A Matter of Trusts

by Neil Brydges, CTA, Sladen Legal

Residency of a trust: don't get it wrong

This article looks at what determines the tax residence of a trust and what the consequences can be from a change of tax residence.

The Full Federal Court decision in *Harding v FCT*[1] (*Harding*) and the High Court decision in *Bywater Investments Ltd v FCT*[2] (*Bywater*) focused minds on the residency tests for individuals and companies. But what of the residency tests for trusts? And what does the jurisprudence on individual and corporate residency mean for the residency of a trust?

Source and residency

Before exploring the residency tests for trusts, it should be noted that a fundamental principle of Australian tax law is that Australian tax residents are assessed in Australia on ordinary and statutory income from all sources, whether inside or outside of Australia, unless a statutory rule overrides this general rule.[3] A non-resident, however, is generally assessable only on income from Australian sources or on income on a basis other than having an Australian source.[4]

Australia's double tax treaties, for countries where Australia has such an agreement, can alter these general principles.

The "source rules" help Australia tax income derived by non-residents while the "residency rules" cause the taxation of Australian tax residents on their worldwide income.

For instance, if income derived by an Australian resident trust has an Australian source and the trust distributes that income to a foreign beneficiary, prima facie Australia has a right to tax that distribution. Conversely, foreign source income derived by an Australian trust may not be assessable in Australia if distributed to a foreign beneficiary but should be assessable if distributed to an Australian beneficiary.

Similarly, the residency of the trust will determine whether the trust's income from all sources is assessable in Australia (Australian trust) or only income with an Australian source or income on a basis other than having an Australian source (foreign trust). That is, while different concepts, source and residency are "two sides of the same coin" when it comes to determining any Australian tax liability on a distribution to a beneficiary.

Residency of trusts

A trust is a resident of Australia for an income year if the trust has *a* resident trustee *at any time* during the income year or the central management and control (CMC) of the trust was in Australia *at any time* during the income year.[5] A non-resident trust is a trust that is not a resident trust.[5]

If a trust has multiple trustees, only one need be a resident for the trust to be a resident. This is because s 95(2) of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) refers to "a trustee", which connotes that the requirement is satisfied if any trustee is a resident, even if that trustee is one of a number of trustees where the other trustees are not Australian residents for taxation purposes.

The tests are interactive. For example, a trust with a foreign company as trustee will be an Australian resident trust if the foreign company carries on business in Australia and the company's CMC is in Australia causing the trustee to be an Australian resident. Similarly, if there is a foreign resident trustee (individual or corporate), and the trustee exercises the CMC of a trust in Australia, the trust will be an Australian tax resident despite the trustee being a foreign resident.

This latter example also raises the possibility that the trust could be a resident of Australia and the foreign country (under the residency tests in that country). In this case, for countries where Australia has a double tax agreement, most agreements have a "tie breaker" rule in circumstances of dual residency.

The residency tests for companies and trusts both include the concept of CMC. While there is considerable jurisprudence, including *Bywater*, on CMC for companies, there is not an Australian court decision considering CMC for trusts. However, in the Canadian Supreme Court decision of *Fundy Settlement v Canada*,[6] the court said that "there are many similarities between a trust and a corporation" and CMC is where "[the trusts] real business is carried on".[7]

While the Australian corporate jurisprudence on CMC is useful in the context of trusts in determining what activities constitute CMC, it is likely the concept for trusts is somewhat different because s 95(2) includes the word "the" before "central management and control" which the s 6(1) ITAA36 residency test for companies does not. That is, a company may have multiple places of CMC,[8] while for trusts, there either must be only one CMC (in Australia) or, if there is more than one, the predominant one must be in Australia.

Harding concerned the "domicile test" under the s 6 definition of residency for an individual. The court's decision turned on the meaning of the term "permanent place of abode". The court found, regardless of the nature of Mr Harding's accommodation (being a "temporary" serviced apartment), that it was correct to conclude his place of abode was Bahrain rather than Australia for Bahrain was the "place" where he was living.[9]

For trusts with individual trustees, *Harding* "expanded" what could be a permanent place of abode such that for an individual Australian-resident trustee, it may be "easier" for that individual to stop being an Australian resident or "harder" for an individual foreign-resident trustee to become an Australian trustee (with the flow-on consequences for the trust of which the individual is trustee in both cases).

Is there a difference for capital gains tax?

Unlike for individuals and companies, for trusts there is a separate residency test for capital gains tax (CGT) purposes.

For trusts other than unit trusts, the test for CGT purposes is the same as the s 95 test.

For unit trusts, there is a different test for CGT purposes, with the s 95 test for other purposes. A unit trust is an Australian tax resident for CGT purposes for an income year if at any time:

1. any property (not just real property) of the trust is situated in Australia or the trust carries on a business in Australia; and
2. the CMC of the trust is in Australia or Australian residents held more than 50% of the beneficial interests in the income or property of the trust.

Therefore, it is possible for a unit trust to be a non-resident for most Australian tax purposes but a resident trust for CGT purposes (or vice versa). For example, a unit trust may have a foreign trustee and CMC (and so would not be an Australian tax resident for most purposes) but if the unit trust owned property situated in Australia and Australian residents held more than 50% of the units, the trust could be an Australian resident trust for CGT purposes.

Trusts ceasing to be a resident of Australia or becoming a resident of Australia

A trust ceases to be a resident of Australia

If a trust ceases being a "resident trust for CGT purposes", CGT event I2 in s 104-170 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) happens. The time of the event is when the trust stops being a "resident trust for CGT purposes".[10]

A trust ceases being a "resident trust for CGT purposes" at the time during an income year when the trust no longer meets the requirements of that definition.[11]

The trustee of the trust is required to work out if it has made a capital gain or a capital loss for each CGT asset that it owned (in the capacity as trustee of the trust) just before the time of the CGT event.[12] The trustee makes a capital gain (loss) if the market value of the asset (at the time of the event) is more than the asset's cost base (reduced cost base).[13] If the trust is a fixed trust, foreign resident beneficiaries may be able to disregard their share of the capital gain.[14]

The only exceptions relate to "taxable Australian property" that is:[12]

1. "taxable Australian real property";
2. an asset used in carrying on a business through a permanent establishment in Australia; or
3. an option or right to acquire the above.

A trust that stops being a "resident trust for CGT purposes" during an income year does not make any capital gain or capital loss in that income year from any CGT event that happens from the time at which it stops being a resident trust in the income year until the end of that income year, unless the asset is "taxable Australian property" and Div 855 ITAA97 applies.[11]

A trust becomes a resident of Australia

If a trust becomes a "resident trust for CGT purposes", the trustee is taken to acquire the CGT assets it owns at their market value at the time the trust became a "resident trust for CGT purposes" except for an asset that:[15]

1. is "taxable Australian property"; or
2. the trustee acquired before 20 September 1985.

The above does not apply if the trust, just before it became a "resident trust for CGT purposes", was a transferor trust.[16]

A trust becomes a "resident trust for CGT purposes" at the time during an income year when the requirements of that definition (see above) are satisfied.

A trust that becomes a "resident trust for CGT purposes" during an income year does not make any capital gain or capital loss in that income year from any CGT event that happens from the beginning of the income year until the time at which it becomes a resident trust in the income year, unless the asset is "taxable Australian property" and Div 855 applies.[11]

What does it mean?

The residency rules are complex. The Board of Taxation has recommended the modernisation of the individual residency rules,[17] while the corporate residency tests are complicated post-*Bywater* by the Australian Taxation Office views in TR 2018/5 considering that case.

The difficulties in the individual and corporate residency tests (including the related concept of CMC) can play out in the residency tests for trusts, for which specific guidance — judicial or otherwise — is minimal.

As a change of residency of a trust can result in significant tax costs for a trust (or its beneficiaries), in a world where individual mobility is common, individuals who are trustees or directors of a corporate trustee should consider whether changes in their circumstances also affect the residency of the trust. Getting it wrong can have consequences beyond their personal affairs.

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References

1 [2019] FCAFC 29.
2 [2016] HCA 45.
3 Ss 6-5(2) and 6-10(4) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).
4 Ss 6-5(3) and 6-10(5) ITAA97.
5 S 95(2) of the *Income Tax Assessment Act 1936* (ITAA36).
6 [2012] 1 SCR 520.
7 Ibid at [14]-[15].
8 See, for example, para 31 of TR 2018/5. See also *Koitaki Para Rubber Estates Ltd v FCT* (1941) 64 CLR 241.
9 The Commissioner of Taxation has applied for special leave to appeal the *Harding* decision to the High Court. At the time of writing, the High court has not heard the special leave application.
10 S 104-170(2) ITAA97.
11 TD 1999/83.
12 S 104-170(3) ITAA97.
13 S 104-170(4) ITAA97.
14 S 855-40 ITAA97.
15 S 855-50(1) ITAA97.
16 S 855-50(4) ITAA97.
17 Board of Taxation, "Self-initiated review of the income tax residency rules for individuals", 2018.