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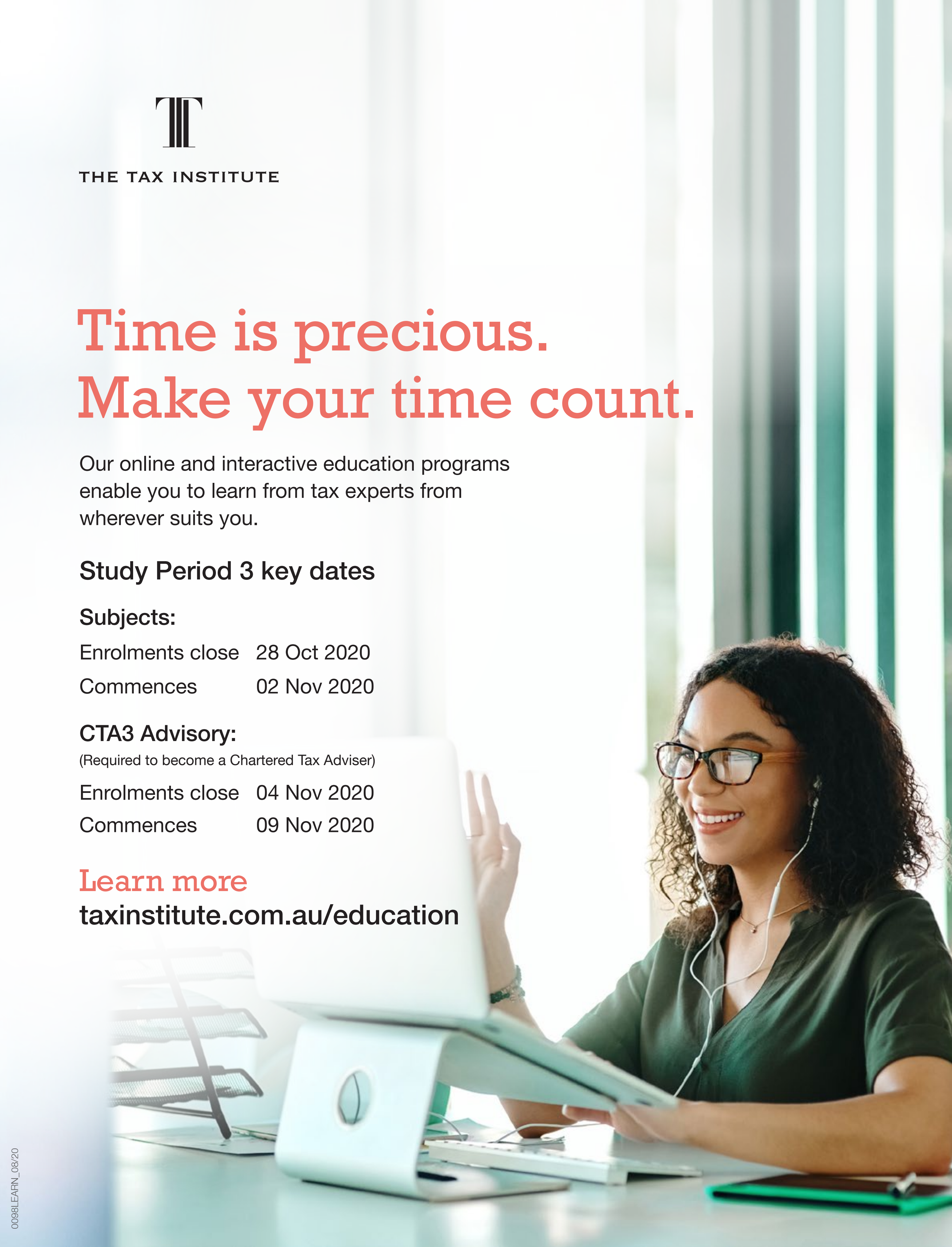
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Contents

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Burton v FCT – the death of the Aussie trust in international tax planning

by Peter Harper, CEO and Managing Director, Asena Advisors, LLC

Abstract: *Burton v FCT* is one of the most impactful tax cases of the last decade. It will have a dramatic impact on the manner in which Australian and foreign capital utilises Australian structures to invest in US assets. In this article, the author explores the impact of the case on the derivation of US sourced capital gains by the trustee of an Australian discretionary trust and what this will mean for the future of trusts when it comes to international tax planning for private clients.

Introduction

Will the Full Federal Court's decision in *Burton v FCT*[1] (*Burton*) finally mark the end of the Australian discretionary trust as a preferred structure for international tax planning?

The refusal of the High Court of Australia to hear the appeal of *Burton* marks a new era in the use of trusts to hold investments in US "pass through" structures such as LLCs, LPs and partnerships.

Prior to 2019, for many Australian private clients with a US presence, Australian trusts were considered the entity of choice because of their flexibility. Foreign sourced capital gains that were not "taxable Australian property" could flow through an Australian discretionary trust to a US beneficiary (that is, a non-resident of Australia) without Australian tax, and US sourced capital gains that were taxed in the US could flow to an Australian resident, without further tax in Australia.

There is now irrefutable evidence that the Australian Government and the ATO wish to tax income or gains sourced from outside of Australia, and Australians living outside of Australia, at higher rates than they do gains derived from Australian sources, or by tax residents of Australia.

Is there any value for Australians who have relocated overseas and who are now "foreign beneficiaries" of Australian trusts in retaining their Australian trusts as part of their cross-border structuring?

TD 2019/D6

The ATO's approach to taxing US sourced income derived by a discretionary trust in Australia prior to the release of TD 2019/D6 was important for two reasons.

(1) The classification of Australian discretionary trusts for US tax purposes

The first reason being that most Australian discretionary trusts are classified as "grantor trusts" under the US *Internal Revenue Code 1986* (Code) and as such attribute all income, gains and losses to the grantor.[2]

For a trust to be a grantor trust, it first needs a "grantor". The US *Treasury Regulations* state:[3]

> "… a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer … of property to a trust. For purposes of [the Code] the term property includes cash. If a person creates or funds a trust on behalf of another person, both persons are treated as grantors of the trust […] However, a person who creates a trust but makes not gratuitous transfers to the trust is not treated as an owner or any portion of the trust under sections 671 through 677 or 679."

In practice, when most Australian discretionary trusts are settled, the settlor settles a nominal amount of money on the trust, and after settlement, the controlling individuals or "grantors" for US tax purposes (often the primary beneficiaries) gift or lend such funds as required to sustain the corpus of the trust.

The trust would then be classified as a "grantor trust" in the US if it satisfies the preconditions referenced in ss 671 through 677 and 679 of the Code. For most Australian discretionary trusts, the most relevant section will be s 679, which deals with foreign trusts having one or more US beneficiaries.

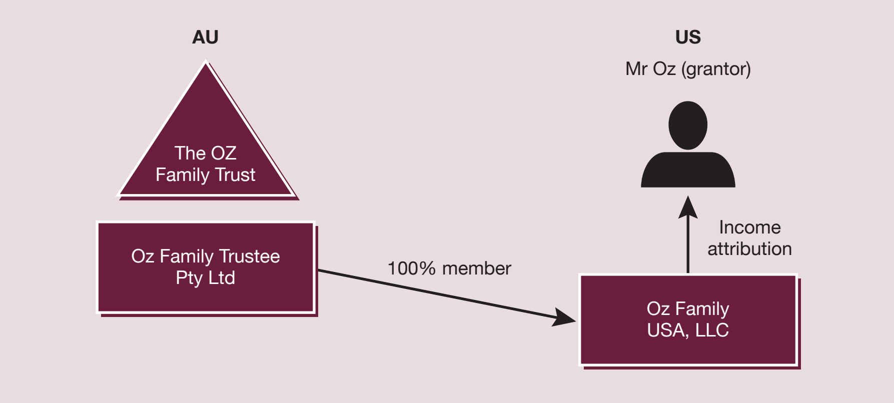
For Australian grantors that have migrated to the US and ceased to be Australian tax residents, but still hold US investments like interests in LLCs, LP or partnerships through an Australian resident discretionary trust, the income or gains flowing to such trusts would only be taxed in the US as US sourced business income.

Prior to the release of TD 2019/ D6, this position meant that, even though the gains from the sale of a US asset would be attributed to the grantor under the Code, the grantor would not be in any worse position than they would have been had they owned the interest directly. In many ways, this position mirrored the tax policy that underpinned the sourcing articles of the Australia–US tax treaty (treaty) and specifically art 13, which allocates taxing rights between the US and Australia in respect of the alienation of property.[4]

(2) A similar capital gains tax treatment in both the US and Australia

The second reason being that an investment made in an asset that generated a capital gain from a US trade or business would be taxed in Australia at

Figure 1. Attribution of income to US grantor



a similar effective tax rate to the long-term capital gains tax (CGT) rate in the US.

The decision in *Burton*, while logical (when you track through the reasoning of the Full Court Justices Steward and Jackson), is very jarring. In that case, it was held that the taxpayer was only entitled to 50% of the foreign income tax offsets (FITO) associated with various US sourced capital gains because the other 50% of the capital gain was not treated as assessable income for Australian tax purposes. This determination was made after considering art 22 of the treaty which concerns relief from double taxation, s 102-5 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) which concerns the method statement and how to determine a net capital gain, and s 770-10 ITAA97 which concerns the application of FITO to a net capital gain.

In 2004, Mr Burton as trustee acquired certain rights in respect of oil and gas wells in Pennsylvania, and between 2010 and 2012, he either sold rights to, or triggered contractual payments from, the Chesapeake Energy Corporation for the amounts and on the terms set out in various agreements. Some of those investments were taxed as royalties and others were taxed as capital gains. The taxation of the royalties was not contentious.

In the Full Court judgment, their honours considered the application of art 22, the extent to which that article prevented double taxation, and ss 102-5 and 770-10 and how the method statement impacted the net capital gain and the associated FITO. While the arguments presented by Logan J in his dissenting judgment were compelling, as the taxpayer was not granted leave to appear before the High Court, this means that the judgments of Steward and Jackson JJ are now prevailing law.

It was at paras 119 and 120 where Steward J most eloquently summarised his opinion:

> [119] "The contention that the word 'income' refers to an underlying gain is perhaps too imprecise. Moreover, there is no reason to read the word 'income' as referring to one indivisible gain which is the subject matter against which competing sovereign states seek to impose tax. Nor is the reference to 'income' a reference to 'assessable income', as contended for by the Commissioner. Rather 'income' should be read as a concept which is independent of, but not divorced from, the domestic income tax regimes of each sovereign power (respectively income tax imposed by the Internal Revenue Code (US) and income tax imposed under federal law of Australia: Art 2(l))."

> [120] "In each case, *the word 'income' must bear a nexus, expressed by the words 'in respect of', with US 'tax paid' and 'Australian tax payable'.* That directs attention to how each taxing regime taxes that income. The mistake which the taxpayer makes here is to commence its consideration of Art 22(2) with the identification of all of the US tax paid on the underlying gain. *But because the purpose of Art 22(2) is the allowance by Australia of a credit against tax payable, in my view, the starting point must be the identification of what income Australia taxes.* Because of the operation of the CGT 50% discount for individuals, Australia does not tax all of the gain made here; it taxes 50% of it (leaving aside the effect of any offsetting capital losses). That is the income, for Art 22(2) purposes, in respect of which Australian tax is payable. *The question which then must be answered is what was the US 'tax paid … in respect of' that income. In my view only half of the US tax paid can be said to be in respect of the income taxed in Australia.* In other words, the applicable general principle expressed in the first element of Art 22(2) is that US tax paid on income the subject of Australian tax shall be allowable as a credit against the Australian tax paid on that income." (emphasis added)

What this means in 2020 is that, assuming a US sourced capital gain is taxed at the long-term CGT rate of 20% in the US (and no state income tax applied), an Australian resident individual taxpayer would only be able to offset 10% of the US tax paid as a credit against their Australian CGT liability. This would take the effective tax rate from any US sourced capital gain from 23.5% to 33.5%, and for gains that are sourced in high tax states like California, from 33.3% to 40.15% (see example 1 below).

Example 1. Calculation of the effective tax rate on a US sourced capital gain

23.5% is the total of the 20% US federal long-term CGT rate, and assuming a full tax credit, a further 3.5% in Australia (23.5% Australian discount CGT rate on a marginal tax rate of 47%).

33.5% is that same number with one-half of the 20% FITO being disallowed.

33.3% is total of the 20% US federal long-term CGT rate and 13.3% Californian state CGT rate.

40.15% is the same number with one-half of the 33.3% FITO being disallowed (23.5% Australian discount CGT rate and a 16.65% FITO).

Abolition of the general discount

This has a far more significant impact for private clients who run privately owned multinational businesses that span the US and Australia and who are forced to relocate to the US temporarily or permanently, in order to grow their business.

When the general discount for non-residents was abolished in 2012, little thought was given to how it would impact Australian entrepreneurs who had moved to the US. For Australians who own multinational businesses through trusts and are classified as "grantors" for US tax purposes, the gains from the sale of their businesses would now be taxable in Australia at the top non-resident tax rate of 45%, if they could not distribute the gain to an Australian resident beneficiary. For those living in the state of California, the effective tax rate could be as high as 58.3% (see example 2 below).

Example 2
Australian top non-resident marginal tax rate (no CGT discount) = 45%
US federal tax = 0% (credit for Australian taxes paid)
US Californian state CGT rate = 13.3%
Global effective tax rate = 58.3%

Furthermore, even if the trustee identifies an appropriate Australian resident beneficiary to whom to distribute the foreign sourced capital gain, it would be of little benefit because the grantor trust rules would require that the capital gain be distributed to the US resident grantor to ensure that a foreign tax credit was available under US law for the federal tax paid in Australia.

Conclusion

With the recent change to the way in which foreign sourced income will be taxed in Australia as a result of *Burton* and the change of government and ATO policy as it concerns non-residents and foreign sourced income, it is time to reassess the value of trusts in your operating structure and make a determination as to whether it makes sense to transition to a corporate structure, especially if you are considering an overseas business expansion or relocation for personal reasons.

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Acknowledgment

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References

1 [2019] FCAFC 141; and see “Special leave application results 2020”, High Court of Australia, available at www.hcourt.gov.au/registry/special-leave-applications-results-2020.

2 Subpart E (grantors and others treated as substantial owners) of the *Internal Revenue Code* (US).

3 S 1.671-2(e)(1) of the *Treasury Regulations* (US).

4 *Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (Australia–US tax treaty) (as amended to 2001).