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Discretionary trusts, non-TAP gains, and foreign beneficiaries

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THE TAX INSTITUTE

Discretionary trusts, non-TAP gains, and foreign beneficiaries

by Adam Crowley, ATI, Partner, RSM Australia

The Australian tax system differentiates between residents and non-residents. In the context of fairness, those who contribute to the system should also benefit from the system. As non-residents are typically unable to benefit from government spending in the same way as residents, many would consider it only fair that these individuals are not subject to the same scope of taxation as those who reside in Australia. With this in mind, parliament introduced Div 855 ITAA97. The effect of Div 855 is relatively simple. It seeks to narrow the range of assets that are subject to Australian capital gains tax for foreign residents. While the intent of the provisions is apparent, that is, foreign residents should not be subject to Australian tax on non-taxable Australian property (TAP) assets, the complexity arises where a foreign resident receives a distribution of a non-TAP capital gain via a resident discretionary trust.

Introduction

The foundations of a sound tax system are built on the notions of efficiency, equity and simplicity.[1] Put simply, this means that the tax system should minimise distortion, apply fairly, and be clear and concise in its application.[2]

While determining "fairness" may be subjective, in the context of the Australian tax system, it is generally accepted that "fairness" occurs when individuals in similar circumstances are taxed similarly.[2] It seems to therefore follow that it would also be "unfair" to impose the same scope of taxation on those in different circumstances.

For this reason (in part), the Australian tax system differentiates between residents and non-residents. In the context of fairness, those who contribute to the system should also benefit from the system. As non-residents are typically unable to benefit from government spending in the same way as residents,[3] it is only *fair* that these individuals are not subject to the same scope of taxation as those who reside in Australia.

With this in mind, and a desire to encourage investment in Australia and better align with OECD standards,[4] the parliament repealed former Div 136 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) and introduced Div 855 ITAA97. The effect of Div 855 is relatively simple. It seeks to narrow the range of assets that are subject to Australian capital gains tax for foreign residents.[4]

While the Division seemingly achieves its desired effect for CGT assets held directly, or indirectly via fixed trusts, it falls apart where discretionary trusts are concerned.

The discussion that follows considers the notion of fairness when applying Div 855 in the context of discretionary trusts. To this end, first, it outlines the form of the relevant provisions and their interaction. Second, it considers the applicable case law, recent ATO determinations, and critiques from the profession. Finally, it seeks to demonstrate that what otherwise appears unfair is, in effect, necessary to protect the integrity of the Australian tax system.

CGT and trusts

Division 855 ITAA97

Division 855 provides that a foreign resident's liability for CGT is determined by whether the relevant asset is "taxable Australian property" (TAP) (s 855-15 ITAA97). Broadly, TAP assets are defined to include direct interests,[5] or indirect[6] non-portfolio interests,[7] in real property situated in Australia,[8] assets used in carrying on business through a permanent establishment in Australia,[9] options or rights in the abovementioned,[10] or assets elected to be TAP[11] to defer a capital gain under CGT event I1.[12]

The substantive provisions that mitigate CGT for foreign residents are ss 855-10 and 855-40 ITAA97. Section 855-10 states that foreign residents can disregard a capital gain or loss from a CGT event that happens in relation to a CGT asset that is *not* TAP (non-TAP). Similarly, s 855-40 provides that a foreign resident can disregard a non-TAP gain made through a "fixed trust".[13] In effect, s 855-40(1) seeks to provide comparable taxation treatment to foreign residents as between direct and indirect ownership of non-TAP assets.

While the intent of the provisions is apparent, that is, foreign residents should not be subject to Australian tax on non-TAP assets, the complexity arises where a foreign resident receives a distribution of a non-TAP capital gain via a resident discretionary trust.[14]

Division 6 ITAA36

Under s 95 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), the net income[15] of a trust estate is calculated as if the trustee were an Australian resident taxpayer. This requires the trust to include income from sources both inside and outside of Australia (s 6-5(2) ITAA97). Where a foreign resident beneficiary has been made "presently entitled"[16] to a share of the trust's net income, the taxation of the beneficiaries' share (or the trustee on the beneficiaries' behalf) is typically administered by ss 97 and 98 ITAA36.

Under these provisions, the assessable income is limited to so much of the share of the trust net income as is attributable to a period when:

– the beneficiary *was* a resident;[17] and
– the beneficiary *was not* a resident and is also attributed to *sources* in Australia.[18]

One anomaly that arises is that, while foreign residents owning assets *directly* are only subject to tax if the asset is "TAP" (s 855-15), those same foreign residents, if made presently entitled to net income (including a net capital gain) via a discretionary trust, would otherwise be taxed by reference to the "source" of the gain if it were not for Div 6E ITAA36 (discussed below). Unfortunately, the CGT rules do not contain any provisions that expressly determine the source, and the TAP tests in Div 855 are said to not be relevant for this purpose.[19] Thus, case law principles of source being a "practical hard matter of fact"[20] will apply.

To evidence the perceived unfairness of this anomaly, should a foreign resident individual directly hold a portfolio interest of ASX listed shares, as the shares are non-TAP, the foreign resident will not be subject to tax under Div 855.[21] Conversely, as the "source" of a gain in relation to shares is typically where the shares are held and the contract for sale entered,[22] if not for the application of Subdiv 115-C and Div 6E (discussed below), should a foreign resident be made presently entitled to the same gain via a discretionary trust, the gain would be subject to tax as being Australian-sourced.

Subdivision 115-C ITAA97 and Div 6E ITAA36

Overlaying the above interaction between capital gains and trust income are "interim measures" introduced in 2010-11 within Subdiv 115-C ITAA97. The practical effect of the Subdivision is to gross-up net capital gains that have been discounted in the hands of the trustee,[23] and to attribute to the grossed-up gain to the beneficiary.[24] Attribution is done first by reference to a beneficiaries' "specific entitlement" to the gain (streaming),[25] and second by reference to the beneficiaries' "present entitlement" to any gain remaining after that.[26]

To avoid double taxation for the beneficiary,[27] Div 6E ITAA36 will apply to adjust the amount assessable to the beneficiary under Div 6 by the amount of the attributable gain under Subdiv 115-C.[28]

Given the removal of the capital gain under Div 6 and its attribution under Subdiv 115-C, when determining whether a capital gain is taxable, either in the hands of a foreign beneficiary or the trustee on their behalf, confusion arises as to whether "non-TAP status" and/or "source" become relevant. If nothing else, complexity ensues.

Case law and the ATO

Oswal

The Commissioner's views on the interaction of the abovementioned provisions first gained notoriety in *Radhika Pankaj Oswal v FCT* (the *Oswal* case).[29] As far as is relevant, the *Oswal* case concerned a resident discretionary trust that made a capital gain in relation to non-TAP shares held in an Australian company.[29] The trustee made Mrs Oswal presently entitled to the net income of the trust estate (which included the gain) and, as at the relevant time Mrs Oswal was a temporary resident, she was arguably afforded foreign resident treatment under the exemption in s 768-915(1)) ITAA97.

As a *foreign resident*[30] presently entitled to a non-TAP capital gain, Mrs Oswal argued, consistent with policy intentions, that s 855-10(1) ITAA97 applied to disregard the capital gain.

Despite accepting that the gain would have been disregarded if the shares were held by Mrs Oswal directly,[31] the Commissioner advanced two arguments against the taxpayer:

1. that Mrs Oswal did not "make a capital gain … from a CGT event", but rather the trustee had the CGT event, and Mrs Oswal's capital gain arose from the attribution under the gross-up rules within s 115-215 ITAA97; and
2. that Div 855 provides absolutely no relief to a beneficiary of a resident *discretionary* trust.[32] That is, s 855-10 does not apply to beneficiaries,[33] and relief for beneficiaries under s 855-40 only applies to *fixed* trusts.

Beyond the obvious "why should it matter if the gain was made directly or indirectly", the most compelling critiques of the Commissioner's arguments are as follows:

– there is nothing in s 855-10 that states a gain must arise from a CGT event that happens *to the taxpayer*.[32] That is, the Commissioner is reading words into the legislation that do not exist;
– s 102-20 ITAA97 explicitly provides that "*you* may make a capital gain … as a result of a CGT event happening to another entity";
– capital gains can only arise *from* CGT events. To the extent that s 115-215 attributed a gain, it merely deemed the beneficiary to have had the relevant CGT event;[32] and
– there is nothing in the language in s 855-10 that excludes beneficiaries from its application.[32]

Unfortunately, as the *Oswal* case was settled before judgment, the above interpretations are left unresolved. Fortunately, we did not have to wait too long for guidance.

Greensill

In a recent decision from the Federal Court in *Peter Greensill Family Co Pty Ltd (trustee) v FCT* (the *Greensill* case),[34] similar issues to *Oswal* were contested.

In the *Greensill* case, the Commissioner assessed the trustee of a discretionary trust under s 98 in relation to $58m of capital gains that it made over a three-year period on the disposal of shares which were not "taxable Australian property". In each year, the trustee resolved to distribute 100% of the capital gains from the sale of those shares to Mr Alexander Greensill, a foreign resident.

Following an ATO review, the Commissioner issued assessments to the trustee under s 98 on the basis that the capital gains distributed to Mr Greensill, being deemed or attributable capital gains under Subdiv 115-C, were assessable to the trustee and not disregarded under Div 855.

The taxpayer contended that the capital gains distributed to Mr Greensill were capital gains "from a CGT event" which were to be disregarded by operation of s 855-10(1). It was submitted that Mr Greensill's capital gains were from the happening of CGT events to exempt assets, and that there was no amount, in respect of Mr Greensill within s 115-220, on which the trustee was liable to be assessed under s 98.

In response, the Commissioner contended that Mr Greensill was deemed to have made capital gains as a result of s 115-215(3), and that those deemed capital gains were not disregarded under s 855-10. As such, Mr Greensill was assessable on his net capital gain for each income year. The Commissioner also contended that the trustee was liable for the tax that had been assessed to it as trustee, regardless of whether s 855-10 applied to disregard the capital gains deemed to have been made by Mr Greensill.

In finding in favour of the Commissioner, Thawley J held that:

– s 855-10(1) did not apply to disregard any of the trust's capital gains as the trust was neither a foreign resident nor a trustee of a foreign trust; and
– the amount which s 115-220 required the trustee to be taxed on under s 98 is an "attributable gain", being simply an amount which the statute requires to be calculated, and is not a capital gain capable of being the subject of s 855-10(1).

In relation to Mr Greensill:

– Mr Greensill, as a presently entitled beneficiary, was assessed under s 115-215; and
– an attributable gain calculated under s 115-215 is not a capital gain *from* a CGT event within the meaning of s 855-10(1). It is an amount which is calculated by reference to CGT events which occurred in respect of CGT assets of a trust.

While much of the taxpayers arguments proceeded upon an assumption that the policy objective of Div 855 was the non-taxation of foreign beneficiaries in respect of non-TAP capital gains, Thawley J was quick to point out that the purpose of the legislation is to be derived from what the legislation says, not from an *a priori* assumption about the desired or desirable operation of the provisions.

While the court has sided with the Commissioner, only time will tell if the decision was the correct one. Given the tax liability involved, one can only assume that an appeal to the Full Federal Court is likely.

Draft tax determinations

Unsurprisingly, the Commissioner's view in TD 2019/D6 is that foreign beneficiaries of a resident discretionary trust that are presently (or specifically) entitled to non-TAP gains are assessable in Australia on those gains.[35]

The arguments advanced in support are principally the same as those in *Oswal* and *Greensill*, ie that, primarily, a capital gain that a foreign resident beneficiary makes because of the operation of s 115-215(3) ITAA97 is not a capital gain *from* a CGT event that happens to the beneficiary; instead, such an event happens to the trustee.[36] The ATO reasons that, while s 855-10(1) does not expressly provide that the relevant CGT event must happen "to" the foreign resident, this is an inference which may be drawn from the statutory context.[36] This statutory context seems to be the mere existence of s 855-40. In other words, if s 855-10 is sufficient to exclude foreign beneficiaries from tax, why did the drafters feel it necessary to include s 855-40?

The ATO then doubled down on its position in TD 2019/D7,[36] claiming that a foreign beneficiary of a discretionary trust is assessable on non-TAP capital gains, irrespective of whether the gain has an Australian *source* or not.[37]

The combined result of TD 2019/D6 and TD 2019/D7 is the ATO disregarding both "non-TAP status" and "source" to impose tax on foreign beneficiaries of discretionary trusts. At this point, it seems that "fairness" as we understand it vanishes.

The ATO's position has been heavily criticised by practitioners, academics and professional associations. Grouped into areas of "policy" and "technical application", the criticism is summarised below.

Policy

Professional associations have labelled the ATO's interpretation as "unsustainable,"[38] "inconsistent with basic international taxation principles",[39] not "aligned with the overarching policy of the trust tax provisions",[39] and "not a suitable outcome from a policy perspective".[39]

Academics have described TD 2019/D6 as "[t]he ATO simply read[ing] the ambiguous language of a small number of provisions to produce a revenue maximising result without regard to underlying policy", and TD 2019/D7 as "just highlight[ing] how confusing the legislation is without advancing any particular reason for the ATO's preferred analysis".[40]

Despite numerous changes to legislation surrounding the taxation of trusts over the years, the policy intent has remained consistent, that is, the "conduit treatment" of trust income. This treatment effectively requires that a beneficiary should be taxed the same as if they had held the asset or derived the income directly.[39]

While the intended policy behind Div 855 was to "narrow the range of assets on which foreign residents will be liable to Australian CGT",[41] the ATO's interpretation does the opposite.[42]

The ATO has misinterpreted the policy intention of s 115-215. That policy intention is to allow streaming, and not to create a dichotomy between gains from CGT events and gains *from* attribution.[39]

Technical application

The ATO has effectively read words into s 855-10(1) that do not exist (being that nothing expressly excludes beneficiaries).[43]

Although the ATO considers that non-TAP and foreign-sourced capital gains should be caught by Subdiv 115-C and subject to tax, if the same foreign gain were on revenue account, it appears that the gain would not be subject to tax under s 98 ITAA36.[40]

As a matter of proper statutory interpretation, s 6-10 ITAA97 applies to modify Subdiv 115-C when determining how capital gains will be taxed. Although s 6-10(5)(b) provides that a foreign resident's assessable income includes statutory income "on some *basis* other than having an Australian source", it is argued that Subdiv 115-C does not provide a relevant "basis" for including the gain, and, as such, the source limitation in s 6-10(5)(a) applies to restrict the gain from being included in the foreign resident's assessable income.[44]

Finally, Professor Richard Vann has stated that "[i]t is a mystery why the ATO continues to be unwilling to use the various means at its disposal to reach the sensible interpretive and policy outcomes, but instead creates more and more unintended consequences in relation to trusts and CGT".[41]

> *"… it is time for the long-awaited reform of trust taxation …"*

Why?

To unravel the mystery, in the author's opinion, the ATO's position is not grounded in policy nor proper statutory interpretation. Instead, it is an attempt to protect the integrity of the tax system from avoidance due to the inadequacy of existing provisions within the tax legislation.

CGT events I1 and I2

When an individual, a company or a trust ceases to be a resident,[45] CGT events I1 or I2 will occur. Broadly, the consequence is that the taxpayer is deemed to have disposed of all of its post-CGT assets at the time it ceases to be a resident, with the exception of assets that are TAP, ie assets that remain taxable in Australia irrespective of residency.[46] The capital gain or loss that occurs is determined by reference to the cost base (or reduced cost base) of the asset and its market value at the time of the CGT event.[47]

The effect of these provisions is to capture capital gains that have accrued to taxpayers while they are Australian tax residents. Without CGT events I1 and I2, taxpayers may simply avoid tax in Australia by changing residence and subsequently realising gains on the disposal of non-TAP assets, relying on Div 855 to exclude the assets from taxation.

One issue with CGT events I1 and I2 is that they only apply in relation to CGT assets held by the taxpayer just before the time of cessation.[47] Where a taxpayer owns a non-TAP asset directly, CGT events I1 and I2 apply without issue. Where a taxpayer owns a non-TAP asset indirectly via an interest in a fixed trust, it is the interest in the fixed trust itself that is the relevant CGT asset (s 108-5 ITAA97), and similarly, the provisions apply without issue. However, where a taxpayer is a mere object of a discretionary trust, until the beneficiary is made entitled,[48] the taxpayer has no CGT asset that may be recognised for CGT events I1 and I2.[49] This is because mere objects of discretionary trusts do not ordinarily have the necessary interest in the trust (or its assets) prior to the exercise of discretion in their favour.[49]

Accordingly, if Div 855 applied to non-TAP gains distributed from discretionary trusts, it seems that tax may be avoided by trustees holding off on realising capital gains on the disposal of non-TAP assets until beneficiaries (that would have otherwise been assessable on the distributed gain) become non-residents.

Acknowledging that s 115-220 ITAA97 may still assess the trustee on the gain under s 98 ITAA36, the question then arises as to whether, as the Commissioner contends, s 115-220 does not test whether the beneficiary's attributable gain satisfies the conditions in s 98, but rather it increases the amount assessable to the trustee under s 98 without regard to those conditions,[50] or alternatively, whether s 115-220 only applies to amounts which satisfy the requirements of s 98.[39]

The difference here is significant, as the former does away with source and residency (the trustee being taxed on the full gain), and the latter makes taxation contingent on the gain being "attributable to a period when the beneficiary was a resident" or "attributable to sources in Australia" (s 98(2A)(c) and (d) ITAA36).

Under the latter interpretation, the following questions are posed:

– When is a capital gain included in net income, and when is it attributable to a period when the beneficiary was a resident? Does this capture unrealised gains that have accrued while the beneficiary was a resident, or does it only capture gains that are realised while the beneficiary *is* a resident (thus excluding gains realised *after* the beneficiary ceases to be a resident)?

– If the source of the capital gain is the relevant factor, do we arrive at the taxation of gains that were otherwise exempt as non-TAP assets (eg ASX listed shares), and is the 100+ year old case law determining *source* even relevant in a global society where intangible assets and instruments are so disconnected from geography?

Notwithstanding the above, a conclusion that Div 855 applies to discretionary trusts would seemingly also result in increased s 100A ITAA36 or Pt IVA ITAA36 activity, such as distributions (on paper) of non-TAP gains to foreign resident beneficiaries, only for the proceeds to be gifted or loaned back to Australian residents.

If Australia's tax system can be so easily undermined, those with means will seek to exploit it, resulting in outcomes that most Australians would hardly consider "fair".

Conclusion

Despite the foundations of a sound tax system being built on efficiency, equity and simplicity, when it comes to the interaction between CGT, residency and trusts, it is arguable that our current system falls short of all three objectives. In the author's opinion, the solution is *not* for the ATO to deviate from policy objectives, read words into the legislation, or stretch the scope of provisions to address gaps that they were not intended to cover. Instead, it is time for the long-awaited reform of trust taxation[51] and a re-write into the ITAA97. Only then can we hope to achieve a tax system that is moving towards efficiency, equity and simplicity.

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3 Either through their lesser use of public facilities and infrastructure (as they live and reside elsewhere), or their exclusion from the social security system (typically being ineligible for Medicare, Centrelink etc).

4 Page 32 of the explanatory memorandum to the Tax Laws Amendment (2006 Measures No. 4) Bill 2006.

5 Item 1, s 855-15 ITAA97.

6 Item 2, s 855-15 ITAA97.

7 S 855-25 ITAA97.

8 S 855-20 ITAA97.

9 Item 3, s 855-15 ITAA97.

10 Item 4, s 855-15 ITAA97.

11 Item 5, s 855-15 ITAA97.

12 S 104-165(3) ITAA97.

13 S 995-1 ITAA97 (a "fixed trust" is a trust in which persons have fixed entitlements to all of the income and corpus of the trust).

14 S 995-1 ITAA97 ("resident trust for CGT purposes").

15 S 95(1) ITAA36 (broadly, total assessable income less allowable deductions).

16 *FCT v Whiting* [1943] HCA 45; *Union Fidelity Trustee Co of Australia Ltd v FCT* [1969] HCA 36; *Taylor v DCT* [1969] HCA 25; and *FCT v Harmer* (1990) 21 ATR 623.

17 Ss 97(1)(a)(i) and 98(2A)(c) ITAA36.

18 Ss 97(1)(a)(ii) and 98(2A)(d) ITAA36.

19 ID 2010/54.

20 *Nathan v FCT* [1918] HCA 45.

21 S 855-10 ITAA97.

22 *Australian Machinery and Investments Co Ltd v DCT* [1946] HCA 65; ID 2010/54; ID 2010/55.

23 S 115-215(3) ITAA97.

24 S 115-215(4A) ITAA97.

25 Ss 115-227(a) and 115-228 ITAA97.

26 S 115-227(b) ITAA97.

27 That is, under both Div 6 ITAA36 and Subdiv 115-C ITAA97.

28 S 102UX ITAA36.

29 *Radhika Pankaj Oswal v FCT*, 10 June 2016; T Russell, "Trust beneficiaries and exemptions from CGT: reflections on the Oswal litigation", (2016) 51(6) *Taxation in Australia* 296 (a settlement was reached between the parties prior to judgment, and the Pt IVC proceedings were discontinued).

30 Mrs Oswal was a temporary resident, albeit treated as a foreign resident for CGT purposes under Div 855 pursuant to s 768-915(1).

31 *Radhika Pankaj Oswal v FCT*, 10 June 2016 (assuming the CGT asset was not TAP).

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33 The ATO arguing that such a finding is evidenced by the mere existence of s 855-40.

34 [2020] FCA 559.

35 TD 2019/D6, n 68.

36 TD 2019/D7, n 69.

37 S Campbell, "TD 2019/D6 and TD 2019/D7: (further) unintended consequences?", (2020) 54(6) *Taxation in Australia* 323; T Russell, "Trust beneficiaries and exemptions from CGT: reflections on the Oswal litigation", (2016) 51(6) *Taxation in Australia* 296.

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41 Para 4.1 of the explanatory memorandum to the Tax Laws Amendment (2006 Measures No. 4) Bill 2006 (Cth).

42 Letter from DJ Honey (Pitcher Partners) to the Australian Taxation Office, 4 October 2019.

43 Letter from M Croker (CA ANZ) to the Australian Taxation Office, 4 October 2019; letter from DJ Honey (Pitcher Partners) to the Australian Taxation Office, 4 October 2019.

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46 Ss 104-160(3) and 104-170(3) ITAA97.

47 Ss 104-160(4) and 104-170(4) ITAA97.

48 A Kayis-Kumar and CJ Taylor, *The application of capital gains tax to trusts: conceptual, technical and practical issues, and a proposal for reform*, School of Taxation and Business law, Business School, University of New South Wales, 2019.

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