was undertaken or the services were rendered outside of Australia when the individual was a foreign resident, the income is foreign source income derived by a non-resident and, therefore, non assessable.

It is, however, difficult to see how that approach can survive what was said by the Full Court of the High Court in *Saeed v Minister for Immigration and Citizenship* [2010] HCA 23 at [31]:

> As Gummow J observed in *Wik Peoples v Queensland*, it is necessary to keep in mind that when it is said the legislative "intention" is to be ascertained, "what is involved is the 'intention *manifested*' by the legislation". Statements as to legislative intention made in explanatory memoranda or by Ministers, however clear or emphatic, cannot overcome the need to carefully consider the words of the statute to ascertain its meaning.

The principle remains that such income is derived when it is received – see *FCT v Sun Alliance Investments Pty Ltd (in liquidation)* (2005) 225 CLR 488 at [43].

If the individual was previously resident in a country with which Australia has a double tax agreement (a ***DTA***) when the services were performed, then the individual would, no doubt, seek to rely on the dependent services article of the DTA to claim exemption from Australian tax. Generally, the article says that Australia cannot tax the remuneration, as the employment was not exercised in Australia. The article does, however, say that it applies to *remuneration derived by a resident of a Contracting State* and it is because the individual is likely to have ceased being a resident of the other country when the income is derived that the problem arises.

The OECD Commentary regarding Article 15 (Income from Employment) of the OECD Model DTA says at [2.2] that, in effect, the exemption applies regardless of when that income may be paid to, credited to or otherwise definitively acquired by the employee.

The Australian courts have told us that DTAs are to be interpreted liberally – see, for example, Lindgren J in *Undershaft (No 1) Limited v FCT* [2009] FCA 41 at [38] to [45] – and, in light of the position expressed in the OECD Commentary, there is a strong likelihood that the DTA will act as a shield in this instance provided that there is no other basis for excluding the application of the article (such as a limitation of benefits article). However, that approach now needs to be qualified by the less liberal views expressed by Dowsett J (and agreed with by Edmonds and Gordon JJ) in *Russell v FCT* [2011] FCAFC 10 at [25] to [31] inclusive.

6.5 DTAs

Dual residency, which often occurs when an individual moves from overseas to Australia, is sometimes seen as offering a solution to the taxation of amounts received during the transitional income year where the different concepts of income year (theirs and ours) intersect, provided, of course, that there is a relevant DTA to rely on.

First, one has to assert that the individual is a tax resident of the other jurisdiction and then you need the DTA to apply such that:

1 Under the tie-breaker provisions in the DTA regarding residency the individual is taken to be a tax resident of the other jurisdiction for the purposes of the DTA.

2 It effectively excludes Australia's right to tax the income or gain involved.

In some cases there are "limitation of benefits" clauses. The UK and Singapore DTAs are examples of where the DTA will limit the individual's right to claim an exemption from Australian tax.

For example, article 23(1) of the UK DTA provides that:

> Where under this Convention any income or gains are relieved from tax in a Contracting State and, under the law in force in the other Contracting State, a person in respect of that income or those gains is taxed by reference to the amount thereof which is remitted to or received in that other State and not by reference to the full amount thereof, then the relief to be allowed under this Convention in the first-mentioned State shall apply only to so much of the income or gains as is taxed in the other State.

In many instances, UK tax depends on the income being remitted so that a UK resident who, for example, used a Dutch service company to shelter professional services income from tax, could not rely on the UK DTA to prevent Australia from taxing income paid to him by that company even though he was a UK resident for the purposes of the DTA as that income was not remitted and taxed in the UK.

It is also worth noting that insofar as the income of the Dutch service company is personal services income (***PSI***) under Part 2-42, the Dutch DTA would not operate to protect the PSI from tax in Australia – see *Russell v Commissioner of Taxation* [2009] FCA 1224 and on appeal [2011] FCAFC 10.

7 ELECTIONS

When people transition, there is a tendency to overlook the elections that need to be made. The most obvious ones are:

1 Family Trust and Interposed Entity Elections.

2 CFC Elections.

3 TOFA and Forex Elections.

Timing can be critical.

Amongst these elections, attention is drawn to the murky world of the functional currency rules in Subdivision 960-D of Part 6-1.

Included in the very short list of entities allowed to make a functional currency election are:

(a) an attributable taxpayer of a CFC (Item 4 of the table in section 960-60(1)); and

(b) a transferor trust (item 5 of the same table).

Oddly, in the case of a transferor trust, the election must be made by the trust. Assuming that the choice is to be made by the trustee, as trusts will rarely be persons, a further oddity is the way "transferor trust" is defined in section 960-75:

> A ***transferor trust*** is a trust where, having regard to all relevant circumstances, it would be reasonable to conclude that another entity is, or is likely to be, an attributable taxpayer in relation to the trust for the purposes of Division 6AAA of Part III of the *Income Tax Assessment Act 1936*.

Bearing in mind that tax is imposed on the attributable taxpayer, it is not entirely clear why the choice needs to be made by the trustee. No doubt it has something to do with the fact that a transferor trust only has one amount of attributable income in respect of an income year, but it is still a curious approach to the matter from a practical perspective, as the trustee of a trust will rarely be aware that the trust is a transferor trust.

Another oddity of the functional currency rules is the time at which the election needs to be made. Generally, most taxpayers will find that they can only make prospective elections for the next income year or statutory accounting period.

A further failing of the functional currency rules is that they do not apply to a foreign trust that is not a transferor trust. Bearing in mind the purpose expressed in section 960-59, you would expect all non-resident trusts to account in the relevant functional currency and to determine net income accordingly for the purposes of Division 6.

PART B OUTBOUND

When it comes to an exit, some very similar issues arise.

Nevertheless, most of the time, the focus is likely to be on the CGT exit rules in Subdivision 104-I, the implications for an onshore trust and company structure and the self managed superannuation fund.

Obviously, because of the residency issue, some people are counselled to dispose of their main residence (and to take other steps) which tends to be more of an emotional issue rather than a tax issue, but can, of course, be a tax issue.

Again, amidst the many issues, I propose to focus on the following:

1 Residency of related entities.

2 The deemed disposal of assets.

3 CFCs, transferor trusts and FAFs.

4 Unwinding structures.

5 Source.

8 RESIDENCY OF RELATED ENTITIES

Because of the adverse rules applicable on the exit of an entity, the general approach is for retained entities to remain as Australian residents.

8.1 Companies

Obviously, in the case of a company incorporated in Australia, the residency does not change, although the source of its income might and that obviously impacts on the company through the possible application of foreign tax and the potential for that to generate foreign income tax offsets and conduit foreign income.

The CFC rules and section 23AJ, section 23AH and the conduit foreign income rules enable active foreign source income to flow through to non-residents with minimal Australian tax.

With respect to Australian source income, subject to what happens in the new jurisdiction, at least the tax is theoretically set at 30%.

Chances are the company will have retained profits and related franking credits. Obviously, one cannot “trade” those credits and the likely consequence is that the company will become an “exempting entity” for the purposes of Division 208.

That should not, of itself, cause any problems as the company can still pay franked dividends that are, therefore, not subject to withholding tax (assuming that they are fully franked) with the incentive that by delaying any distribution of retained earnings there will not be an top-up tax (although there could, of course, be further tax to pay elsewhere).

Consequently, the fact that the company’s tax residence remains in Australia, may not have any direct adverse consequences.

8.2 Foreign hybrids

Division 830 deals with a foreign hybrid that ceases to be a foreign hybrid. Whilst one tends to focus on hybrids as holding foreign assets, that may not necessarily be the case.

8.3 Trusts

If the residency of a trust estate (including a deceased estate) changes – i.e. from resident to non-resident - then that change only applies from the start of the next income year.

The same, in theory, applies if the residency of a trust changes for CGT purposes. Interestingly, the Commissioner takes the approach that the trust can stop being a resident trust for CGT purposes other than at the end of the income year – see paragraph 6 of TD 1999/83.

8.4 General partnerships

Aside from the rules that apply to foreign hybrids (that are treated as general partnerships), Division 5 takes no account of the change.

From the perspective of the CFC rules, there may be a change and the partnership may cease to be an Australian partnership and may also cease to be an attributable taxpayer.

9 THE DEEMED DISPOSAL OF ASSETS

9.1 CGT

9.1.1 Individual and Companies

The relevant event is CGT event I1, which occurs when the individual or company stops being an Australian resident (section 104-160(2)).[18]

[18] The term used is “you”. However, the relevant definitions effectively restrict CGT event I1 to individuals and companies (including deemed companies).

The section requires the individual or company to determine if he, she or it has a capital gain or capital loss for *each*[19] CGT asset aside from:

1 Any pre-CGT asset.

2 Taxable Australian property covered by item 1 or 3 (but not 2 of the table in section 855-15) – Australian real property and certain assets used in carrying on a business in Australia through a permanent establishment (defined by reference to section 23AH).

3 Certain options or rights.

These are most but not all categories of taxable Australian property. There is no exclusion for an interest in a company or trust that is an indirect Australian real property interest – item 2 of the table in section 855-15.

Thus there is a difference between direct ownership of land and indirect ownership, which in the case of a company may well tell against making a decision to expatriate the company.

In determining whether there is a capital gain or loss, the CGT event works as if there is a sale at market value.

In the case of assets covered by item 2 of the table in section 855-15, section 104-160(4A) allows a cost base for those indirect Australian real property interests equal to their market value because those assets remain subject to the CGT (as taxable Australian property).

An individual is provided with a single opportunity to disregard all capital gains and losses from all CGT assets covered by CGT event I1 (section 104-165). That choice, which is often made by default – by the way the tax return is prepared - is an all or nothing choice and it is possible that by inadvertently returning a gain or taking a loss in error destroys the validity of the choice.

If the choice is made, the assets that benefit from the choice are taken to be taxable Australian property (if they are not already taxable Australian property) and to continue to be so until a CGT event happens to the asset that involves "you ceasing to own the asset" or you again become an Australian resident – see section 104-165(3).

There are at some interesting aspects that follow from the exception.

The first is that the individual can be taxed on the asset countless times unless the individual ceases to own it, so if the individual is contemplating dealing with such an asset, he or she should cease to own it.

The second is that CGT event K3 will not apply to an individual if he or she leaves these assets to a non-resident in his or her will (assuming the individual is still a non-resident) – see section 104-215.

The third is that some DTAs will allow the individual to avoid tax completely. For example, under Article 13 (Alienation of Property) of the new NZ DTA, Australia retains a right to tax assets that are subject to the choice. However, the effect of Articles 13(5) and 13(7) is to limit Australia's taxing right to alienations within the next 7 years. So once the 7 year period is over, Australia cannot tax the capital gain and New Zealand will not tax it either, unless the law in New Zealand is altered to tax capital gains.

In some other cases, Australia agrees to forgo the taxing right. See, for example, the US, French and Norwegian DTAs.

9.1.2 CFCs and branches

Normally, if a company disposes of its shareholding in a CFC, then it can potentially avail itself of the

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[19] The emphasis is in the Act.

reduction in Subdivision 768-G. However, if an Australian company expatriates, then that possibility is not available to it unless it disposes of the shares prior to expatriating.

This is because section 768-505 requires the CGT event to be one of A1, B1, C2, E1, E2, G3, J1, K4, K6, K10 or K11. CGT event I1 is conspicuous by its absence, although the policy reason for this is not clear.

The equivalent provision with respect to a foreign branch is section 23AH. That section applies to any CGT event, so there is some prospect of the capital gain being disregarded.

9.2 Trusts

The rules for trusts are the same as for companies. However, there will be a timing lag as noted earlier unless one follows the Commissioner's position in TD 1999/83. Relevantly, the Commissioner takes the view that the residency can stop before the end of the income year and that CGT events that happen after the point in time when the change happens are only taxable if they relate to taxable Australian property.[20]

The rule also applies to a superannuation fund, but that potentially leads to double tax as there are specific rules in Division 295 that aim to deal with the change in residence.

Sections 118-20(4A) and 118-20(4B) do not necessarily deal with the issue, which suggests that the intended effect of CGT event I2 is that it does not apply to a superannuation fund even though it is a trust.

9.3 Forex

From a CGT perspective, foreign currency is a CGT asset (see Note 1 to section 108-5). Consequently, the "I events" can happen to foreign currency.

There is no rule in Division 775 that matches this, so the anti-overlap provision in the CGT, section 118-20, has no application.

That presumably leaves open the issue of what happens when an actual disposal or other forex realisation event occurs. Clearly, section 775-15 or section 775-30 can then apply and the issue should then be a source issue (in theory).

Obviously, scope for double taxation or double deductions (treating a capital loss as a deduction for this purpose) or a hybrid exists and the sections designed to deal with these issues, section 775-15(4) and 775-30(4) do not work appropriately in this situation.

9.4 TOFA

See the discussion at 4.3.3.

9.5 Depreciable assets

For depreciation purposes, there is no balancing adjustment event at the time of the residence change.

For CGT purposes, if the asset is or was attributable to a permanent establishment in Australia, then it falls outside of the "I events".

For assets held as part of a foreign branch, then a company should be able to rely on section 23AH, but not an individual or a trust and, in so far as there is a taxable gain, sections 118-20 and 118-24 would not appear to apply.

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[20] This assumes that the change from Division 136 to Division 855 in 2006 does not cause the TD to fall away.

9.6 Trading stock

Section 118-25 allows one to disregard any capital gain or loss on a deemed disposal.

From an income perspective, the trading stock is still on hand and has not been disposed of. If the trading stock is subsequently disposed of as an asset of what is a non-Australian business, subject to the impact of a relevant DTA, the issue would then be dealt with under section 6-5, so that the issue becomes a question of source.

9.7 Revenue assets

There is no equivalent to section 118-25 for revenue assets, so the possibility of double taxation arises unless the assets are covered by item 3 of the table in section 855-15 or, in the case of an individual, the choice to defer the taxing time is made under section 104-165.

9.8 Deferred ESS interests

There is a potential exception from CGT event I1 for such interests in Subdivision 130-D; see section 130-80.

9.9 Division 974

See the discussion at 4.8.

9.10 Debt forgiveness

If one is contemplating a debt forgiveness of a resident entity, then one does need to factor in that the market value substitution rule is not applicable if the creditor is a non-resident unless the debt is taxable Australian property of the creditor.

10 CFCS, CFTS AND TRANSFEROR TRUSTS

Aside from the CGT issue associated with CGT event I1, there is no rule that a change in residence of the attributable taxpayer causes the CFC, CFT or transferor trust to crystalise any gains or losses that are then attributed to the attributable taxpayer.

In the case of a CFC, there is, as noted above, a CGT event for the attributable taxpayer as shareholder, although the individual can make the choice to defer which means that there is an effective permanent deferral of the gain. This is because, instead of subsequently disposing of the shares in the ex-CFC and triggering the CGT, the ex-CFC can dispose of its assets and pay a dividend which should be excluded from assessability as it is paid by a non-resident entity to a non-resident entity from profits derived from non-Australian sources and therefore not subject to tax under section 44(1)(b) (regardless of what section 44(1A) and 44(1B) do to the notion of what is profits).

When it comes to transferor trusts, these will almost always be discretionary trusts. Consequently, a transferor will generally not have a CGT asset or, if the rights held are regarded as a CGT asset, then that CGT asset will have little or no value – see *CCSD v Buckle* (1998) 192 CLR 226 at [40] and [41].

11 UNWINDING STRUCTURES

Speaking generally, there is unlikely to be strong reasons to unwind an offshore structure held through Australia, other than a desire to remove the structure from the overly complex and excessive Australian tax rules.

At present, and subject to what happens with ATO ID 2005/200 (discussed below), any offshore structure flowing through Australia (because there is an Australian holding company or it is owned by an Australian trust or Australian partnership from a CFC perspective) can be retained with a relatively low tax cost, subject to certain caveats.

11.1 CFCs

If a CFC is held by an Australian resident company, then the rules will allow active income into and out of Australia on a tax free basis (putting aside taxes in the source jurisdictions) through such provisions as:

1 The CFC rules which limit taxation to passive income and in some cases even the passive income is not taxed.

2 Section 23AJ means that the dividends received are non-assessable non-exempt income.

3 The CGT reduction in Subdivision 768-G.

4 The conduit foreign income rules in Subdivision 802-A that allow unfranked dividends to be paid out on a tax free basis.

5 The functional currency rules.

If the CFC is held through an Australian trust or Australian partnership, then the aim of section 460 is to prevent tax being paid by a non-resident on what is otherwise attributable income. To quote the explanatory memorandum to *Taxation Laws Amendment Bill (No 6) 1990*:

> Section 460, to be inserted by the Foreign Income Bill, ensures that a person who is a non-resident during a year of income is not liable to Australian tax as a partner or beneficiary (including indirectly by a liability imposed on the trustee in respect of such a beneficiary) on income attributed to an Australian partnership or Australian trust under section 456 to 459 in respect of the period where the partner or beneficiary was a non-resident. An exception is made where the partner or beneficiary is a CFC.

11.2 Transferor trusts

If one has such a trust, there will be attribution only in respect of the period up to the cessation of residence – see section 102AAZD(1)(e).

11.3 Resident company

In so far as local assets are held through a local company incorporated in Australia, one cannot change the status of the company except indirectly through a DTA (which raises issues beyond the scope of this paper).

As noted earlier, the company may be subject to restrictions on the franking of dividends, but otherwise nothing changes (subject to issues such as withholding tax, thin capitalisation and transfer pricing).

There may, of course, be opportunities to reduce the Australian tax through restructuring or introducing debt, especially as the interest will generally be subject to a reduced rate of tax (i.e. 10% through the withholding tax rules). Doing that raises issues such as thin capitalisation, transfer pricing, deductibility of the interest and, naturally, Part IVA and Subdivision D of Division 3 of Part III.

11.4 Resident trust

Whilst it is easier to change the residence of a trust, maintaining the trust as a resident trust for CGT purposes and as a resident trust estate for Division 6, is not necessarily all bad.

In theory, Division 6 only taxes a non-resident beneficiary to the extent to which the net income is "attributable to sources in Australia". Consequently, there is scope to limit the application of Division 6.

One interesting issue that arose in 2005 concerned the taxation of FIF income included in the net income of a resident trust estate where there were non-resident beneficiaries. This was dealt with by the ATO in ID 2005/200. The facts of the ID are:

> The resident trust estate's net income under section 95 of the ITAA 1936 for a year of income includes FIF income under subsection 529(2) of Part XI of the ITAA 1936.
>
> The trust has non-resident beneficiaries.
>
> All the beneficiaries of the trust are presently entitled to the income of the trust as determined by the trust deed.
>
> The FIF income is not income attributable to sources in Australia.

The ATO's conclusion was that section 99A applied to the FIF income on the basis that the proportionate approach (since definitively approved as applicable to section 97 in *FCT v Bamford* [2010] HCA 10) was not applicable due to the wording of section 99A.

The repeal of Part XI does not totally kill the issue and it remains to be seen what is done about the ID, which is generally considered to be wrong.[21]

12 SOURCE

There is no source rule for statutory income, but, in theory, the source rule is meant to be the same as for ordinary income (*a practical, hard matter of fact* – per Isaacs J in *Nathan v FCT* (1918) 25 CLR 183 at 190) - see Lindgren J in *Fowler v FCT* (2008) FCA 528 at [52].[22]

In relation to Division 230, the TOFA EM points out that the effect of section 230-15(7) is to retain the general source rules:

> 3.69 Gains from financial arrangements included in assessable income pursuant to subsection 230-15(1) will still retain their character as either statutory or ordinary income (see note 2 to subsection 6-10(2) of the ITAA 1997). Apart from some specific rules for determining a gain or loss on a financial arrangement where there is a change of residence during an income year (see Chapter 11), Division 230 does not disturb the general rules relating to foreign residents contained within Division 6 of the ITAA 1997. The structure of that Division (and, in particular, subsections 6-5(3) and 6-10(5) of the ITAA 1997) ensures that foreign residents are only taxed on their gains from financial arrangements that have an Australian source.[23]

Bearing in mind that there are few statutory source rules, it places a significant onus on all non-resident taxpayers to determine whether a notional gain has an Australian source. The obvious illustration of the problem is the ATO's dispute with TPG.

As noted earlier, Division 13 of Part III allows for source to be determined by the Commissioner in certain circumstances. Inherent in the Division is the notion that business income (derived on an arm's length basis) is Australian sourced if it is attributable to a permanent establishment.

Other provisions also provide a form of source rule – see for example the withholding tax rules, section 44(1)(b) and the MIT rules.

The DTAs also apply there own source rule by saying that that which can be taxed here is deemed to be Australian sourced. However, importantly, in the case of business profits, the connecting factor is the permanent establishment.

Division 855, on the other hand, applies a different test for capital gains – "taxable Australian property" – as a quasi source rule.

One would hope that when the courts look to interpret the legislation that they will be conscious of Division 13 of Part III in particular and place some emphasis on the need for business income to be connected to a permanent establishment.

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21 There are references to it in the consultative material relating to the changes to the CFC and transferor trust rules.

22 I take comfort from the fact that Tony Frost and Betsy Rumble arrived at the same conclusion in their branch report to the 63rd Congress of the International Fiscal Association – Volume 94b at page 91.

23 The TOFA also tells us that the withholding tax rules take precedence so Division 230 will not tax a non-resident on what is regarded as a gain in relation to interest and the like.

Better still, the Government could heed the call from the Asprey Committee[24] and legislate.

16 February 2011

[24] Taxation Review Committee, Full Report, 31 January 1975