International Taxation of Trust Income

Principles, Planning and Design

MARK BRABAZON

TAX LAW

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To my parents
Charlie and Geraldine Brabazon

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PREFACE

The trust is as familiar to lawyers in common law countries as the company or the partnership. According to Maitland, it is 'the greatest and most distinctive achievement performed by Englishmen in the field of jurisprudence'.[1] It has also long served, among other things, as a tool of tax planning and avoidance. How to tax trusts and their income raises difficult problems. It has not been found satisfactory to treat them as fiscally opaque, but neither can they be treated as purely transparent. Trust tax rules tend to be chimerical, borrowing selectively from the taxing paradigms of other kinds of entity, and sui generis, containing features that do not clearly resemble anything else. They also vary between countries and frequently include special international rules. As one might expect, there are recurrent themes, but they play out differently in different tax systems. This makes for a degree of difficulty (or opportunity) where there are cross-border features in the residence of the persons who capitalize or hope to benefit from the trust, the location of its investments, the source of its income or the situs of its administration.

This book has three goals. The first is to identify the principles by which countries tax trust income and distributions internationally. The tax systems of Australia, New Zealand, the United Kingdom and the United States provide the main data for this purpose. The second is to identify unintended non-taxation and double taxation associated with the presence of a trust. This turns on how the trust tax settings of different countries interact with each other in non-treaty and treaty situations, particularly where they disagree on the attribution of trust income for tax purposes. The third is to propose principles of tax design to respond to problems of double and non-taxation. This is done by developing principles that can be used to identify the functional character and relative strength of taxing claims by reference to the fiscal interests

[1] F W Maitland, *The Unincorporated Body*, 3 Maitland, Collected Papers (Bristol University, 1911) www.efm.bris.ac.uk/het/maitland/unincor.mai.

that they represent and by offering solutions to identified anomalies in non-treaty and treaty situations.

Although trusts have been significant features in the tax landscape for a long time, this is the first systematic and structural study of international trust taxation as a topic in its own right from a global perspective. It is written with a view to the practitioner, the scholar, the administrator and the legislator designing or redesigning tax laws and treaties. It invites further research, particularly from the perspective of other countries that do or do not recognize the trust in their general law. The book is based on my doctoral thesis in the University of Sydney.

There are many people without whom this book would not have come to fruition. I am profoundly indebted to Richard Vann, my supervisor, for his consistent support of my work, his thoughtful advice and the deep insight that he brought to the project from which the book originated. I am also indebted to Lee Burns, my previous supervisor, for suggesting that an earlier, more modest research project might support a doctoral thesis; to Michael Dirkis, my auxiliary supervisor; and to friends and colleagues who have patiently read drafts and given their support and encouragement. I thank the University of Sydney and the Ross Parsons Centre for their support in presenting my work internationally. Finally, I wish to thank my dear partner Estelle, who has cheerfully accommodated this project from beginning to end as an obstinate house guest.

GLOSSARY

attribution — Particular income is attributed to a person or entity if, for tax purposes, the income is treated as belonging to that person or entity or its tax treatment is determined by reference to the fiscal characteristics, particularly residence, of the person or entity (page 16). See also 'fiscal attribution' and 'indirect attribution'.

conduit (situation/ treatment) — A situation in which or treatment by which a country refrains from taxing a local or resident entity that is recognized as delivering foreign income to a non-resident (page 14). This implies attribution to the non-resident.

current taxation — In a trust context, taxation of trust income to the trust, a beneficiary or grantor by reference to trust-level derivation and as income of the tax period in which the income is so derived (page 17).

differentially transparent — Of a trust or other entity, having the property that the attribution of particular entity-level income to the entity and/or a participant depends on criteria other than or additional to the form and characteristics of the entity (page 60).

donative trust — A trust which effects a controlled transfer of wealth over time to persons whom the grantor desires to favour (page 11).

fiscal attribution — See 'attribution' (page 16).

fiscal residence of a trust — See 'trust residence' (page 101).

grantor — One who voluntarily capitalizes a trust with economic value, whether by gift or by an undervalued transaction or dealing (page 8).

inbound (taxation or attribution) — Of taxation, the source-based taxation of income attributed to non-residents; of attribution, the attribution to non-residents of income taxable on a source basis (page 14).

income derived by or through a trust — Income derived or recognized at the level of the trust, regardless of whether it is treated for tax purposes as income of the trust, a beneficiary or a grantor (page 15).

income (derived) from a trust — An actual or constructive distribution from a trust to a beneficiary to the extent that it is recognized as tax-law income of the beneficiary, other than as representing the delivery of beneficiary-attributed trust income (page 15).

indirect attribution — Attribution of income to a taxpayer by reference to an item of income of another (such as trust income) without clearly excluding the principal attribution of the same item to the other (such as the trust), who may or may not also be taxable in the same country, or without clearly acknowledging identity between the two incomes (page 17).

investment trust — A trust in which the beneficiaries are also grantors and, subject to the terms of the trust, are entitled to the benefit of its income (page 11).

non-current taxation — In relation to distributions, tax that is imposed otherwise than by necessary reference to current trust-level derivation of income (page 17).

outbound (taxation or attribution) — Of taxation, the taxation of residents on foreign income; of attribution, the attribution of foreign income to residents (page 14).

proxy (taxation) — In a trust context, the substantive and final taxation of a trust on trust-attributed income that will not be taxed again by the same country on distribution, whether because distributions are not taxed or because the income is exempt to the extent that it is traceable into a distribution (page 44).

reverse hybrid — An entity is a reverse hybrid with respect to particular income if that income is not attributed to it in a country (if any) where it is resident and is not attributed to any participant in the participant's residence country (page 160).

round-trip (situation/ treatment) — A situation in which a country denies inbound treatment to locally sourced income that passes through an offshore or non-resident entity back to a resident (page 14).

settlor nexus — The connection with New Zealand by reference to which that country taxes trust-attributed income on a worldwide basis (described in greater detail at page 105).

tax-law income	Income for the purposes of income tax and/or capital gains tax, as distinct from trust-law or accounting purposes (page 14).
taxable presence	A presence in a particular country that attracts net-basis taxation, particularly where the taxpayer is non-resident and would otherwise escape taxation or be taxed on a gross basis (page 61).
trust attribution	Trust income that is not attributed to a beneficiary or grantor, but is the fiscal responsibility of the trust entity on behalf of the trust, is fiscally attributed to the trust as a whole (page 100).
trust entity	The taxpayer that is fiscally responsible for trust-attributed income (page 100) – typically, the trust itself or the trustees collectively in that capacity.
trust income	Income derived or recognized at the level of the trust, regardless of whether it is treated for tax purposes as income of the trust, a beneficiary or a grantor (page 15).
trust residence	In a country that taxes on a residence/source basis, the connection by reference to which that country taxes trust-attributed income on a worldwide basis (page 101).
trust-law income	Income according to the concepts of trust law (page 14).
trust-level income	See 'trust income' (page 15).
trust-related income	Income derived by, through or from a trust (page 16).

ABBREVIATIONS

1963 OECD Draft	OECD, *Draft Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital* (1963)
2017 Update	OECD, *The 2017 Update to the OECD Model Tax Convention* (2017) (approved by the OECD Council on 21 November 2017)
ATO	Australian Taxation Office
BEPS	base erosion and profit shifting; attributively, of the OEDC/G20 BEPS project and its various Actions
BEPS Action 2 Report	OECD/G20 BEPS Project, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report* (2015)
BEPS Action 6 Report	OECD/G20 BEPS Project, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6: 2015 Final Report* (2015)
CG	HMRC, *Capital Gains Manual*, www.gov.uk/hmrc-internal-manuals/capital-gains-manual
CIR	Commissioner of Inland Revenue (NZ)/Commissioner of Internal Revenue (US)
CTA 2009	*Corporation Tax Act 2009* (UK)
DCT	Deputy Commissioner of Taxation (Australia)
DIR	dividend, interest and (or) royalty
FA [year]	*Finance Act [year]* (UK); a second such Act (*Finance (No 2) Act [year]* (UK)) is abbreviated as FA (No 2) [year]
FCT	Federal Commissioner of Taxation (Australia)
G20	Group of Twenty (Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, México, Russia, Saudi Arabia, South Africa, Korea, Turkey, the United Kingdom, the United States and the European Union)
HMRC	Her Majesty's Revenue and Customs (UK)
IntTAA	*International Tax Agreements Act 1953* (Cth)

IRC	Inland Revenue Commissioners (UK)/Internal Revenue Code (US)
IRD	Inland Revenue Department (NZ)
IRS	Internal Revenue Service (US)
ITA NZ	*Income Tax Act 2007* (NZ)
ITA UK	*Income Tax Act 2007* (UK)
ITAA 1915	*Income Tax Assessment Act 1915* (Cth)
ITAA 1922	*Income Tax Assessment Act 1922* (Cth)
ITAA 1936	*Income Tax Assessment Act 1936* (Cth)
ITAA 1997	*Income Tax Assessment Act 1997* (Cth)
ITR 1936	*Income Tax Regulations 1936* (Cth)
ITTOIA	*Income Tax (Trading and Other Income) Act 2005* (UK)
MLI	*Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*, adopted 24 November 2016, initial signatures 7 June 2017 (entered into force 1 July 2018)
NRWT	non-resident withholding tax (NZ)
OECD	Organisation for Economic Cooperation and Development
OECD Commentary/ OECD Comm	OECD, 'Commentaries on the Articles of the Model Convention' in OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017* (2017); in an historical context, previous versions of these. Pinpoint references are identified by Article and paragraph, thus: 'OECD Comm Art 24 [67]'. The Introduction to the model treaty and commentaries is cited as Intro in lieu of the Article number.
OECD Model	OECD, 'Model Convention with Respect to Taxes on Income and on Capital'; in an historical context, previous versions of this
Partnership Report	OECD, Committee on Fiscal Affairs, *The Application of the OECD Model Tax Convention to Partnerships,* Issues in International Taxation, No 6 (OECD, 1999)
PE	permanent establishment
TAA Au	*Taxation Administration Act 1953* (Cth)
TAA NZ	*Tax Administration Act 1994* (NZ)
TCGA	*Taxation of Chargeable Gains Act 1992* (UK)
TIOPA	*Taxation (International and Other Provisions) Act 2010* (UK)
TSEM	HMRC, *Trusts, Settlements and Estates Manual,* www.hmrc.gov.uk/manuals/tsemmanual/index.htm

UN Model	*United Nations Model Double Taxation Convention between Developed and Developing Countries 2017* (UN, 2018); in an historical context, previous versions of this
US Model	*United States Model Income Tax Convention* (2016); in an historical context, previous versions of this

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1

Introduction

This book examines the principles by which countries exert international taxing claims over income derived by, through or from a trust and the interaction of those taxing claims in treaty and non-treaty situations. It derives an initial set of principles, policies and tax settings by examining the national tax laws of Australia, the United States, the United Kingdom and New Zealand. It then considers the interaction of national tax laws more broadly, in light of the work of the OECD/G20 BEPS project[2] and by reference to the OECD Model tax treaty.[3]

This introductory chapter begins by outlining the aims and significance of the present work and its methodology. It goes on to identify the phenomenon of the trust as a legal institution and an economic entity and briefly to outline the tax design options and challenges that these features present, including distinctions between transparent and opaque taxing paradigms, between single and dual taxing points, and between the entity and its participants as potential taxpayers. It next identifies the range of international taxing perspectives that different countries may apply to the same factual arrangements and establishes terminology that will be used in later chapters. This is followed by an outline of the scope of coverage of the present study and an abbreviated summary of the trust rules in the tax systems of the surveyed countries. The chapter concludes with an outline of the structure of the book and a summary of following chapters.

[2] The joint project of the OECD and G20 on base erosion and profit shifting (BEPS), described in Section 7.1.5. For a summary explanation of the BEPS project and its 15 Actions, see OECD/G20 BEPS Project, *Explanatory Statement: 2015 Final Reports* (2015).

[3] OECD, 'Model Convention with Respect to Taxes on Income and on Capital' in OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017* (2017). See Section 7.1.1. References to the OECD Model in this book in an historical context relate to the version that was current at the relevant time.

1.1 Aims, Significance and Methodology

The goals of this book are to identify the principles by which countries tax income derived by, through or from a trust in an international context where more than one country has a potential taxing claim, to identify situations of double- or non-taxation that can arise from the interaction of national tax systems in treaty and non-treaty situations and to postulate principles of tax and treaty design to avoid inappropriate double- or non-taxation.

Trusts are legally, economically and socially significant and serve legitimate non-tax purposes in jurisdictions where they are recognized by the general law. The features that make trusts useful also make them attractive vehicles for tax arbitrage and avoidance. It is important that countries understand and address the international taxation of trust-related income in a coherent and principled way. Globalization has increased the importance of developing an international tax architecture that responds to cross-border arrangements. The BEPS project has shed light on the international significance of hybrids and other fiscally transparent entities. Trusts are probably the most challenging class of such entities because of their fundamental flexibility, the potential indeterminacy of interests in income and capital, the role of the grantor as an extra participant and the difficulty that some countries experience in conceptualizing an entity without separate legal personality as a subject of taxation or a fiscal resident. Conversely, if tax systems and the international tax order can rise to that challenge and get the international fiscal treatment of trusts right, the solutions they develop may also provide answers to problems concerning the treatment of other hybrid and transparent entities.

The first stage of the project is based on analysis of trust rules in the national tax systems of Australia, the United States, the United Kingdom and New Zealand. These countries have been chosen as a representative sample of jurisdictions that recognize the trust as part of their general law, have advanced economies and stable, highly developed legal systems and follow the general residence/source paradigm of international taxation but that differ sufficiently in their trust rules and related international settings to demonstrate potential mismatches and to enable conclusions to be drawn about the interaction of divergent rules and settings more generally. The survey has been limited to four countries in order to keep the project within manageable bounds. The text also includes a small number of references to particular Canadian trust tax rules which diverge from those in the surveyed countries in ways that are conceptually significant,

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although no general survey of that country's trust rules is attempted. The present work is conceived as foundational: it provides a basis for similar analysis to be extended and applied to other jurisdictions, including those which do not recognize the trust in their general law.

The method of analysis of trust rules in the surveyed countries is functionally comparative.[4] The structural elements of the comparison reflect the logic of international taxation and the influence of tax treaties. The first division is between taxation of trust income by current attribution and taxation of trust distributions. The next division concerning trust income reflects the choice of taxpayer to whom trust income is currently attributed: grantor, beneficiary or trust. The grantor, beneficiary and trust chapters are then divided between general principles of attribution, inbound settings and outbound settings; the trust chapter also addresses the fiscal residence of trusts. Further functional subdivision of the attribution, inbound and outbound sections of these chapters varies according to the subject matter, the logic of international taxation and, in some cases, the historical background. The purpose of the analysis is to facilitate an understanding of the range of actual and possible international tax settings and their underlying logic.[5] For that reason, particular countries are not always discussed in the same order. In some contexts, the order is varied to facilitate the illustration of a spectrum of approaches or the historical development of fiscal strategies.

The second stage of the project is global in focus. It assesses the interaction of national tax systems generally, informed by conclusions based on the earlier analysis. It is largely framed by reference to work of the BEPS project on hybrid entities and preventing the abuse of tax treaties (Actions 2, 6 and 15). Analysis of treaty situations is principally framed by reference to the OECD Model treaty, the Partnership Report and corresponding elements of the BEPS project, supplemented by consideration of the US Model and selective elements of the treaty practice of other countries.

[4] A functional approach focuses on 'the functions of tax rules of different countries with the goal of identifying similarities and differences between domestic tax systems as well as potential alternative solutions to common problems' and thereby seeks to overcome the heterogeneity and apparent incomparability of tax concepts in different countries: Carlo Garbarino, 'An Evolutionary Approach to Comparative Taxation: Methods and Agenda for Research' (2009) 57 *American Journal of Comparative Law* 677, 681, 687–688.

[5] The comparison of trust rules is not a first-order objective but a necessary means to facilitate the identification and description of jurisdictional taxing principles and their interaction.

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The working normative hypothesis is that inappropriate non-taxation should be avoided by national tax systems selectively expanding their claim to tax in situations that would otherwise represent unintended lacunae due to mismatches between tax systems – principally, negative conflicts of attribution and double non-residence of trusts – in a way that avoids inappropriate double taxation. Inappropriate double taxation should be addressed by treaty and, more selectively, by unilateral credit, exemption or non-taxation by reference to the tax treatment of the other country. In both treaty and non-treaty situations, this implies the need to recognize overlapping tax claims and to develop model, bilateral or unilateral principles of taxing priority.

The present work does not seek to engage with fundamental economic critiques of income taxation. It takes the general system of international income taxation as given and addresses national tax systems, their mutual interactions and the global matrix of tax treaties in light of the body of scholarship that has grown up around the international tax work of the OECD, particularly but by no means exclusively focused on tax treaties, and which reflects an historically balanced combination of legal analysis, international relations and economic policy.[6]

Within that body of scholarship, relatively little attention has been devoted to a systematic consideration of international trust taxation. The most notable exceptions[7] are a 1989 study by the international tax group in response to the Hague Trusts Convention, which comprised a comparative account of taxation in a number of common law and civil

[6] See, e.g., H David Rosenbloom and Stanley I Langbein, 'United States Tax Treaty Policy: An Overview' (1981) 19 *Columbia Journal of Transnational Law* 359; Hugh J Ault, 'Corporate Integration and the Division of the International Tax Base' (1992) 47 *Tax Law Review* 565; Reuven S Avi-Yonah, 'All of a Piece Throughout: The Four Ages of US International Taxation' (2005) 25 *Virginia Tax Review* 313; C John Taylor, 'Twilight of the Neanderthals, or are Bilateral Double Taxation Treaty Networks Sustainable?' (2010) 34 *Melbourne University Law Review* 268; Richard J Vann, *Writing Tax Treaty History* (24 March 2011), Sydney Law School Research Paper No 10/19, available at SSRN: https://ssrn.com/abstract=1788603.

[7] See also Alexander Easson and Victor Thuronyi, 'Fiscal Transparency' in Victor Thuronyi (ed), *Tax Law Design and Drafting* (International Monetary Fund, 1998) vol 2, 925, 949–965. The object of that work and others in the same collection was to assist developing countries in the design of their tax systems. Another quite early contribution was Frans Sonneveldt and Harrie L van Mens (eds), *The Trust: Bridge or Abyss between Common and Civil Law Jurisdictions?* (Kluwer, 1992), a collection of essays focusing on the treatment of trusts in certain civil law countries and under the OECD Model.

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law countries[8] and an account of corresponding international taxation including some treaty issues,[9] and the more recent work of Robert Danon on Swiss taxation of trusts with reference to the US, Canadian and New Zealand trust taxation[10] and on the impact of the Partnership Report on conflicts of attribution involving trusts.[11] The 1989 study did not consider grantor taxation, and, while it considered a matrix of international taxing situations, it did not attempt to construct a general or normative explanation of them or of their consequences. That study also preceded the Partnership Report, which fundamentally changed the discourse (even among its dissentients) on the international taxation of non-corporate entities and their income. Professor Danon's work continues to address trusts in treaty situations[12] but has not extended to a general consideration of international trust taxation. Each of those works has informed the analysis in this book at various points, but none has sought to develop a systematic understanding of international trust taxation or to achieve the goals outlined at the beginning of this section.

1.2 The Trust as Legal Institution and Economic Entity

Most jurisdictions that recognize the trust in their general law have inherited the common law of England, including the rules of equity. A small number with a mixed background of common and civil law recognize the trust as an institution of received or unwritten law without separate equity jurisprudence, such as Scotland and South Africa. Others that did not receive the trust have chosen to adopt it by statute, such as Louisiana, Japan and China.[13]

[8] John F Avery Jones et al., 'The Treatment of Trusts under the OECD Model Convention – I' [1989] *British Tax Review* 41.

[9] John F Avery Jones et al., 'The Treatment of Trusts under the OECD Model Convention – II' [1989] *British Tax Review* 65.

[10] Robert J Danon, *Switzerland's Direct and International Taxation of Private Express Trusts with Particular References to US, Canadian and New Zealand Trust Taxation* (Linde/Schulthess/Westlaw/Bruylant, 2004).

[11] Robert J Danon, 'Conflicts of Attribution of Income Involving Trusts under the OECD Model Convention: The Possible Impact of the OECD Partnership Report' (2004) 32 *Intertax* 210.

[12] Trusts are among the entities considered in Robert J Danon, 'Qualification of Taxable Entities and Treaty Protection' (2014) 68 *Bulletin for International Taxation* 192.

[13] There is a rich and growing literature dealing with the reception of the trust in countries of diverse legal backgrounds. See Madeleine Cantin Cumyn, 'Reflections Regarding the Diversity of Ways in Which the Trust Has Been Received or Adapted in Civil Law

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Each trust jurisdiction is legally independent and has its own concept of the trust, and there is no international hierarchy of national definitions. Some local formulations also present difficulties in a comparative context because they are circular or self-referential.[14] There is nevertheless much common ground, and the Hague Trusts Convention provides a useful working definition that captures the essence of an express trust and reflects its understanding in common law jurisdictions:

> For the purposes of this Convention, the term 'trust' refers to the legal relationships created – inter vivos or on death – by a person, the settlor,[15] when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose.
>
> A trust has the following characteristics –
>
> a) the assets constitute a separate fund and are not a part of the trustee's own estate;
> b) title to the trust assets stands in the name of the trustee or in the name of another person on behalf of the trustee;
> c) the trustee has the power and the duty, in respect of which he is accountable, to manage, employ or dispose of the assets in accordance with the terms of the trust and the special duties imposed upon him by law.

Countries' in Lionel Smith (ed), *Re-Imagining the Trust: Trusts in Civil Law* (Cambridge University Press, 2012) 6 and other essays in that book; Tony Honoré, 'Obstacles to the Reception of the Trust: The Examples of South Africa and Scotland' in A M Rabello (ed), *Aequitas and Equity: Equity in Civil Law and Mixed Jurisdictions* (Hebrew University of Jerusalem, 1997) 793; George L Gretton, 'Scotland: The Evolution of the Trust in a Semi-Civilian System' in Richard Helmholz and Reinhard Zimmermann (eds), Itinera fiduciae: *Trust and Treuhand in Historical Perspective* (Duncker & Humblot, 1998) 507; George L Gretton, 'Trusts without Equity' (2000) 49 *International and Comparative Law Quarterly* 599; Lusina Ho and Rebecca Lee, 'Reception of the Trust in Asia: An Historical Perspective' in Lusina Ho and Rebecca Lee (eds), *Trust Law in Asian Civil Law Jurisdictions: A Comparative Analysis* (Cambridge University Press, 2013) 10; Adam Hofri-Winogradow, 'Zionist Settlers and the English Private Trust in Mandate Palestine' (2012) 30 *Law and History Review* 813. Particular differences in local conceptions of the trust will not be considered here.

[14] J D Heydon and M J Leeming, *Jacobs' Law of Trusts in Australia* (LexisNexis Butterworths, 8th edn, 2016) [1.01], make the points that definition is elusive, if not impossible, and that those definitions which have been attempted are merely descriptive. An attempt to define the trust is inevitably circular. Thus, at [1.03]: 'If definition is demanded, then the trust may be defined as the whole relationship which arises between the parties in respect of the property the subject of the trust, and the obligation of the trustee to the beneficiary and the interest of the beneficiary in the property may be regarded as flowing from the existence of that relationship'.

[15] Generally referred to in this book as the grantor – see n 18.

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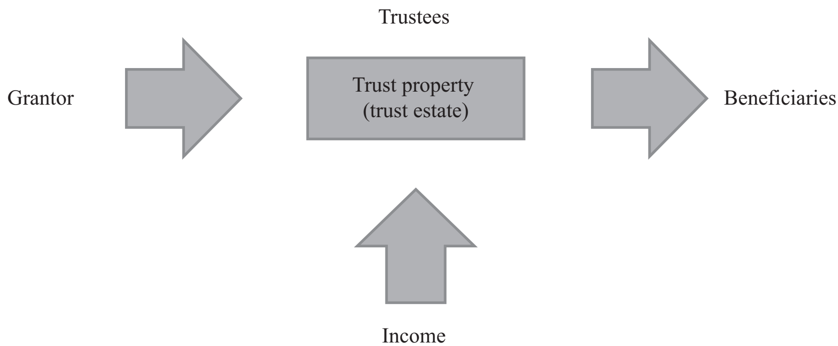

Figure 1.1 The Trust, Its Participants, Property and Income

> The reservation by the settlor of certain rights and powers, and the fact that the trustee may himself have rights as a beneficiary, are not necessarily inconsistent with the existence of a trust.[16]

In an international tax context, express trusts for beneficiaries are the main focus of attention. A corresponding limitation applies to the scope of this book.

The trust is essentially a relationship between property and persons (Figure 1.1). The body of trust property is administered as an economic entity without its own legal personality.[17] It is available to meet liabilities incurred by trustees in carrying out the trust, but not their other or personal liabilities. The trust is legally enforceable by or on behalf of the beneficiaries.

In a tax context, it is usual to refer to the economic entity constituted by the trust property as a whole under the administration of its trustees or the trustees acting in that capacity simply as a trust. Equity purists

[16] *Convention on the Law Applicable to Trusts and on Their Recognition*, opened for signature 1 July 1985, Hague Conference on Private International Law, 1664 UNTS 311, [1992] ATS 2 (entered into force 1 January 1992) Art 2. The function of the Convention is to provide for the recognition of trusts and their proper law by contracting states (Art 1). It does not affect the fiscal powers of such states (Art 19). Of the four surveyed countries, Australia and the United Kingdom have signed and ratified the Convention while the United States has signed but not ratified. New Zealand has not signed. See Hague Conference on Private International Law, 'Status Table for the Convention of 1 July 1985 on the Law Applicable to Trusts and on their Recognition' www.hcch.net/en/instruments/conventions/status-table/?cid=59 (at 14 December 2017).

[17] See Gretton, *Trusts without Equity*, n 13, arguing that the trust should be seen as a special patrimony or *Sondervermögen*.

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may object that a trust is none of these things, but there is no other convenient term. Brevity and common usage dictate that the same term is used to refer to the trust property and/or the trustees in that capacity as that which in equity discourse designates the relationship between property, trustees and beneficiaries.

A trust may be capitalized by the owner of property declaring a trust over it, and so becoming the trustee, or transferring property to another to hold it on trust. The terms of the trust are customarily set out in a deed executed by the person who provides the property and (if they are different persons) the trustees. An existing trust can be augmented or 'fed' by a person, not necessarily the original settlor, voluntarily transferring property to the trustees in that capacity. De facto capitalization can be achieved by providing value in any form gratis or at an undervalue. In order to avoid semantic arguments about the meaning of 'settlor', a person who capitalizes a trust in any of these ways will generally be referred to as a **grantor**.[18]

As a legal institution, the trust is characterized by extreme flexibility and private control.[19] Every trust has its own charter, the terms of which are stipulated or adopted by the grantor. Decisions about the investment and management of trust property can be made or constrained in the trust deed or left to the discretion and future decision of the trustees and/or others stipulated in the deed. The same is true of decisions about the duration of the trust, the ultimate beneficial enjoyment of trust property and the beneficial enjoyment of income derived from it in the meantime. Few constraints apply to the terms of a trust, and trusts are typically not required to be registered or approved in order to take effect. In most

[18] The term is borrowed from US tax law, where it is well understood. The US concept of a grantor refers to a real or economic settlor of a trust in respect of that person's contribution (*Buhl* v *Kavanagh*, 118 F 2d 315 (6th Cir, 1941); *Estate of Kanter* v *CIR*, 337 F 3d 833 (7th Cir, 2003)), including one who feeds an existing trust. It is defined to include a gratuitous transferor of cash or other property and a transferor for undervalue to the extent of the undervalue (26 CFR s 1.671-2(e)). Compare the UK and New Zealand terms 'settlor' (ITTOIA s 620; ITA NZ s HC 27) and the Australian 'attributable taxpayer' (ITAA 1936 s 102AAT) or 'transferor' (a colloquial synonym – cf 'eligible transferor' in ss 347, 348).

[19] See, e.g., John H Langbein, 'The Contractarian Basis of the Law of Trusts' (1995) 105 *Yale Law Journal* 625; Stewart E Sterk, 'Asset Protection Trusts: Trust Law's Race to the Bottom?' (2000) 85 *Cornell Law Review* 1035, 1040–1041; Nuncio D'Angelo, *The Trust: From Guardian to Entrepreneur: Why the Changing Role of the Trust Demands a Better Legal Framework for Allocating Stakeholder Risk* (PhD Thesis, University of Sydney, 2012) ch 1; see also n 23.

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circumstances, a trust can effectively insulate assets from claims made by creditors of the grantor,[20] the trustees (in their personal capacities) and the beneficiaries,[21] and beneficiaries are either immune to trust liabilities or can readily be made so.[22]

Reflecting these features, trusts are used for very diverse purposes, and have historically been used where otherwise available legal forms presented impediments or failed to accommodate to a new economic purpose.[23] Trusts today are variously used as vehicles for collective investment, both retail and wholesale; for special purposes and joint ventures in industry and commerce; to reward or remunerate employees; for pension or superannuation funds; for the holding, management or intergenerational transfer and distribution of family or personal wealth

[20] The main general constraint is the rule for setting aside fraudulent conveyances derived from the *Statute of Elizabeth 1571*, 13 Eliz 1, c 5 and represented in most modern common law jurisdictions that are not also tax havens (e.g. *Conveyancing Act 1919* (NSW) s 37A). Family law and succession law may also constrain the efficacy of dispositions by a spouse or by a person whose deceased estate is in issue. Such rules are not specific to trusts.

[21] A beneficiary's interest in a trust can be insulated from execution or bankruptcy of the beneficiary by making that interest discretionary or defeasible. Even if the interest is available to creditors, the trust assets themselves cannot generally be reached unless the exacting conditions of the rule in *Saunders* v *Vautier* (1841) 4 Beav 115; 49 ER 282 are satisfied, which require a finite group of legally competent beneficiaries to hold exhaustive beneficial interests in trust property and to concur in requiring distribution. This is the strong form of affirmative asset partitioning or (as it has later been called) entity shielding identified by Henry Hansmann and Reiner Kraakman, 'The Essential Role of Organizational Law' (2000) 110 *Yale Law Journal* 387, 395.

[22] See *Hardoon* v *Belilios* [1901] AC 118.

[23] A striking example is the development of the joint stock company.

> 'And so we came by our English *Anstalt* or *Stiftung* without troubling the State to concede or deny the mysterious boon of personality. That was not an inconsiderable feat of jurisprudence. But a greater than that was performed. In truth and in deed we made corporations without troubling king or parliament though perhaps we said that we were doing nothing of the kind'. (Maitland, F W, *The Unincorporated Body*, 3 Maitland, Collected Papers [Bristol University, 1911] www.efm.bris.ac.uk/het/maitland/unincor.mai).

See also n 19. For other illustrations of the trust's propensity to colonize a desirable but unoccupied niche in the fiscal or commercial world, see Erik Röder, 'Combining Limited Liability and Transparent Taxation: Lessons from the Convergent Evolution of GmbH & Co. KGs, S Corporations, LLCs, and Other Functionally Equivalent Entities' (2018) 21 Florida Tax Review 762. Dale Pinto and Stewart Karlinsky, 'Darwinian Evolution of the Taxation of Trusts: A Comparative Analysis' (2007) 10 *Journal of Australian Taxation* 251.

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(family trusts, testamentary trusts);[24] for the conduct of active business or investment; for indirect participation in other businesses such as partnerships; as holding entities; for the holding of particular business assets and to secure assets for the benefit of lenders, creditors or other parties to commercial transactions.[25] The list is not exhaustive, and some of its items are more or less common in particular jurisdictions.

The reasons why people choose the trust form are equally varied. The trust allows separation between decision-making and beneficial enjoyment; a trusted decision-maker can be appointed where beneficiaries are vulnerable or their needs and characteristics are not yet known. It allows beneficial enjoyment to be determined by future events, whether objective (birth, death, marriage) or based on discretionary judgment of a trusted decision maker. It allows a grantor to influence events after death. It allows assets to be protected against adverse claims or ventured commercially with limited liability for an investor. It allows access to professional management expertise and economies of scale. Tax considerations are always important, though not necessarily determinative. The trust is not inherently a tax avoidance vehicle, but its characteristics lend themselves to that purpose, and the historical use of particular types of trusts for avoidance in particular fiscal contexts has been significant.

Trust participants and designers do not have a completely free hand. Where privacy of design and flexibility of the trust are perceived as prone to abuse relative to particular public or social norms, the courts or the legislature may constrain a trust-related dealing or some of its intended effects.[26] In a fiscal context, this is particularly seen in the treatment of

[24] Particularly in Australia and New Zealand, it is common to find such trusts used for the conduct of active business as well as more passive holdings and investments, typically with a high degree of discretion vested in the trustees and/or others associated with the grantor over the beneficial destination of trust income and capital.

[25] See, e.g., Graeme Cooper, 'Reforming the Taxation of Trusts: Piecing Together the Mosaic' (2013) 35 *Sydney Law Review* 187; Charles M Bruce, *United States Taxation of Foreign Trusts* (Kluwer, 2000) 43–48; Charles M Bruce, Lewis D Solomon and Lewis J Saret, 'Foreign Trusts – Continuing Uses' (2004) 7(6) *Journal of Retirement Planning* 39; New Zealand, Law Commission, *Review of Trust Law in New Zealand: Introductory Issues Paper*, NZLC IP19 (2010) [1.15]–[1.18], [2.37]–[2.45]; New Zealand, Law Commission, *Court Jurisdiction, Trading Trusts and Other Issues: Review of the Law of Trusts Fifth Issues Paper,* NZLC IP28 (2011) [2.2]–[2.20]; New Zealand, Law Commission, *Review of the Law of Trusts: A Trusts Act for New Zealand*, NZLC R130 (2013) [2.3].

[26] Prevention of fiscal abuse is not the only instance. A transfer system should also ideally be based on an individual's real economic situation, and special provisions are commonly made in pension or social welfare legislation for the recognition of voluntary

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grantors, international trust accumulations and distributions following tax-sheltered accumulations.

Despite the protean character of the trust, two broad classes may be identified: those which serve to optimize the wealth of investors who contribute assets and become beneficiaries with relatively fixed and objective rights, and those which serve the purposes of a grantor by effecting a controlled transfer of wealth over time to persons whom the grantor desires to favour. The former class essentially represents a form of investment in which the beneficiaries are also grantors. The latter essentially represents a controlled or deferred gift, delivered over a period of time. Most trusts fall fairly clearly into one class or the other.[27] The distinction between **investment** and **donative trusts** is not a trust-law classification; it is proposed here because it is based on features that are relevant to taxation.[28]

1.3 Taxation of Trust-Related Income

1.3.1 Design Options

Countries that recognize the trust in their general law typically provide a special set of tax rules for income derived by or through a trust. Typically, they also distinguish between income and capital gains, probably influenced by a corresponding distinction in trust law and practice.[29]

entrustments and benefactions that a person might acquire under a trust. See also n 20 in relation to fraud, family and forced heirship.

[27] There are undoubtedly trusts that fall close to the border between these classes or have mixed characteristics. For the purposes of the present study, it is sufficient to observe the broad distinction.

[28] The term 'investment trust' as used in this book should not be confused with the same term as commonly used in the United Kingdom to designate a certain class of closed-end collective investment vehicle, generally corporate in its legal form.

[29] The income taxes of the United Kingdom, Australia and New Zealand originally did not regard capital gains as income or seek to tax them, acting under the influence of the trust-law distinction between corpus/capital (which belonged in equity to a remainderman) and income (which accrued to a life tenant or income beneficiary). See Ross W Parsons, 'Income Taxation: An Institution in Decay' (1991) 13 *Sydney Law Review* 435, 436. The United Kingdom now has an entirely separate capital gains tax with its own rate structure; the amount of a person's taxable gains is integrated with income tax rate progression. Australia now treats capital gains as a species of statutory income with its own complex rules, including a discount for non-corporate residents (individuals and some trusts) on the taxable amount of most capital gains. Discounts are transmitted through a trust by a complicated system of cancellations and write-backs so that, at a particular level, the discount matches the fiscal attributes of the person or entity to whom

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Trust-taxing rules need not apply to all trusts. Each of the surveyed countries draws its own boundaries. Each excludes a differently defined subset of those trusts which have been broadly described above as investment trusts, treating them instead like companies or partnerships. Some also extend their trust rules to entities that are not trusts, such as deceased estates under administration. The common heartland of trust taxation is the donative trust, established by settlement inter vivos or by will, which lies between a settlement of property by its original owner and the ultimate beneficial enjoyment of the property and its produce by beneficiaries. As will be seen in the following paragraphs, the structure of trust taxation responds to the particular characteristics of the donative trust, including the separate role of the grantor and the potential indeterminacy of beneficial ownership of trust assets and income.

Assume that a country recognizes the trust as part of its general law and wants to design a system of trust taxation for donative trusts and perhaps some others, unconstrained by history and starting with a blank page. It is immediately confronted by a set of interrelated questions: who should be regarded for tax purposes as deriving the income of the trust, to what extent should the trust itself be regarded as a proper taxpayer (by analogy with a company), and to what extent should distributions from the trust be regarded as income in itself (by analogy with corporate dividends)? There are three potential answers to the first question: the grantor, the beneficiaries and the trust. Using the analogy of a slow-moving gift, the country may say that the grantor should be treated as the owner until the gift has sufficiently passed into the de facto ownership and control of the beneficiaries, or out of the de facto ownership and control of the grantor (which is not necessarily the same thing).[30]

the gain is attributed (ITAA 1997 Sub-div 115-C). New Zealand perseveres with the original distinction but recharacterizes some particular capital gains (mainly to do with land speculation and development) as income; for the purposes of this book, those measures will be ignored. The United States started from an opposite position, recognizing realized capital gains as income, but has developed a set of special rules and rates for capital gains taxation within the income tax. See *Eisner* v *Macomber*, 252 US 189 (1920); Henry Calvert Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (University of Chicago Press, 1938) 146. See also Richard Krever, 'The Ironic Australian Legacy of *Eisner* v *Macomber*' (1990) 7 *Australian Tax Forum* 191, observing that the tree-versus-fruit analogy for capital versus income in that case has been understood in Australia as if it meant the opposite of what the Court actually said.

[30] Early in the history of the trust, Gregory XI favoured treating a feoffee to uses (i.e., a trustee) as agent for the donor of the property concerned: F W Maitland, 'The Origin of Uses' (1894) 8 *Harvard L Rev* 127, 136.

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A related issue is whether a tax claim defined by reference to the grantor should be visited on trust assets in the hands of the trustees or a beneficiary who may receive them. Alternatively, the country may be more impressed by the fact that the income from the trust property is to be enjoyed by the beneficiaries, in which case it will want to tax them and will see them as the proper fiscal owners. But the grantor may be dead, or the trust may have income that is not clearly earmarked for any beneficiary. That raises the question of whether the trust should be taxed or whether one should wait and see to whom the trust property is distributed. Alternatively, the country could just decide to treat the whole arrangement like a company, taxing entity-level income to the entity and distributions as a separate form of income. That creates its own problems, including double taxation and tax deferral, resembling similar problems in classical corporate taxation. Although it is useful to refer to a spectrum from fiscal transparency to fiscal opacity, the actual choices that must be made are more complex.[31]

In practice, of course, a country does not write its tax law on a blank page, but is constrained by its own history and by international considerations – principally, the desire to protect its national tax base against erosion by the opportunistic exploitation of mismatches between taxing systems and the desire to protect its own people in their international dealings.

1.3.2 International Taxation

International taxing perspectives differ from domestic ones. In broad terms, assuming a conventional residence/source paradigm, a country may claim to tax from any of four perspectives: as a source country, or as the residence country of a grantor, a beneficiary or the trust. It may apply that claim to income of the trust by reference to the residence status of the taxpayer to whom it attributes trust income or to a distribution as a distinct species of income from the trust. One or more other countries will have a complementary perspective on the same set of facts involving a trust with income, connections or participants in different countries. A coincidence of overlapping taxing claims may produce double taxation:

[31] See J P le Gall, 'International Tax Problems of Partnerships: General Report' (1995) 80a *Cahiers de droit fiscal international* 655, 662–663; Richard J Vann, 'Australia's Policy on Entity Taxation' (2001) 16 *Australian Tax Forum* 33, 50–57.

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a coincidence of gaps in the taxing claims of countries that could potentially tax produces double non-taxation.

Depending on its taxing perspective, a country may perceive flows of investment or income in a number of different ways. It is conventional to refer to international taxation as inbound or outbound by reference to the flow of investment capital, which is typically in the opposite direction to that of a flow of resulting income. That usage is adopted in this book as if the person to whom income is attributed had provided the investment capital. The premise is counterfactual if trust income is attributed to a beneficiary who is only entitled to it by the exercise of a discretion. Nevertheless, it is expedient to have simple shorthand terms that group the source-based taxation of non-residents (**inbound**) and the taxation of residents on foreign income (**outbound**). These are supplemented by concepts of **conduit** treatment, where a country refrains from taxing a local or resident entity which it recognizes as delivering foreign income to a non-resident, and **round-trip** treatment, where it denies inbound treatment to locally sourced income that passes through an offshore or non-resident entity back to a resident.

1.3.3 Trust Income Concepts

Trust law and tax law have their own concepts of income, referred to in this book as **trust-law income** and **tax-law income**.

From earliest times it has been common for trusts to require that periodic income be applied for the benefit of particular beneficiaries during designated periods, such as lives or years. It was therefore necessary to keep accounts in a way that differentiated between the entitlements of successive income beneficiaries and between the entitlements of income beneficiaries and of remaindermen or capital beneficiaries. Trust accounting conventions developed accordingly but, being ancillary to the purposes of a trust to which they applied, they remained subordinate to the terms of the trust. The criteria that determine whether a particular item is trust-law income may therefore differ from trust to trust and may also be affected by an exercise of discretion by trustees or other decision makers if that is provided for under the terms of the relevant trust.[32]

Tax law, by contrast, is primarily objective. It prescribes definitively what items shall be recognized as income for tax purposes, and when one

[32] See *FCT* v *Bamford* (2010) 240 CLR 481.

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speaks of the income of a trust, it may include items of deemed income that would not be so recognized from the viewpoint of trust accounting. Tax law may also treat as income some items which would not be so recognized by commercial accounting or would be brought to account in a different way or at different times. Tax-law income may include capital gains, if the country in question taxes such gains in that way. The tax-law income of a trust comprises those items that tax law recognizes as income of the trust for tax purposes before any decision is made about their fiscal attribution.[33]

Trust-law income and tax-law income of a trust may differ for a diversity of reasons. They may differ on the inclusion of capital gains or whether a particular item is recognized on capital or income account; they may differ concerning the period in which an item should be recognized; they may differ on the amount, timing or recognition of items to be deducted from an income calculation;[34] particularly in an anti-avoidance context, tax law may recognize an item that trust law would say has not been derived at all. The potential importance of these differences varies from country to country. Difficulties may arise, e.g., if a country's rules of tax-law attribution refer to discretionary or manipulable trust-law entitlements or otherwise diverge from the economic realities of trust-law entitlements[35] or if trusts within the scope of its ordinary trust tax rules commonly engage in active business or activities that give rise to deemed tax-law income.

The term **trust income** – or, more emphatically**, trust-level income** – is used in this book to refer to income derived or recognized at the level of the trust, regardless of whether it is treated for tax purposes as income of the trust, a beneficiary or a grantor. In language that will be encountered particularly in a treaty context, it is **income derived by or through a trust**. By contrast, where a distribution from a trust to a beneficiary is

[33] Thus, if beneficiary attribution is achieved by a deduction system (as it is in the United States – see Section A.1.2), the tax-law income of the trust as that term is used in this book disregards those particular deductions, while items of trust income covered by distribution deductions are pro tanto included in beneficiary-attributed income and excluded from trust-attributed income (Section 1.3.4). The reference to 'tax-law income' focuses on the recognition of income for tax purposes, not its attribution.

[34] Depending on the context, the terminology of trust-law income or tax-law income may be applied to a particular item or to a balance remaining after adjustments or deductions.

[35] As strikingly illustrated by the Australian treatment of trust-level capital gains: see *Davis* v *FCT* (1989) 86 ALR 195, 230; *FCT* v *Bamford* (2010) 240 CLR 481; M L Brabazon, 'Australian International Taxation of Attributed Trust Gains' (2015) 44 *Australian Tax Review* 141 §7.

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recognized as income for tax purposes and not just as the delivery of trust-level income that is currently attributed to the beneficiary, the distribution can be considered to be **income derived from a trust**. Income derived by, through or from a trust may be considered together as **trust-related income**.

Tax systems differ in their treatment of capital gains and in whether they classify taxable gains as income. The general approach in the present work is to treat capital gains as a species of income.

1.3.4 Fiscal Attribution

An income tax can be conceived as a tax on income and, with equal validity, as a tax on persons with reference to their income.[36] The personal subject of taxation may be a natural person, a legal person, or a purely fiscal person, conceived for the purposes of tax law but otherwise lacking legal personality or not precisely corresponding in characteristics, responsibility or capacity to a distinct person that would be legally recognized outside a fiscal context. Fiscal attribution is the connection between a personal subject and an impersonal object of taxation.

If a country taxes on a progressive basis or differentiates between classes of taxpayers such as individuals and companies, or if it exerts its international claim to tax on a conventional residence/source basis, it needs to be able to allocate particular items of income to a person or entity by reference to whose characteristics or residence the applicable tax treatment is determined. That is to say, it needs to be able to identify whose income an item is taken to be for tax purposes. This connection is **fiscal attribution**, or simply **attribution**. It identifies the person or entity that is taken to be fiscally responsible for particular income and that is thus expressly or by implication the personal subject of taxation, even if the legal obligation to pay tax may fall elsewhere, such as by withholding.

A country's rules of fiscal attribution may be explicit or implied, and may be clearly structured or scattered through its legislation. Usually, attribution of income to one taxpayer implies that the same item of income is not attributed to any other taxpayer except in a representative capacity, but that is not always the case. Particularly in an anti-avoidance

[36] The distinction between taxes on persons and taxes on things (including income or items that stood as proxy for income) was regarded as more important in earlier times. See, e.g., E R A Seligman, *Double Taxation and International Fiscal Cooperation* (Macmillan, 1928) ch 4 and proposed taxonomy of taxes at p 84.

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or anti-deferral context, a taxpayer may be made principally liable for tax by reference to an item of income without clearly excluding the principal attribution of the same item to another person or entity, who may or may not be taxable in the same country. This will be referred to as **indirect attribution**.[37]

Trust-related income may be taxed at either or both of two points: its derivation by the trust and its distribution to a beneficiary. Taxation of trust income by reference to trust-level derivation and as income of the tax period in which it is so derived may be referred to as **current taxation**. The person to whom the income is currently attributed – i.e., attributed for the purpose of current taxation – may be the grantor, a beneficiary or the trust entity. It will be convenient to refer to tax that is imposed on distributions otherwise than by necessary reference to current trust-level derivation of income as **non-current taxation**, even if the tax happens to be imposed in the year when the trust derives income that supports the distribution. In this context, defining the economic object of taxation and its connection with trust-level income (if any is required) becomes considerably more complicated. Is the taxable object the distribution as such? Is it so much of the distribution as is supported by earlier trust income and, if so, does it matter whether that income has borne taxation by the same or another country? Are characteristics of the distribution in the hands of the beneficiary, such as periodicity, important? Different countries make different choices and characterize the object of non-current taxation differently. The fiscal attribution of that object as tax-law income of a recipient beneficiary is generally

[37] Indirect attribution may be illustrated by example. The UK transfer of assets abroad rules are a body of international anti-avoidance rules, which relevantly make a resident transferor taxable by reference to income arising to a person abroad. The legislation does not say that the income of the person abroad is treated as income of the resident individual, but that an amount 'equal to the amount of the income of the person abroad' is so treated (ITA UK ss 721(3B), 728(1A)). The particular wording is the result of amendments, explained by Philip Baker, 'Finance Act Notes: Section 26 and Schedule 10: Amendments to the Transfer of Assets Abroad Legislation' [2013] *British Tax Review* 407, 409 on the basis that 'the charge to tax is on a notional attribution of income, rather than the actual income of the non-resident person; the aim of this change being to put beyond doubt, so it would seem, any argument that the charge to tax is overridden by a double taxation convention'. The technique of attributing 'an amount' calculated by a formula with reference to original income derived by an entity or another person does not necessarily imply that such original income is not thereby being attributed to the taxpayer in question. Whether that implication should be drawn depends on the context. Indirect attribution, as that expression is used in this book, is not limited to notional attribution of income (or attribution of notional income) in the sense described by Baker.

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straightforward, but the income so attributed may be characterized as something different from that which was attributed currently.

The unavoidable difficulty of achieving the economic goals of taxation by reference to legal facts which, by their nature, do not reliably correspond to economic integers[38] produces a multitude of detailed rules for specific situations in different countries, as well as inevitable differences that exist between more general attribution rules. Fiscal attribution is ultimately too complex to be captured in a general a priori statement of legal principle that would have international validity.[39] It is nevertheless possible, by examining the actual tax settings of the surveyed countries and the functions that they perform in their respective tax systems, to infer a more or less finite set of possible approaches to the attribution of trust income and consequently to identify how different rule-choices interact where a trust has connections with more than one potentially taxing country and the mechanisms by which those interactions may produce international double taxation or non-taxation.

1.4 Scope

The boundaries of trust tax rules, as has been mentioned, are drawn differently in different countries. They may exclude some arrangements in trust form and include others that are not trusts at all. Particular or specialized classes of trust may attract specialized tax treatment within or without the trust rules. This book is only concerned with private express trusts for beneficiaries that fall within the ordinary operation of the trust rules of at least one potentially taxing country.[40]

[38] John Prebble, 'Ectopia, Tax Law and International Taxation' [1997] *British Tax Review* 383; John Prebble, 'Income Taxation: A Structure Built on Sand' (2002) 24 *Sydney Law Review* 301.

[39] Demonstrated by Joanna Wheeler, 'The Attribution of Income in the Netherlands and the United Kingdom' (2011) 3(1) *World Tax Journal* (Journals IBFD). Although this study only addressed the two named countries and was directed to the feasibility of devising a substantive attribution rule for tax treaties, its conclusions can safely be generalized. See also Joanna Wheeler, 'The Missing Keystone of Income Tax Treaties' (2011) 3 *World Tax Journal* 247 and Joanna C Wheeler, 'Conflicts in the Attribution of Income to a Person: General Report' (2007) 92b *Cahiers de droit fiscal international* 17, both of which include extensive and comparative consideration of the attribution of trust income.

[40] Excluded topics consequently include the following: charities, resulting and constructive trusts, the interaction of trust rules with CFC or FIF rules, corporate-taxed trusts, trusts for superannuation, employment or remuneration purposes subject to specialized tax rules, bare trusts if disregarded for tax purposes, collective investment vehicles and

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Difficulties can arise if one country applies its trust rules to an arrangement which another classifies differently. To assist in framing the discussion of trust rules in the surveyed countries, the following abbreviated summary is provided.

- Australia is highly inclusive and treats most trust-form arrangements as tax-law trusts, although bare trusts are effectively disregarded for capital gains taxation. Business trusts are common. Superannuation funds are excluded. A small class of listed public trading trusts is corporate-taxed.[41] There are special rules for managed funds. Deceased estates are treated as trusts, but some rules (particularly tax rates and capital gains tax rules) are modified.
- The US trust rules focus on donative trusts, usually with passive investments or holding functions. A trust with business purpose and associates is excluded from tax-law trust status as an association:[42] under check-the-box regulations, it may attract corporate, partnership or disregarded tax treatment.[43] Active management of investments implies business purpose;[44] a tax-law trust may, however, hold an interest in an active partnership as a passive investment. A trust with beneficiaries who do not participate in management or control lacks associates and may be in business directly without loss of tax-law trust status.[45] The classification of a foreign trust is determined, as might be expected, by US tax principles.[46] Grantor trusts (those where grantor attribution applies) are within the trust rules, although treated pro tanto as possessions of the grantor. Deceased estates are not tax-law trusts but are subject to the same core rules as complex non-grantor trusts.
- The UK trust rules generally require settled property and therefore a settlement, but a bare trust is treated as if it were an agency for the

managed funds if subject to special tax rules, and trusts for people with special disabilities if subject to special tax rules.

41 ITAA 1936 Part III Div 6C.

42 *Morrissey* v *CIR*, 296 US 344 (1935); 26 CFR s 301.7701-4 Trusts. IRC s 7701(a)(3) defines a corporation for tax purposes to include an 'association'. See Mark L Ascher, 'The Income Taxation of Trusts in the United States' (1999) 53 *Bulletin for International Taxation* 146, 147–148.

43 26 CFR ss 301.7701-2, -3.

44 *CIR* v *North American Bond Trust*, 122 F 2d 545 (2nd Cir, 1941).

45 *Elm Street Realty Trust* v *CIR*, 76 TC 803 (1981). According to Ascher – see n 42, 149 – donative non-grantor trusts (particularly testamentary ones) often run businesses.

46 26 CFR s 301.7701-4.

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beneficiary.[47] Particular classes of collective investment vehicles attract corporate taxation or modified trust taxation. Deceased estates have their own tax rules.

- The New Zealand trust rules generally follow trust-law classification but exclude a class of collective investment vehicles described as unit trusts (although unitization is neither necessary nor determinative of that status), which are corporate-taxed, and bare trusts, which are treated as agency arrangements.[48] Business trusts are common. Deceased estates are generally treated as tax-law trusts.[49]

Transactions in which a beneficiary is the actual or constructive disponor, such as the sale or redemption of an interest in a trust, are not considered in this book.

The complex UK rules dealing with remittance-basis taxation and related distinctions based on domicile (including deemed domicile) are not considered here.[50] The UK rules relating to trusts are generally addressed on the assumption that the fiscal domicile of a grantor or beneficiary is the same as that person's fiscal residence. Although the remittance basis is an important aspect of UK tax planning for income tax and capital gains tax as well as inheritance tax, it does not have clear counterparts in the other surveyed countries.

Tax regimes that attribute income to a resident of the taxing country by reference to a CFC, FIF or similar entity abroad are not considered. Such rules are generally self-contained and have their own structure and design. To address the potential application of such rules to trusts and their intersection with rules of trust taxation would be a substantial undertaking in itself, which lies beyond the scope of the present work. There are, however, some offshore investment regimes that are recognizable as trust taxing rules and therefore included, principally with respect to the outbound taxation of grantors.

[47] ITA UK s 466; TCGA ss 60, 68.

[48] ITA NZ ss HC 1(2), HD 13, YA 1 (definitions of 'company', para (b), 'trust' and 'unit trust'), YB 21.

[49] Vicki Ammundsen, *Taxation of Trusts* (CCH, 2nd edn, 2011) §26.30, §26.60 ff.

[50] The subject is important in UK tax planning, and is addressed at length in other works. See, e.g., Emma Chamberlain and Chris Whitehouse, *Trust Taxation and Estate Planning* (Sweet & Maxwell, 4th edn, 2014) chapters 5, 7, 23 and passim. For consideration of more recent changes, see Robin Vos, 'Finance (No.2) Act 2017 Notes: Section 29 and Schedule 8: deemed domicile: income tax and capital gains tax; Section 30: deemed domicile: inheritance tax; Section 31 and Schedule 9: settlements and transfer of assets abroad: value of benefits' [2017] *British Tax Review* 572.

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The focus of this book is on general rules of trust taxation. The main focus is therefore on private donative trusts and on such other trusts as fall within a country's general trust tax rules. Specialized tax regimes and corporate-taxed trusts are thus outside the scope of the present work, including those which deal in a specialized way with

- collective investment vehicles including managed investment trusts;
- pension, superannuation and employee-related trusts;
- trusts for especially vulnerable, disabled or injured persons;
- public and private charitable trusts; or
- purpose trusts.

Provisions dealing with temporary residents are not considered.

The law in the surveyed countries, the OECD Model and Commentaries and other international materials are described as on 1 July 2018 unless otherwise indicated.[51]

1.5 Structure

Part I of this book (Chapters 2–6) examines the attribution and taxation of trust-related income in the surveyed countries. It seeks to identify the international taxing principles applied by those countries and to infer a range of principles that may practicably and probably be applied by countries more generally. It also examines the potential of those settings to generate double taxation or non-taxation when combined with known or inferred tax settings of other countries addressing the same situations from a different taxing perspective.

Chapter 2 begins by outlining the historical origins of grantor taxation in the United States and the United Kingdom and proceeds to a consideration of general/domestic grantor attribution and taxation rules in those countries and a somewhat different rule in Australia, modifications that apply in

[51] The OECD Council approved the 2017 Update on 21 November 2017. Where particular provisions have been added, changed or renumbered by the 2017 Update, that fact is noted in the text or corresponding footnotes. The UK Autumn budget delivered in August 2018 will affect the treatment of trusts at a number of points, including the general extension of non-resident capital gains taxation to non-residential UK land and elective deferral of capital gains tax exit charges in those (rare) cases where a UK resident trust has trading activities. Detailed coverages of these measures is beyond the scope of this book. The government also announced that it would conduct a review of trust taxation. For more detail, see United Kingdom, HMRC and HM Treasury, Overview of Tax Legislation and Rates (29 October 2018, www.gov.uk/government/publications/budget-2018-overview-of-tax-legislation-and-rates-ootlar).

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inbound or conduit situations, and the application of grantor attribution and taxation in outbound situations. Specific outbound grantor regimes are also considered here and are contrasted with the New Zealand settlor regime. The chapter concludes by summarizing the structural similarities and differences between the various rules and their international settings.

Chapter 3 considers the transparent tax treatment of trusts by attribution of trust income to beneficiaries. It begins by identifying the general beneficiary-attribution principles in each of the surveyed countries and the difference of approach between the United Kingdom and the other countries with respect to vested and discretionary entitlements. The inbound and conduit settings applied to non-resident beneficiaries are then considered, differentiating between major income categories. This section includes consideration of the attribution of entity-level business structures to beneficiaries and the interaction between final withholding regimes for dividend, interest and royalty (**DIR**) income and beneficiary attribution. It is followed by consideration of outbound beneficiary settings, in which a major consideration is the provision of unilateral double tax relief to a resident beneficiary in respect of foreign taxation of trust income, which may have been imposed on the trust or a grantor. The appendix[52] sets out comparative analyses of certain beneficiary attribution settings in the surveyed countries which were judged too detailed for inclusion in the main chapter.

Chapter 4 addresses trust attribution and taxation. It considers the conceptualization of the trust as a taxable subject and the basis on which countries lay claim to tax worldwide trust-attributed income, which is identified as trust residence or functional residence, and then outlines inbound and outbound settings for taxation of the trust. A degree of similarity is observed in the policy functions of a wide concept of trust residence and outbound grantor attribution.

Chapter 5 addresses the taxation of distributions as income from a trust. It first considers the broadly synoptic approaches of Australia, the United States and New Zealand, which use distribution taxation as a complementary international rule. It compares key elements of those countries' rules with reference to scope, tracing principles, international double tax relief (an area of considerable divergence) and the treatment of tax-deferral benefits. It then considers the UK approach, its integration with domestic taxation, its modifications in inbound and outbound situations, and a separate UK rule that applies to capital gains.

[52] The prefix 'A.' is used in cross-references to designate sections of the appendix.

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Chapter 6 serves as a bridge between Parts I and II. It identifies ways in which the interaction of national rules considered in earlier chapters can produce outcomes of double- or non-taxation.

Part II (Chapters 7 and 8) examines the interaction of national laws in the taxation or non-taxation of trust-related income in treaty and non-treaty situations. Building on the work in Part I, it seeks to identify the ways in which unintended double taxation and non-taxation can arise, to assess existing and proposed strategies to prevent or neutralize those outcomes, and to postulate principles of tax and treaty design for that purpose.

Chapter 7 begins by framing the global tax examination by outlining the international tax order, including treaties and the interaction of national laws. In particular, it identifies the normative work of the Partnership Report and Actions 2, 6 and 15 of the BEPS project as particularly relevant to trusts. It accepts the view that tax arbitrage is harmful in treaty and non-treaty situations and that it is desirable for countries to take countermeasures. It then considers non-treaty interactions of trust-related tax claims and certain BEPS project proposals for prevention or remediation of trust-related arbitrage. The chapter concludes by proposing the development of an ordered and differentiated view of taxing claims with respect to trust-related income, the object of which is to identify and prioritize taxing claims and measures for tax-base protection in a way that is effective against trust-based arbitrage and avoids creating undue or unrelieved double taxation.

Chapter 8 considers the application of tax treaties based on the OECD Model to trust-related income. Particular emphasis is placed on the transparent entity clause and saving clause proposed by the BEPS project and now incorporated into the OECD Model and how they apply to trust income, having regard to differential transparency and the possibility of grantor attribution. It considers the availability and extent of treaty benefits in trust situations and proposes a number of drafting strategies, including a proposal to address otherwise unrelieved double taxation where two countries each attribute the same income to their own resident. Consideration is also given to the interaction between tax treaties and national taxation of trust income and, separately, of trust distributions.

Chapter 9 concludes the work by summarizing its main conclusions by reference to each of its principal aims: to identify principles of international taxation of trust-related income; to identify related risks of unintended non-taxation and double taxation; and to propose principles of tax and treaty drafting in response to the other findings.

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PART I

National Tax Laws

Australia, New Zealand, the United Kingdom and the United States

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2

The Grantor

This chapter considers the attribution of trust income to the grantor and international grantor taxation. Section 2.1 introduces the subject. Section 2.2 outlines the history and origin of general rules of grantor attribution which may apply domestically as well as internationally, focusing on the United States and the United Kingdom. Section 2.3 outlines and compares general grantor rules in those countries and in Australia. Section 2.4 considers inbound and possible conduit settings, where the grantor is non-resident. Section 2.5 considers and compares outbound settings in those three countries, including the outbound application of general rules as well as additional dedicated rules that only apply in outbound situations. It also compares the Australian, US and UK rules with New Zealand rules that impose tax-related obligations on a resident grantor. Section 2.6 summarizes the findings of the chapter and sets them in the context of global taxation.

2.1 Grantor Attribution

Current trust income may be attributed for tax purposes to the grantor, to beneficiaries, or to a trust entity representing the trust as a whole. It is convenient to consider the grantor first, although this reverses the usual order of presentation in most descriptive works dealing with trust taxation. Where grantor attribution applies, the transaction by which the grantor parted with income-generating trust capital is implicitly or expressly disregarded. This implies that grantor attribution should take priority over whatever attribution would otherwise apply, which is indeed what one finds in domestic situations and in some international ones.

Grantor attribution is consistent with the economic thinking that was dominant in tax design when most grantor attribution rules were devised. Under the comprehensive concept of income, an economic flow that enhances the net store of wealth available for a person's personal use

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is his or her income.[53] Voluntary benefaction is equivalent in this context to personal use.[54] Until trust property unequivocally belongs to ascertainable beneficiaries – until the slow-moving gift is perfected – grantor attribution of income generated by the inchoate gift is consistent with comprehensive income taxation.

2.2 History and Origins

The general and domestic grantor regimes of the United States,[55] the United Kingdom[56] and Australia[57] trace their origins to the second and third quarters of the twentieth century. Their history discloses their underlying policy, rationale and relationship with fiscal theory.

In a closed system with low tax rates and limited progression, the temptation to engineer an artificial fiscal attribution of income is relatively low. When tax rates and fiscal progression exploded at the time of the First World War, wealthy individuals and their advisors responded with an array of tax avoidance strategies. A recurrent theme was the hope that income produced by entrusted capital would be attributed to the trust entity or beneficiaries in whose hands (under then-prevailing tax law) it would be taxed more lightly than if it were attributed to the grantor. Typically, the ultimate beneficiaries of the trust were people for whom the grantor would in any event wish or be obliged to provide, or who could be trusted to comply with the grantor's wishes. In some accumulation scenarios, they might even include the grantor.

These strategies encountered differing judicial and legislative responses in different countries.

[53] Simons, n 29, 49; Robert M Haig, 'The Concept of Income: Economic and Legal Aspects' in R M Haig and E R A Seligman (eds), *The Federal Income Tax: A Series of Lectures Delivered at Columbia University in December, 1920* (Columbia University Press, 1921) 1, 7 and 27; Georg Schanz, 'Der Einkommensbegriff und die Einkommensteuergesetze' (1896) 13 *Finanzarchiv* 1, 5. Economic public finance theory today is heavily contested and has departed widely from ideas that were conventional in the middle half of the twentieth century, although comprehensive income remains an influential idea behind comprehensive income taxes (see, e.g., Alan J Auerbach, 'Directions in Tax and Transfer Theory' in Melbourne Institute (ed), *Australia's Future Tax System Conference* (Melbourne Institute of Applied Economic and Social Research, 2010) 63, 64; Glen Loutzenhiser, *Tiley's Revenue Law* (Hart, 8th edn, 2016) ch 1).

[54] Victor Thuronyi, 'The Concept of Income' (1990) 46 *Tax Law Review* 45, 73–74.

[55] IRC ss 672–677. The grantor rules of which these provisions are part are known as Subpart E (in full: IRC Subtitle A Chapter 1 Subchapter J Part I Subpart E).

[56] The settlements legislation, ITTOIA Part 5 ch 5.

[57] ITAA 1936 s 102.

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2.2.1 United States

The US courts solved the problem by adopting a strongly purposive interpretation of the general attribution rule.[58] The seminal authority is *Helvering* v *Clifford*.[59] Mr Clifford had declared trusts over certain securities to pay or hold the income they produced for the following five years for the exclusive benefit of his wife, which she duly received. The Supreme Court upheld assessments of the husband on the basis that for income tax purposes he was still the effective owner of the trust corpus and, hence, of resulting income. The Court's reasoning was brief and broad. It was informed by a sense of the statutory scheme of the income tax and a concern 'lest what is in reality but one economic unit be multiplied into two or more by devices which, though valid under state [trust] law, are not conclusive' so far as the tax statute is concerned.[60] It mandated 'analysis of the terms of the trust and all the circumstances attendant on its creation and operation'.[61] The Court was particularly concerned with the grantor's retention of control over the management of trust assets and the practical impact of the trust on his economic position and his potential practical benefit from trust income.[62]

[58] For a succinct but more detailed account of the history and background of the grantor trust rules down to their 1954 codification, see Jay A Soled, 'Reforming the Grantor Trust Rules' (2001) 76 *Notre Dame Law Review* 375, 378–388.

[59] *Helvering* v *Clifford*, 309 US 331 (1940).

[60] Ibid, 331, 335 (footnote omitted). The Court's analysis was based exclusively on the general taxing provision and not at all on any of the specific grantor taxing provisions which had been present in the legislation since 1924 (adverted to by Roberts J, dissenting, at 339–341). That general provision was the *Revenue Act of 1934*, Pub L 73–277, 48 Stat 680 s 22(a) (see now IRC s 61(a)), which included among 'gross income' all 'gains, profits, and income derived . . . from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever'. The majority held (at 334) that '[t]he broad sweep of this language indicates the purpose of Congress to use the full measure of its taxing power within those definable categories. . . . Technical considerations, niceties of the law of trusts or conveyances, or the legal paraphernalia which inventive genius may construct as a refuge from surtaxes should not obscure the basic issue. That issue is whether the grantor after the trust has been established may still be treated, under this statutory scheme, as the owner of the corpus'.

[61] *Helvering* v *Clifford*, 309 US 331, 335 (1940).

[62] Ibid, 331, 335–337 (1940).

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Regulations were promulgated[63] and case law grew up in the *Clifford* area, as it was known, charting the various situations in which grantor taxation would be attracted. The concept of control was central: 'if the grantor retains so large a measure of control over the trust that the amount or certainty of [its] distributions is or may be severely affected, then each annual distribution partakes of the nature of an annual gift by the grantor'[64] with the consequence that fiscal responsibility for trust income should be allocated to the grantor alone. In deciding where to draw the line, the view was taken that a balance should be struck between allowing prudent family property planning, which required a measure of retained control and would be discouraged if the scope of grantor taxation were drawn too widely, and precluding tax avoidance by shifting income into lower tax brackets of particular beneficiaries or (as was then possible) the trust itself without other material and practical change.[65]

The 1954 rewrite of the Internal Revenue Code treated the policy decisions in the *Clifford* regulations as both sound and sufficiently important to be elevated into the statute. It detached grantor taxation from its original foundation in the general taxing rule and relocated it into the trust sections of the Code although, reflecting its original rationale and policy basis, the grantor was not made taxable as a quasi-beneficiary but as the fiscal owner of relevant trust assets, with corresponding entitlement to deductions and credits arising from the affairs of the trust.[66] The domestic components of the grantor trust rules still substantially reflect the structure and policy of the 1954 Code.

[63] The authority of US tax regulations is greater than those of tax regulations in most other common law countries. The view is taken that 'Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes and that they constitute contemporaneous constructions by those charged with administration of these statutes which should not be overruled except for weighty reasons' (*CIR* v *South Texas Lumber Co*, 333 US 496 (1948), 501). This judicial deference has the effect of giving the regulations an interpretive weight with respect to their parent Act. It is common in US tax regulations to find discussion and interpretation of case law as well as the terms of the IRC.

[64] H Brian Holland et al., 'Proposed Revision of the Federal Income Tax Treatment of Trusts and Estates – American Law Institute Draft' (1953) 53 *Columbia Law Review* 316, 359.

[65] Ibid, 359–360.

[66] Ibid, 361–362.

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2.2.2 Australia and New Zealand

The Australian historical material is limited and indicates a comparatively low level of mid-century concern with tax avoidance of the kind that the US and UK grantor rules addressed.[67] New Zealand did not have a general grantor regime before the 1988 reforms which established the settlor regime discussed in Chapter 4 and still does not.

2.2.3 United Kingdom

In the United Kingdom, by contrast, the courts proved receptive to income-shifting strategies and were reluctant to look further than literal legal form. Parliament responded by enacting anti-avoidance rules, the broad strategy of which was to attribute shifted income back to the grantor. A cat-and-mouse game ensued as wealthy taxpayers, their lawyers and accountants thought up new forms of lawful tax avoidance (as it was characterized), to which the Revenue responded by urging Parliament to stem the leakage of tax by plugging each new scheme and eventually its foreseeable variants. The rules were laid down in stages, the most important of which date from 1922, 1936, 1938 and 1946.[68] This

[67] See Royal Commission on Taxation, *Third Report* (1934) (*Ferguson Report*, vol 3) p 124, [723], [724], with respect to revocable trusts and Explanatory Memorandum, Income Tax Assessment Bill 1941 (Cth), commentary on cl 16 (s 17 of the *Income Tax Assessment Act 1941* (Cth)) with respect to income entitlements of and distributions to the grantor's unmarried infant children. Although these resemble elements of the UK legislation, the historical sources indicate that the taxing practice of the Australian States provided the immediate inspiration for ITAA 1936 s 102. Any UK inspiration can only have been secondary or mediated.

[68] The history and policy of the first three have been usefully traced in a series of articles by David Stopforth (David P Stopforth, 'The Background to the Anti-Avoidance Provisions Concerning Settlements by Parents on Their Minor Children' [1987] *British Tax Review* 417; David P Stopforth, 'Settlements and the Avoidance of Tax on Income – The Period to 1920' [1990] *British Tax Review* 225; David P Stopforth, 'The First Attack on Settlements Used for Income Tax Avoidance' [1991] *British Tax Review* 86; David P Stopforth, '1922–36: Halcyon Days for the Tax Avoider' [1992] *British Tax Review* 88; David P Stopforth, 'The Pre-legislative Battle over Parental Settlements on Their Children' [1994] *British Tax Review* 234; David P Stopforth, 'The Legacy of the 1938 Attack on Settlements' [1997] *British Tax Review* 276). FA 1946 s 28, enacted under the post-war Labour government, carried the package further than pre-war Conservative governments had been prepared to go. Among other things, it finally plugged the surtax avoidance scheme in the *Duke of Westminster's* case (*IRC* v *Duke of Westminster* [1936] AC 1).

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settlements legislation, as it was known, was substantially revised in 1995[69] and rewritten a decade later as part of the tax law rewrite project.[70] It is still extraordinarily complex.

2.3 General Grantor Rules

The general, domestic grantor regimes of the United States, the United Kingdom and Australia all displace fiscal attribution to beneficiaries or to the trust in respect of affected income, at least in their main areas of operation,[71] during the life or existence of the grantor. That is to say, grantor attribution takes priority over beneficiary or trust attribution. All result in ultimate taxation at the grantor's rate. All reflect a concern to prevent tax-driven arbitrage of the fiscal attribution rules and consequent tax avoidance by income shifting. All are capable of having international application and resisting international tax arbitrage by controlled attribution, at least where the grantor in question is resident. But there are also significant differences between them.

- The United States[72] and the United Kingdom[73] use wide, substantive grantor definitions. Seemingly by an uncorrected historical accident, Australia uses a narrow, formal definition,[74] which has resulted in its

[69] FA 1995 s 74, Sch 17, amending what was then *Income and Corporation Taxes Act 1988* (UK) Part XV.

[70] It is now located in ITTOIA Part 5 ch 5.

[71] This is explicit in the US rules and the first and second rules of the UK settlements legislation (ITTOIA ss 624(1), 629(1)). It is implicit in the Australian rule (see ITAA 1936 s 102(2B)(a), (3)). The third and fourth rules of the UK settlements legislation are an exception; see Section 2.3.2.

[72] The US grantor concept is now defined in 26 CFR s 1.671-2(e). It refers to a real or economic settlor of a trust in respect of that person's contribution (*Buhl* v *Kavanagh*, 118 F 2d 315 (6th Cir, 1941); *Estate of Kanter* v *CIR*, 337 F 3d 833 (7th Cir, 2003)), including one who feeds an existing trust and a transferor for undervalue to the extent of the undervalue.

[73] ITTOIA s 620. A 'settlor' is one who makes or enters into a settlement directly or indirectly, and includes one who feeds a trust by providing funds directly or indirectly. A donative trust is a 'settlement': see n 83.

[74] ITAA 1936 s 102 refers to a person who 'has created a trust'. In *Truesdale* v *FCT* (1970) 120 CLR 353 Menzies J held that the expression refers to a formal settlor and not to one who feeds an existing trust. It is difficult to imagine that the drafters of the legislation intended that meaning because it completely undermines the obvious purpose and policy of the rule. The method of statutory interpretation ('There is no equity about a tax' – at 362, quoting Rowlatt J in *Cape Brandy Syndicate* v *IRC* [1921] 1 KB 64, 71) would not be followed today. See, e.g., Murray Gleeson, 'Justice Hill Memorial Lecture: Statutory Interpretation' (2009) 44 *Taxation in Australia* 25; the modern interpretive approach is

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rule being a dead letter in practice. The use of a nominal settlor, which is routine in Australia, avoids the rule entirely. Other aspects are nevertheless of interest for the tax design possibilities that they illustrate.

- The United States taxes the grantor directly and gives no right of indemnity from trust assets. The United Kingdom taxes the trust on a representative basis for the grantor and taxes the grantor with credit for trustee taxation; by a system of cross-indemnities, it procures the effect that the trust income in question (as retained in the trust or as distributed to a beneficiary) bears tax at the grantor's rate (see Section 2.3.2). Australia taxes the trust at the grantor's rate; by not taxing the grantor, no question of indemnity arises.
- The substantive criteria by which the grantor rules are engaged are examined further in the following sections. They reflect broadly similar themes but are not identical. The US criteria embody wide notions of potential control or benefit by the grantor. The UK criteria reflect a wide notion of potential benefit. The idea of control may not be entirely absent from the UK rules, but it is largely subsumed in extended notions of potential benefit. Broadly speaking, the US rules impose grantor attribution in a wider range of situations than their UK counterparts. Australia uses rudimentary benefit rules.

New Zealand takes a different approach from the other surveyed countries. Its settlor regime has no impact in a purely domestic situation.

2.3.1 United States

The United States directly attributes current trust income and gains to a grantor if the requisite potential control or influence or potential benefit is not negated for the relevant year. The substantive elements of its general rule relate to potential reversionary interests,[75] potential discretionary

generally traced to *Cooper Brookes (Wollongong) Pty Ltd* v *FCT* (1981) 147 CLR 297. Even literally, feeding an existing trust by contributing additional assets may be described as creating a trust over those assets (see *Baldwin* v *CIR* [1965] NZLR 1; *Tucker* v *CIR* [1965] NZLR 1027, both of which were cited to the Court in *Truesdale* but not followed). The decision may be criticized as bad law, but it has stood without challenge for over 40 years.

[75] IRC s 673. The wording of s 673(a) illustrates how this is done: 'The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds 5 percent of the value of such portion.' The

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appointment of income or corpus,[76] administrative powers that could result in disposals at an undervalue,[77] potential revocation or revesting,[78] and potential current or deferred distribution of trust income to the grantor.[79] Spousal powers and interests are attributed to the grantor.[80] The tests for grantor attribution are broad and highly elaborated.

The absence of provision for a grantor to be indemnified by the trust or a beneficiary for tax on attributed trust income enables some complicated US tax planning, principally directed to the avoidance of gift and estate taxation.[81]

reference to ownership of a trust connotes ownership of the trust property or, as it is expressed in Australia, the trust estate. The other substantive rules follow a similar pattern.

[76] IRC s 674.

[77] IRC s 675.

[78] IRC s 676.

[79] IRC s 677. Discretionary distributions that have the effect of discharging the grantor's obligation to support an infant child are also caught under s 677(b) and related regulations.

[80] IRC s 672(e).

[81] Some taxpayers have established trusts, colloquially known as intentionally defective grantor trusts or IDGTs, that deliberately satisfy one or more of the criteria for grantor trust status as a means to minimize or avoid transfer taxes, principally by exploiting a mismatch between the income tax and transfer tax criteria for recognizing a grant in trust as a transfer of fiscal ownership. See Mark L Ascher, 'Grantor Trust Rules Should Be Repealed' (2011) 96 *Iowa Law Review* 885, 903–907; Soled, n 58, 398–403; Robert T Danforth, 'Proposal for Integrating the Income and Transfer Taxation of Trusts' (1999) 18 *Virginia Tax Review* 545, 573–600; Laura Cunningham and Noel B Cunningham, 'Tax Reform Paul McDaniel Style: The Repeal of the Grantor Trust Rules' in Yariv Brauner and Martin James McMahon (eds), *The Proper Tax Base: Structural Fairness from an International and Comparative Perspective – Essays in Honour of Paul McDaniel* (Kluwer, 2012) . The United States has an extensive system of transfer taxes on voluntary or successional transmission of personal wealth – gift tax, estate tax and generation skipping tax. The transfer taxes are generally imposed at high headline rates, but are subject to elaborate thresholds, concessions and relief measures. They are not integrated with income taxation, although some concepts operate more or less in parallel. In particular, a grantor's transfer of wealth into trust qualifies as a presently taxable gift if it is characterized as a completed gift; if it is characterized as incomplete, its transfer tax recognition is put off until it becomes complete or the grantor dies, in which case it forms part of his or her taxable estate. A grant in trust that is an incomplete gift usually corresponds to a grantor trust, and a completed gift to a non-grantor trust. The correlation, however, is imperfect. A grant in trust can be so structured to be a completed gift but give rise to a grantor trust. The grantor bears income tax year by year on trust income, the trust estate grows without deduction of that tax, no gift tax is payable on the implied transfer of value and the grantor's potentially taxable estate is diminished by the payment of income tax. The ultimate fiscal effect can be magnified by techniques based on leveraging and particular gift tax rules. It has also been

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2.3.2 United Kingdom

The UK settlements legislation[82] is not limited to trusts – in practice, it is mostly concerned with other arrangements – but its concept of a 'settlement' clearly includes a donative trust.[83] There are four basic rules. The first attributes current trust income to a grantor if there is a possibility of trust property reverting or being applied for the benefit of the grantor, spouse or civil partner.[84] The second attributes current trust income to a grantor if it would otherwise be attributed to or is applied in benefaction of an infant child of the grantor.[85] Both rules attribute trust income to 'the settlor and . . . the settlor alone'.[86] This excludes beneficiary attribution and hence beneficiary taxation,[87] but taxation of trustees 'as persons

argued that such trusts can be used to minimize income tax (Ascher, n 81, 907–930; Soled, n 58, 403–406). The identified income tax strategies generally depend on mismatches within the grantor trust rules themselves (including the capacity to 'toggle' grantor trust status on and off from year to year) or between those rules and rules relating to the cost base (USA: basis) of assets.

[82] ITTOIA Part 5 ch 5. A recent suite of anti-avoidance amendments to the settlements legislation and the outbound capital gains taxation of beneficiaries, TCGA s 87 and related provisions, was implemented by FA (No 2) 2017, discussed by Vos, n 50. Further anti-avoidance measures have been added by FA 2018s 35, Sch 10. Many but not all of the amendments focus on cases involving resident but non-domiciled or deemed domiciled settlors, for whom increasingly complex special provision is made. Cases involving such settlors are outside the scope of this book.

[83] The definition includes 'any disposition, trust, covenant, agreement, arrangement or transfer of assets' (ITTOIA s 620). It is so widely cast that the courts have found it necessary to identify an implied limitation to the effect that there is no relevant settlement if there is no element of bounty, even if the arrangement is tax-driven (*IRC* v *Plummer* [1980] AC 896; *Jones* v *Garnett* [2007] 1 WLR 2030 (HL)). The element of bounty is implicit in a donative trust. ('Settlement' and related terms are differently defined outside the settlements legislation. Contrast the trust-based different definitions in ITA UK ss 466, 467 and TCGA ss 68, 68A.)

[84] ITTOIA s 624.

[85] ITTOIA s 629. The child must be unmarried and not in a civil partnership.

[86] ITTOIA ss 624(1), 629(1).

[87] This follows directly where the trust income would otherwise be currently attributed to a beneficiary other than the settlor. A similar effect is achieved by different means where a beneficiary receives 'an annual payment in respect of income' from trustees in the exercise of a discretion and the payment can be identified as having been made out of trust income that is attributed to a settlor and charged to tax under the settlements legislation in the same or a previous year: in that case, the beneficiary receives a quarantined and non-refundable tax credit at the additional rate, which cancels out his or her income tax liability on the corresponding payment (s 685A).

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by whom any income is received' is preserved.[88] This is the same basis of taxation that applies where trustees receive income that is fiscally attributed to a beneficiary. The trustees are taxed in a representative capacity, and the tax they pay is treated as paid on behalf of the grantor.[89] If the grantor must pay additional tax after attribution and credit, he or she may recover a corresponding amount from the trust or a beneficiary who is entitled to the relevant trust income; if the grantor receives a refund, he or she must disgorge it in favour of the trust or beneficiary.[90]

The second rule is also extended to benefaction of a child that would not otherwise be attributed as the child's income to the extent that the trust has sufficient retained or accumulated income to cover the benefaction, regardless of whether that income is or could be so applied as a matter of trust law.[91] If prior-year trust income is relied on, which has already been attributed to a beneficiary or to the trust in the year of its derivation, the rule seems to require a fresh attribution of that income and an adjustment as between the grantor and the taxpayer to whom the income was originally attributed: the original attribution is not negated, but its effect is reversed.

A third rule catches capital payments (principally loans) directly or indirectly from the trust to the grantor, spouse or civil partner.[92] It attributes income to the grantor to the extent that a payment can be matched with trust-level income that is not currently attributed to beneficiaries or otherwise attributed to the grantor in the year of payment or any of the following 10 years. A fourth rule brings payments from a connected body corporate into the ambit of the third rule.[93]

A grantor's third-rule income is treated as arising in the year when matching with trust income occurs. The capital payment is grossed up at the trust rate with credit reflecting tax paid by the trustees on the supporting trust income.[94] The object of attribution appears to be the

[88] ITTOIA s 646(8). Chamberlain and Whitehouse, n 50 §9.29 comment that '[t]he result is extraordinary complexity with unnecessary reclaims'.

[89] TSEM 4512 (at 27 December 2017); ibid, §9.30, §9.31. The tax paid by the trustees is also excluded from the trustees' tax pool in order to prevent double-credit. (The tax pool operates as a special tax imputation system for discretionary distributions of trust income. See ITA UK ss 497, 498; Section 5.3.1.)

[90] ITTOIA s 646. A refund will arise if, for example, the trustees have paid tax at the trust rate (equal to the top personal rate) and the grantor is not in the top tax bracket.

[91] ITTOIA s 631.

[92] ITTOIA s 633 and related provisions.

[93] ITTOIA s 641.

[94] ITTOIA s 640. The credit is capped at the trust rate.

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capital payment plus gross-up, recharacterized as deemed income, rather than the supporting trust income. This distinction may affect the claim to tax if the grantor is or becomes non-resident, the trust entity is or becomes non-resident or the supporting trust income has foreign source.

The United Kingdom no longer has a domestic grantor attribution rule for capital gains.[95] In a domestic context, gains are attributed to the trust entity and taxed at the top capital gains tax rate.

There is no grantor attribution rule for corporation tax.

2.3.3 Australia

The Australian grantor rule applies if the grantor, being the formal settlor of the trust, is living or in existence, and either the grantor has power to acquire a beneficial interest in trust income or income-producing capital or, alternatively, trust income is payable to, accumulated for or applicable for the benefit of an infant child of the grantor. It presents an unusual form of grantor attribution: the grantor is not taxable, but tax is imposed on the grant and its economic produce by reference to the grantor's fiscal residence and tax rate. The characterization of this as a rule of grantor attribution is supported by the use of the grantor's rate, the exclusion of other forms of attribution,[96] and the international aspect of the rule: it ignores the fiscal residence of the beneficiaries and the trust and only results in taxation to the extent that trust income has an Australian source or that the grantor is resident. There is no right of recourse to the grantor; presumably this was thought unnecessary, given that the trust property including the taxed income is available for payment of tax.[97]

[95] A domestic grantor taxation regime applied for capital gains tax until 2008 (TCGA s 77, repealed by FA 2008 Sch 2 cl 5). Having settled on a single 18% rate of capital gains tax for individuals and trustees, Parliament repealed the general grantor attribution rules on the basis that they no longer served a useful purpose (Explanatory Notes, Finance Bill 2008 (UK), notes to cl 6 Sch 2 para 5). The single rate was replaced by the present two-rate structure in 2010 (FA (No 2) 2010 s 2, Sch 1), but the reintroduction of domestic grantor attribution was evidently thought unnecessary because trustees were to be taxed on trust gains at the higher rate. See Loutzenhiser, n 53, §32.7 for a brief history of capital gains tax policy and rate changes.

[96] ITAA 1936 s 102(3), precluding assessment of a beneficiary or of a trustee 'otherwise than under this section'.

[97] See ITAA 1936 s 254.

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In practice, the real grantor is never the formal settlor of an inter vivos trust. Such grantors commonly exercise plenary dominion over their trusts by various permutations of reserved powers, rights of veto and the appointment of a grantor-controlled corporate trustee. This has come to be accepted as normal, and the use of trusts to minimize tax by income splitting is tolerated.[98]

Other technical ambiguities[99] are unlikely to be resolved while the narrow grantor concept remains.

The logic of the Australian rule has much in common with the New Zealand settlor regime enacted 50 years later, considered in the context of outbound grantor taxation in Section 2.5.3 and trust residence in Section 4.2.4. Both choose the trust (trustees) as the legal taxpayer to which income is attributed. Both apply an international taxing claim by reference to the residence of the grantor. Both contemplate that tax will be paid from trust property. They differ in their relationship with beneficiary attribution (the Australian rule displaces it; the New Zealand rule does not), the rate of tax (Australia uses the grantor's rate; New Zealand uses the trust rate, which is presently equal to the top personal rate), applicability where the grantor is non-resident (the Australian rule can apply where the grantor is non-resident in respect of Australian income; the New Zealand rule requires grantor residence) and personal liability of the grantor (the grantor is not liable in Australia; the grantor

[98] See, e.g., Treasurer Australia, *Tax Reform: Not a New Tax, A New Tax System – The Howard Government's Plan for a New Tax System* (AGPS, 1998) pp 105, 113, 115, referring to income splitting through trusts as something that should be preserved. The diversion of income through an inter vivos trust to infant children is no longer fiscally effective because they are generally taxed on such income at the top personal rate, but income splitting among related adult beneficiaries and 'bucket' companies (closely held corporate beneficiaries – the Australian corporate tax rate is significantly lower than the top personal rate) is commonplace. It is also common for beneficiaries' entitlements to remain in the hands of the trust as unpaid present entitlements, save to the extent that funds must be outlaid to pay the beneficiaries' tax. This is an important source of working capital for many closely held trusts.

[99] It is unclear whether the rule applies automatically or only at the discretion of the Commissioner of Taxation. See the words 'the Commissioner may assess' in ITAA 1936 s 102 and the enigmatic reference to s 102 in s 128B(3)(e). It is also unclear how the rule interacts with the streaming rules for capital gains and 'franked distributions' (dividends with imputation credits attached). The streaming rules (ITAA 1936 Part III Div 6E, ITAA 1997 Sub-divs 115-C, 207-B) date from 2011. ITAA 1936 s 102UX in Div 6E displaces taxation under other operative provisions of the general trust rules in Div 6 but does not mention s 102.

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may incur liability in New Zealand as deemed agent, with right of indemnity from the trust).

2.4 Inbound Settings

Assuming a residence/source basis of international taxation, grantor-attributed income is only taxable if the grantor is resident or the income has a local source. Foreign-sourced trust income attributed to a currently non-resident grantor does not attract taxation; if grantor attribution holds in respect of that income and excludes attribution to others, its appointment or distribution to a resident beneficiary is tax free. If the income would have been attributed to a resident trust or beneficiary but for grantor attribution, the situation is effectively treated as a conduit one. Similarly, if locally sourced income is attributed to a non-resident grantor, it may be taxed on a specifically inbound basis, which may differ from the basis of taxation if the income were attributed to a resident beneficiary or trust. These results follow if a general grantor attribution rule is internationally unqualified.

The general US grantor rules were originally unqualified in that sense and enabled a grantor trust with a non-US grantor[100] whom those rules would treat as its owner for tax purposes – a foreign grantor trust, as it was termed – to distribute income to US beneficiaries free of US income tax. If (as was often the case) the income had been generated in a tax haven and had not attracted tax in the grantor's country, it could reach a US beneficiary practically free of income tax. This was regarded as abusive, and Congress responded by enacting a general rule that turns the grantor rules off if they would result in attribution to a non-US person.[101] The general rule turns grantor attribution off in conduit and inbound situations. But the general rule is not universal, and the exceptions to it are exploitable as tax planning opportunities. A simple revocable trust with a non-US grantor still qualifies as a grantor trust.[102]

[100] A 'United States person' or US person is taxable on worldwide income. The concept includes a citizen, a resident individual, a domestic corporation and a domestic trust (IRC s 7701(a)(30)). References in this book to a US grantor or beneficiary should be understood in a corresponding sense.

[101] IRC s 672(f), as amended by the *Small Business Job Protection Act of 1996,* Pub L 104–188, 110 Stat 1909 s 1904.

[102] The general rule does not apply if the grantor retains power to re-vest title to the relevant trust property or if the only distributions permitted during the grantor's life are to the

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The United Kingdom takes a slightly different approach. It turns its grantor rules off where, broadly speaking, they would result in attribution of foreign income to a non-resident.[103] Grantor attribution remains if the income has a UK source. Grantor attribution is turned off in conduit but not inbound situations.

In Australia, it appears that grantor attribution only applies to the extent that it results in Australian tax;[104] if so, foreign-sourced trust income is not attributed to a non-resident grantor. Conduit grantor attribution is thus prevented; inbound grantor attribution is not prevented, but a related provision dictates net-basis assessment taxation of DIR income that would ordinarily be taxed gross or untaxed to a non-resident.[105]

A country's decision to turn a general grantor attribution rule off in relation to a non-resident grantor and foreign-sourced income does not imply that the principle of the general rule is regarded as unsound or lacking in general validity. It is better explained as a response to the risk of international arbitrage, which arises if the grantor's country does not have or successfully enforce a grantor attribution rule that is similar to that of the first country. The essence of the problem is a conflict of attribution, with the country of the trust and/or the beneficiary

grantor or grantor's spouse (IRC s 672(f)(2)(A)). The rationale is that 'the ownership arrangement is such that it is the economic equivalent of the grantor owning the assets of the trust and making a gift directly to the recipient' (Bruce, n 25, 121). These exceptions – particularly the first – are important in international tax practice. They are strictly but clearly drawn. It is well recognized that a foreign grantor can secure the benefits of US grantor attribution by sound lawyering of the trust settlement so that it comes within one or other of the exceptions (Bruce, 117–128; cf 26 CFR ss 1.672(f)-1 and 1.672(f)-3).

[103] ITTOIA s 648(2); cf s 577(2). For consideration of the difficult interaction between s 648 and the rules relating to 'disregarded income' arising to a non-resident, on which the claim to tax is limited to tax deducted at source (ITA UK s 811 etc), see Chamberlain and Whitehouse, n 50, §9.21. The question is whether attribution to a non-resident grantor of UK income that would otherwise be attributed to a resident beneficiary, but that would qualify as disregarded for a non-resident, attracts disregarded income treatment (see Section A.3.3). If so, the tax burden will usually be lower than if that income were simply attributed to the resident beneficiary.

[104] ITAA 1936 s 102(3) says that, where s 102 'is applied to the assessment' of trust income, other forms of taxation are excluded in respect of income 'to which this section has been so applied'. The domestic grantor rule only overrides ordinary taxation of the beneficiary or the trust entity where it results in tax liability. There is a separate argument from the wording of s 102 that the section only applies at the Commissioner's discretion.

[105] ITAA 1936 s 128B(3)(e) precludes the ordinary inbound DIR tax settings from applying to grantor-attributed income under s 102.

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attributing income to a non-resident grantor and the grantor's country attributing the same income to a non-resident trust or beneficiary, resulting in an absence of residence taxation. If the source country does not tax – perhaps because it is a tax haven, perhaps because the particular income attracts a concessional rule – the income escapes tax altogether, notwithstanding that it flows to a beneficiary or trust that is otherwise within the first country's taxing jurisdiction.

Where a taxing country turns inbound grantor attribution off in order to prevent arbitrage due to non-taxation or low taxation of the grantor abroad, that rationale provides support for the view that that country should recognize actual foreign taxation of the grantor in the same way as taxation of the trust or beneficiary to whom trust income is attributed instead – this is relevant to the double tax relief entitlements of a resident trust or beneficiary.[106] Where source taxation is involved, foreign taxation of the grantor may also be relevant to treaty benefits under a tax treaty with the grantor's country of residence, which may or may not also be the residence country of the taxpayer (trust or beneficiary) to whom the source country attributes the subject income in lieu of grantor attribution. The recognition of foreign grantor taxation for treaty purposes is considered further in Chapter 8.

2.5 Outbound Settings

Outbound grantor attribution primarily connotes the attribution of trust income to a grantor who is taxable without territorial limitation (one who is fiscally resident) where the trust income has a foreign source. An outbound grantor attribution rule may also be expected to apply in what is effectively a round-trip fashion, where trust income is locally sourced but the trust or beneficiaries to whom it would otherwise be attributed are only taxable on a source basis. In either case, it is factually likely that the trust will be fiscally non-resident; this may also be a condition of the rule, bearing in mind that trust-attributed income of a resident trust is ordinarily fully taxable on a worldwide basis.

A general grantor attribution rule such as those discussed earlier gives rise to grantor attribution if the grantor is resident, one of the other connections is foreign, and the conditions for general grantor attribution

[106] See Sections 3.3.3 (beneficiary) and 4.4 (trust), and Table 6.1 in Section 6.1.3.

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are satisfied. From the viewpoint of the grantor's country, the inappropriate attribution of foreign income to a non-resident trust or beneficiary and consequent non-taxation is avoided by grantor attribution. But a grantor's country may not be content with this and may want greater protection for its national tax base.

Unless a general grantor rule is so drawn that grantor attribution applies unless and until the capital and income of the trust are fully subject to objectively ascertainable beneficial ownership such that its current income may be effectively attributed among the beneficiaries – which is not the case in any of the surveyed countries – it remains possible for foreign-sourced trust income to escape current taxation under that rule in the grantor's country. If foreign income is accumulated in a non-resident trust that does not satisfy the criteria for general grantor attribution and thus escapes current grantor taxation, it will still at some time be distributed or applied for the benefit of one or more beneficiaries. This gives rise to a number of potential policy concerns for the grantor's country:

- Attribution of trust income away from the grantor results in local non-taxation, not just rate arbitrage.
- The trust still serves the grantor's purposes and does not yet fully belong to its beneficiaries. The grantor's country may consider that it is justified in attributing trust income to the grantor (Section 1.3.1), even though it does not do so in its domestic grantor rule.
- The management of the trust concerning the beneficial destination of trust assets may in fact reflect the grantor's wishes or retained influence, although those things fall short of the country's requirements for general grantor attribution. The practical reality of such a situation may differ little from one that falls within the country's general grantor attribution rule. This creates an incentive to avoidance which, depending on the country's other tax rules, may be lawful and effective.
- The information available to revenue authorities about control and benefaction of a trust outside their jurisdiction may be inadequate, unreliable or difficult to verify. This implies a risk of evasion or non-detection of taxable income.
- Economic benefit referable to income that has escaped current taxation by the grantor's country may ultimately flow back to the grantor or a resident beneficiary or associate in a changed, disguised or undisclosed form that is ostensibly or legally non-taxable. Such benefits are difficult for revenue authorities to identify and to trace. This is largely a risk of

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evasion and non-disclosure, although in some permutations (where the ultimate benefit is legally non-taxable) it may be characterized as avoidance.
- If such benefit does flow back to a resident taxpayer in a disclosed and taxable form at the time of distribution, taxation by the grantor's country is deferred.

These concerns, or some combination of them, may lead a country to impose special outbound rules of grantor attribution and taxation.

2.5.1 United States and Australia

The United States and Australia enacted special outbound rules in 1970[107] and 1990,[108] respectively. They have much in common by way of policy, design and international operation; there are also significant differences. The Australian rule was largely modelled on the US rule, but the domestic treatment of grantors in the two countries was different. The Australian rule reflected a degree of conceptual integration with contemporaneously enacted CFC rules, and, at other points, the Australian drafters simply made different policy choices from their US counterparts. A summary of some of the main points follows:

- Both rules apply only to a grantor who is fiscally resident in the current year.[109] Both use a wide and economically based concept of grant or transfer of value.[110]

[107] IRC s 679, enacted by the *Tax Reform Act of 1976*, Pub L 94–455, 90 Stat 1614 s 1013.

[108] ITAA 1936 Part III Div 6AAA Sub-div D (ss 102AAS–102AAZG) and related definitions in Sub-div A, colloquially referred to as Div 6AAA or the transferor trust rules, enacted by the *Taxation Laws Amendment (Foreign Income) Act 1990* (Cth) s 18. The operative provision is ITAA 1936 s 102AAZD.

[109] *Australia*: ITAA 1936 s 102AAZD. *United States*: The requirement that the grantor be a US person in the current year in order to engage specifically outbound attribution under IRC s 679 results from s 672(f) (see John L Peschel and Edward D Spurgeon, *Federal Taxation of Trusts, Grantors & Beneficiaries* (Thomson/Westlaw, electronic looseleaf) (at 27 December 2017) §16.03). If a grantor has emigrated and jettisoned US person status after the grant, the analysis flips from outbound to inbound. Unless the trust is simply revocable or otherwise within s 672(f)(2) (in which case grantor attribution applies regardless of s 679), s 672(f) turns any grantor rule off because it would result in attribution to a non-US person.

[110] The grantor concept in the Australian rule corresponds to an 'attributable taxpayer' as defined in ITAA 1936 s 102AAT. The Australian rule is complicated by the inclusion of provisions that define an attributable taxpayer by reference to transactions with a

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- Neither rule depends on retained control or interest, unlike the corresponding domestic rules.
- Both rules only address income of a trust that is fiscally non-resident in the current year.
- The US rule is limited to trust income referable to the relevant grant. The Australian rule achieves a similar result by an administrative discretion to exclude trust income that is shown not to be referable to the grant.[111]
- As a matter of policy, both rules respond primarily to the same risk: deferral/avoidance of tax on trust income accumulated abroad and ultimately destined (albeit not predestined) for the benefit of residents.[112] In effect, both countries tax the grantor as **proxy**[113] for unascertained future beneficiaries, presumptively resident, to whom the economic

non-discretionary trust. As the main practical and policy focus of the rule is on discretionary trusts, its description in this book is generally confined to that context.

[111] ITAA 1936 s 102AAZD(7).

[112] *United States*: See Bruce, n 25, ch 10; Charles M Bruce and S Gray, 'US Taxation of Foreign Trusts: Post-1976 Act Changes and Continued Uses' (1988) 17 *Tax Management International Journal* 192; New York State Bar Association, 'Report on Foreign Trusts' (1976) 31 *Tax Law Review* 265; Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976* (HR 10612, 94th Congress, Public law 94-455) (1976) 219–220 'Reasons for Change'. Bruce comments at 162–163: 'Congress wanted to eliminate some of the anomalies in this area of the law and in the use of foreign trusts as a means of achieving tax deferral. In order to achieve this end, it decided to drop a large bomb (in the form of section 679) on the area.' *Australia*: See Treasurer, *Taxation of Foreign Source Income: A Consultative Document* (AGPS, 1988) 39: 'In the case of a non-resident trust, the probability of residents benefiting from the advantage of deferral is most likely to be determined by reference to the residence of the 'transferor' (the person who transfers property to a non-resident trust). Where a resident taxpayer directly or indirectly transfers property into a non-resident trust located in a low-tax jurisdiction and it is not possible to determine the beneficiaries who are to be indefeasibly entitled to the income of the trust, it can be presumed that the advantages of deferral constitute one of the principal motivations for the transfer. In these circumstances, and in the absence of a resident trustee, until such time as resident or non-resident beneficiaries become presently entitled to the income of the trust, the most appropriate person to be assessed on accumulating trust income is the resident transferor. Accordingly, the accruals rules applicable to non-resident trusts will assess such income to the transferors of such trusts.' See also Lee Burns and Richard Krever, *Interests in Non-Resident Trusts: A Review of the Conflicting Income Tax Regimes* (Australian Tax Research Foundation, 1997) 38–39.

[113] The concept of proxy taxation as used in this book refers to taxation of one subject on a final basis without reference to the characteristics of others, who may be unidentified or unidentifiable but who are in a policy sense the presumptive owners of the relevant income that is the object of taxation. Proxy taxation is inherently a rough-and-ready strategy.

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benefit of trust income will ultimately flow. The US rule requires at least the legal possibility that trust capital or current income may flow to a beneficiary who, in the current year, is a US person. Australia has no equivalent requirement; the grantor's fiscal residence is sufficient. The grantor's residence may be seen as an indicator of the presumptive residence of ultimate beneficiaries, as well as providing a formal and practicable basis for the assertion of taxing jurisdiction.

- The US rule supplements and is integrated with the corresponding domestic grantor rule. Like the domestic rule, it frankly attributes current trust income directly to the grantor and away from other potential taxpayers. The Australian rule is separate and structurally different from its domestic counterpart, which it displaces in the event of an overlap.[114] Its intent is to attribute current trust income, but this is done by prescribing a complex calculation of deemed income, the starting point of which is trust income; double taxation is relieved by targeted rules that apply if and when previously attributed trust income is economically delivered to the grantor or a resident beneficiary.[115]
- While both rules require the resident grantor to pay tax on current trust income, neither prescribes a statutory right of indemnity from the trust. This probably does not reflect a conscious policy choice in either country and can produce anomalous results.[116] The premise of grantor taxation, whether domestic or outbound, implies that the grantor should have such a right.
- Both countries exclude some foreign trusts that are perceived as presenting a low risk of deliberate avoidance. Each applies its own exclusion criteria. The US rule does not catch pre-immigration trusts, provided that a sufficient time (five years) has elapsed between the grant and the grantor's fiscal immigration. The Australian exemptions

[114] ITAA 1936 s 102(2B)(b). Burns and Krever, n 112, 65, attribute this to the practical difficulty of applying the mechanism of s 102 (taxing the trust as proxy for the grantor) to a non-resident trust with foreign income. There was evidently no appetite to strengthen, reform or repeal the ineffective domestic rule.

[115] Most of the calculation is achieved through ITAA 1936 s 102AAU, 'attributable income of a trust estate'. For detailed consideration, see ibid, 45–48.

[116] The basic anomaly is that the burden of tax does not diminish the pool of wealth to which the taxed income is added. In the United States, the absence of indemnity is the fulcrum of complicated transfer tax avoidance strategies. Tax paid by the grantor is not recognized as a taxable transfer, but diminishes the grantor's taxable estate and allows the trust to grow tax-free. See Ascher, n 81, 903–907; Soled, n 58, 398–403; Danforth, n 81, 573–600; Cunningham and Cunningham, n 81.

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are narrow and complicated, and require (among other things) an absence of grantor control.[117]

- A major point of difference concerns the priority and relationship between outbound grantor attribution and foreign beneficiary taxation of the trust or its beneficiaries.
  - The US rule permits access to foreign tax credit for foreign taxation of the grantor or the trust on attributed trust income.[118] If a foreign country attributes and taxes trust income to its resident beneficiary, however, outbound grantor attribution and taxation still apply, and the grantor receives no relief for foreign taxation of the beneficiary.[119] This is so even if US tax principles, applied from the perspective of the beneficiary's country, would also attribute the income to the beneficiary and notwithstanding that the beneficiary's entitlement or distribution on which foreign taxation is based may falsify the presumptive basis of the US rule.
  - The Australian rule does not engage the foreign tax credit, but provides its own complex system of exclusions and deductions.[120] Broadly speaking and with some simplification, there are two tiers. At the first tier, trust income is excluded from grantor attribution if it is subject to tax other than by final withholding or on a designated concessional basis in any of seven 'listed countries' (Canada, France, Germany, Japan, New Zealand, the United Kingdom and the United States)[121] or if it is recognized as representing a current distribution that is subject to residence taxation in a listed country.[122] The attribution

[117] See Burns and Krever, n 112, 49–64. The exemptions are embedded in the concept of an 'attributable taxpayer' in ITAA 1936 s 102AAT.

[118] This follows from the simple device of deeming the grantor to be the owner of the trust to the extent that it reflects the grant. If the trust is taxed, the grantor is taken to be taxed. This supplies the nexus required by IRC s 901(b)(1)–(4).

[119] See n 295; IRS, Technical Advice Memorandum 9413005 (1994). A case might perhaps be made for saying that foreign tax is paid by the trust, and thus by the grantor as deemed owner, if tax is collected from the trust by final or non-final withholding, notwithstanding that the personal subject of taxation as perceived by the foreign country is the beneficiary.

[120] ITAA 1936 s 102AAU. As Burns and Krever, n 112, 49, observe: 'An examination of the exemptions in Division 6AAA vividly reveals the complex and convoluted manner in which the Division has been drafted.'

[121] ITR 1936 reg 152C, Sch 10, via ITAA 1936 ss 102AAB and 320. These countries are recognized as imposing tax on a comparable basis to Australia (ibid, 45). The listed country concept is borrowed from the CFC rules.

[122] ITAA 1936 s 102AAU(1)(b), (c)(viii); cf the definition of 'listed country trust estate' in s 102AAE and 'subject to tax' in s 324, adopted via s 102AAB. The subject to tax test is agnostic about the identity of the taxpayer: it focuses on the economic object of taxation and fact of non-withholding taxation.

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rule turns itself off and yields taxing priority to the foreign country in respect of income subject to first-tier foreign taxation. This reflects the avowed policy basis of the rule more closely than the corresponding US treatment of foreign taxation.

At the second tier, deductions are allowed for other listed or non-listed country taxation of the attributed income.[123] That this ultimate relief is only granted by deduction, not credit, reflects the anti-avoidance purpose of the transferor trust rules;[124] assuming that the foreign tax is borne by the trust entity, it is less generous than the corresponding US treatment. The notion that the conjunction of an Australian grantor with foreign beneficiary residence, trust residence or trust investment in any country other than the seven listed 'good' ones should be equated with tax avoidance may surprise some of those countries, and it indicates how seriously Australia regarded the issue of trust-based tax deferral and avoidance when the rule was designed.

- Another major point of difference concerns the priority and relationship between outbound grantor attribution and general attribution to a trust or beneficiary if, without the special outbound grantor rule, that attribution would result in local taxation.
  - The US rule, like its domestic counterpart, displaces attribution to and taxation of a US beneficiary, even if the beneficiary receives current trust income. The outbound grantor rule displaces other US attribution and taxation, including withholding (subject to information and disclosure requirements).
  - The Australian rule, unlike its domestic counterpart, is displaced by beneficiary and trust attribution rules if they lead to Australian net-basis taxation of particular trust income. Affected income is excluded,[125] as also are Australian franked dividends,[126] the payment of which to a

[123] ITAA 1936 s 102AAU(1)(d).

[124] Burns and Krever, n 112, 48–49, citing the *Information Paper*, Treasurer, *Taxation of Foreign Source Income: An Information Paper* (AGPS, 1989) 128.

[125] ITAA 1936 ss 102AAU(1)(b), 102AAE(2) (if the trust is a listed country trust estate); s 102AAU(1)(c)(i) (otherwise). Australian withholding tax on dividend, interest or royalty income does not qualify because it is not imposed under the provisions mentioned in s 102AAE(2) or s 102AAU(1)(c)(i). See ss 128B, 128D.

[126] ITAA 1936 s 102AAU(1)(c)(iii). A dividend is franked by the attachment of imputation credits representing prior Australian corporate taxation.

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non-resident attracts no further taxation.[127] In these cases, as with first tier exclusions referable to foreign taxation, the outbound grantor rule turns itself off and defers to otherwise applicable taxing rules. Australian final withholding tax is recognized in the same way as similar foreign tax: only by deduction.[128]

2.5.2 United Kingdom

2.5.2.1 Income Tax

The UK settlements legislation is supplemented in outbound situations by the transfer of assets abroad rules.[129] These are a separate set of anti-avoidance measures, the original version of which was enacted in 1936.[130] They are part of the income tax and only affect UK resident individuals,[131] their spouses and civil partners.[132] The rules are not limited to trusts or to any particular form of arrangement. The primary condition for their application is that income becomes payable to a

[127] ITAA 1936 ss 128B(3)(ga), 128D.

[128] ITAA 1936 s 102AAU(1)(d). Final withholding tax on unfranked dividends, interest or royalties may be imposed where the item in question is attributed to a non-resident beneficiary on the basis of present entitlement (s 128A(3) with relevant charging rules in s 128B), but not where the item is attributed to the trust itself (s 128B(3)(d)) – this preserves net-basis taxation of non-resident trusts under s 99 or s 99A on items that are not currently earmarked for or attributed to a particular beneficiary and may ultimately benefit one who is resident or non-resident.

[129] ITA UK Part 13 ch 2 (ss 714–751).

The amendments to the settlements legislation and the transfer of assets abroad rules made by FA 2018 s 35, Sch 10 are mainly focused on complex situations involving non-domiciled or deemed domiciled settlors, which are not considered in this book. For further consideration, see Vos, n 50. The main new provisions are ITTOIA ss 643A–643N and ITA UK ss 733B–733E, 734A and 735C.

[130] FA 1936 s 18, Sch 2. The original idea was summed up by the Chancellor of the Exchequer, Mr Chamberlain, in terms which are still helpful for an understanding of the rules:

> The first proposal concerns the avoidance of tax by an individual living in this country who transfers his property to persons abroad in such a way that, while he himself retains control over the property and himself enjoys the income from it, in the light of the Income Tax law as it stands at present he does not appear to be in receipt of the income. I am going to deal with that by providing that the income arising from property of this kind shall be taken as the measure of tax liability. (United Kingdom, *Parliamentary Debates*, House of Commons 21 April 1936 vol 311 cc45-8)

[131] ITA UK ss 721(1), 728(1), 732(1). The rules do not attribute income to entities, even those which are subject to income tax.

[132] ITA UK s 714(4).

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person abroad as a result of a transfer of assets and/or one or more associated operations.[133] In essence, the person who makes the transfer is equivalent in a trust context to a grantor. A resident grantor who suffers attribution under these rules will usually also satisfy the criteria for grantor taxation under the settlements legislation, although the criteria and rule structures are different.[134] If both regimes apply, the settlements legislation takes precedence.[135] The transfer of assets abroad rules will not be examined further in the present work.[136]

2.5.2.2 Capital Gains Tax

The United Kingdom also has an outbound regime of grantor capital gains taxation. As has been mentioned, there is no general or domestic grantor capital gains rule. In broad terms, a UK resident and domiciled grantor of a non-resident trust in which he or she is deemed to have an interest is treated as having a capital gain equal to the net current-year gains of the trust, disregarding 'NRCGT' gains and losses referable to UK residential land on which the trust is taxable.[137] (Surprisingly, there is no mention of capital gains referable to a UK branch or agency, which are

[133] ITA UK ss 716 (definition of 'relevant transfer'), 721(1), 728(1), 732(1). A transfer is a 'relevant transfer' if it is a transfer of assets and income becomes payable to a person abroad as a result of the transfer and/or one or more associated operations.

[134] The most significant trust-related area where the transfer of assets abroad rules attribute foreign income that would not be caught by the settlements legislation relates to the current income of lower tier entities. An important function of the transfer of assets abroad rules is to reach income of lower tier entities. In this respect, they resemble a CFC regime for resident individuals – a function not performed by the UK CFC rules, which are part of the corporation tax. This may be illustrated by *IRC* v *Botnar* [1999] STC 711; (1999) 72 TC 205, a complicated case in which the ultimate grantor of a Liechtenstein settlement and his wife were excluded from being beneficiaries under that settlement but the trustees had a wide power to transfer trust property to other settlements, notwithstanding that an excluded person might benefit under the latter. Income of companies owned directly and indirectly by the trustees of the first settlement was held assessable to the taxpayer under the transfer of assets abroad rules.

[135] See ITA UK ss 721(3C), 728(2A).

[136] The decision to exclude those rules reflects their broader focus and limited practical relevance to trusts, the priority rule mentioned earlier and the general exclusion of CFC rules (cf n 134). For consideration of the transfer of assets abroad rules and their application in a trust context, see Chamberlain and Whitehouse, n 50. For the impact of amendments by FA (No 2) 2017 relating to non-domiciliary and deemed domiciled settlors and the relationship between the transfer of assets abroad rules and the settlements legislation, see Vos, n 50. That relationship is further affected by amendments in FA 2018 s 35, Sch 10.

[137] TCGA s 86.

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also taxable to non-residents.) The interest test is satisfied if a prescribed nexus by way of actual or potential beneficial application exists between trust property or income originating from the settlor and a related 'relevant person'.[138] There is an obvious similarity to the concept of a retained interest under the settlements legislation,[139] although the class of potentially benefited persons is wider. The form of words used for attribution refers to 'an amount equal' to the net trust-level gain referred to earlier.[140] The HMRC view is that the trust-level gains themselves are not attributed, but a notional amount calculated by reference to them.[141]

The grantor has a statutory right to recover the amount of a resulting UK tax liability from the trustees.[142] The efficacy of the statutory indemnity, like its income tax counterpart under the settlements legislation, depends on a number of factors including what assets the trust has in the United Kingdom, the terms of the trust, the proper law of the trust and the terms of any arrangement between the grantor and the trustees pertaining to the original grant. Caveat grantor.

In some circumstances involving a capital distribution from a non-resident trust to a close family member of the settlor or an onward payment by an original beneficiary to such a person, a resident grantor may attract outbound taxation as if he or she were a beneficiary in receipt of a capital distribution.[143] This involves an extension of rules which are primarily targeted at resident beneficiaries.[144] The point of targeting the grantor in this way is that the distribution may be pregnant with trust-level capital gains which would otherwise escape UK taxation if the close family member or original beneficiary is non-resident or otherwise escapes UK residence taxation.

2.5.2.3 Foreign Tax Credit

The UK foreign tax credit rules are engaged and deliver unilateral double tax relief to a resident grantor to whom an amount calculated by

[138] TCGA Sch 5 cl 2. The class of relevant persons includes the grantor (settlor), his or her children and grandchildren, the spouses and civil partners of any of these, companies they control, and companies associated with such companies.
[139] See ITTOIA ss 624, 625 (n 84).
[140] TCGA s 86(4)(a).
[141] CG 38345 (at 27 December 2017) – but see n 146.
[142] TCGA Sch 5 cl 6.
[143] TCGA ss 87G, 87L, added as part of a suite of anti-avoidance measures by FA 2018 s 35, Sch 10.
[144] TCGA s 87 and related provisions (see Section 3.3.2).

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reference to trust income or gains is attributed, subject to the usual requirements of those rules. The trust-level attributed or notionally attributed income or gains must respectively arise or accrue in the territory of the foreign taxing country, the foreign tax must be calculated by reference to it, that tax must have the requisite correspondence with UK income or capital gains tax and so on,[145] but the rules do not require identity between the UK and foreign taxpayers. The better view appears to be that the unilateral credit applies where foreign tax and UK tax share a common calculation base, whether by direct or indirect attribution, and even if the foreign taxpayer is the trust or a beneficiary. In the case of notionally attributed items, HMRC takes the view that treaty provisions which would have the effect of allocating exclusive taxing rights to the other country based on attribution to a different taxpayer are not engaged; this view would preclude treaty benefits of that kind for grantors under the transfer of assets abroad rules and the capital gains tax rule, but not under the main provisions of the settlements legislation.[146] Where treaty provisions allow credit relief, unilateral relief is displaced, even if the latter would be more generous,[147] but that generally should not prove an impediment: first, a simple non-qualification for treaty relief should not displace unilateral relief; secondly and perhaps more significantly, the double tax relief articles of UK treaties frequently take a non-standard form, referring to income as a common basis of tax calculation rather than as a common object of taxation.[148]

[145] TIOPA s 9.

[146] See CG 38545 (at 27 December 2017), including the following: 'Articles in double taxation agreements which give sole taxing rights to the alienator's country of residence do not apply to the gain chargeable on the settlor under [TCGA s 86]. That is because the person making the disposal is the trustees and not the settlor. Section 86 does not deem the trustees' gain to accrue to the settlor. Instead section 86(4) treats the settlor as accruing a gain equal to the gain that accrues to the trustees.' Cf Baker, *Finance Act Notes*, n 37, 409, referring to similar notional attribution provisions in the transfer of assets abroad rules (ITA UK ss 721(3B), 728(1A)). Most of the provisions of the settlements legislation, however, involve direct attribution.

[147] TIOPA s 11 (see Loutzenhiser, n 53, §74.4.1.1.)

[148] See n 146. CG 38545 (at 27 December 2017) also says, 'Credit relief may be given for any foreign tax paid on the gains. This is because the gain chargeable on the settlor is calculated by reference to the gain that accrues to the trustees. Foreign tax credit is allowed either under the credit Article in a double taxation article by [TIOPA s 18(1)] or unilaterally by [TIOPA s 9(2)].' Unlike OECD Model Art 23, the double tax relief articles of UK treaties may grant relief where UK tax is computed by reference to the same income or gains by reference to which the foreign tax is computed – see, e.g., Australia–UK 2003 Art 22(2)(a); New Zealand–UK 1983 Art 22(1), (2); UK–US 2001 Art 24(4)(a).

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2.5.3 New Zealand

New Zealand has two rules by which a grantor (settlor) may incur payment obligations relating to tax on trust income. The first makes a currently resident grantor liable as a deemed agent for the trustees.[149] The second is purely elective, by which a grantor may irrevocably undertake an obligation to satisfy the actual or notional income tax liability of the trustees.[150] Both regimes are limited to 'trustee income' – trust income that is not currently attributed to a beneficiary.[151] These rules have been considered in greater detail elsewhere.[152]

The agency regime only applies if the trust is without a personally resident trustee at some point in the tax year.[153] In certain circumstances – if the settlor is a natural person whose earliest New Zealand residence[154] postdates the last relevant settlement on the trust – agency liability only arises if the settlor has also opted into the elective liability regime.[155] The grantor's liability does not displace the principal liability of the trustees, although in certain permutations the grantor may be liable as agent notwithstanding that the trustees are not directly liable or assessable.[156] In all such cases, however, the trustees are liable indirectly because the grantor as deemed agent has a statutory right of indemnity.[157]

As a matter of fiscal policy, the grantor's liability is justified by regarding the trust as an emanation of the grantor's will and purpose or as an economic agent of the grantor, regardless of whether that person

[149] ITA NZ s HC 29.

[150] ITA NZ s HC 33. A similar election may also be made by a trustee or beneficiary.

[151] ITA NZ s HC 7. In some circumstances, beneficiary income of a resident minor may be treated as trustee income (see s HC 35), and may contribute to the liability of a grantor. This will be disregarded for the purposes of the present analysis.

[152] M L Brabazon, 'Trust Residence, Grantor Taxation and the Settlor Regime in New Zealand' (2016) 22 *New Zealand Journal of Taxation Law and Policy* 346.

[153] ITA NZ s HC 29(1).

[154] Disregarding any period of residence on or before 17 December 1987.

[155] ITA NZ s HC 29(5). There are also grandfathering provisions for trusts that have not received a settlement since 17 December 1987, the date on which the government published a consultation document foreshadowing new international tax rules. See Brabazon, *Trust Residence*, n 152.

[156] ITA NZ s HC 25(4). The trustees are not directly liable if the trustee income has a foreign source, none of the trustees is resident within the tax year, and no grantor was resident after 17 December 1987 up to and including the date of a relevant grant (settlement). In that situation, a grantor is liable if he or she has made the requisite election.

[157] ITA NZ ss HD 5(2), HD 12(2).

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has retained any level of influence or control,[158] to the extent that trust income is not currently attributed to a beneficiary on the basis (described in the next chapter) of vested entitlement or current distribution. The statute, however, does not attribute trust income to the grantor, does not claim to impose principal tax liability on the grantor, and does not seek to cast the burden of tax ultimately upon the grantor. The better view is that the agency regime does not amount to grantor attribution or grantor taxation in any sense that would be relevant to the adjustment of taxing claims between countries under a tax treaty or to a claim for unilateral or treaty double tax relief.[159] It will be shown in Section 4.2.4 that, in respect of accumulated trust income, New Zealand uses trust attribution and fiscal residence to pursue policy goals that other countries seek to achieve by outbound grantor attribution.

The same conclusion applies to the obligations of a grantor as elector under the elective regime. That regime makes the elector liable to 'satisfy the income tax liability that the trustee' – the relevant trust entity – 'would have' if the trust had a currently resident grantor and trustees,[160] i.e., trust-rate taxation of worldwide trustee income subject to any double tax relief that would be available to the trust on the same notional basis. The election once made is irrevocable. Except in the case of a resident grantor who attracts the agency regime, an elector has no statutory right of indemnity from the trustees. The elector's obligation is to satisfy a notional liability (which may also be an actual liability) of a person other than the grantor – i.e., the trust entity – with respect to income attributed to the trust and taxed on an assumption of fiscal residence. The elector's fiscal residence, personal tax affairs, deductions and allowances are all immaterial.

A non-elective obligation of a grantor under the agency regime depends on and is secondary to an actual tax liability of the trust entity. An elective obligation of a grantor, whether or not it attracts the agency regime, may exist with or without an actual tax liability of the trust. If the agency regime applies, the grantor has a statutory right of indemnity. If not, tax law does not address the question of indemnity. Whether such a

[158] See John Prebble, 'New Zealand's 1988 International Tax Regime for Trusts' (1989) 6 *Australian Tax Forum* 65, 86–87 and John Prebble, 'New Zealand Trust Taxation: The International Dimension' (1999) 53 *Bulletin for International Fiscal Documentation* 398, 399.

[159] Brabazon, *Trust Residence*, n 152.

[160] ITA NZ s HC 33(2).

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right exists in a particular case depends on the application of trust law to its facts and circumstances.

2.6 Summary

The grantor rules of the surveyed countries present a challenging diversity of international and domestic settings and approaches to taxation. Table 2.1 gives a shorthand comparative summary of the Australian, US and UK settings described earlier in this chapter. The New Zealand settings do not lend themselves to analysis as a system of grantor attribution or grantor taxation, despite an underlying fiscal policy that recognizes the trust (to the extent that it accumulates income) as an economic agent of the grantor.

The last row of the table is labelled 'International priority/DTR'. Where the foreign country taxes the same income, whether by attribution to the grantor, the trust or a beneficiary, and whether on a source or residence basis, the grantor's residence country needs to decide how to regard that taxation. It may exclude the income from grantor attribution (as Australia does in some situations), it may grant double tax relief by credit, or by deduction, or it may grant no relief at all. The particular settings imply a view, taken by the grantor's country, about the normative strength of its international claim to tax relative to that of the other country in the various situations to which they apply. The exclusion setting may imply that its own claim to tax is principally intended to prevent arbitrage by ensuring that tax is imposed by one country or the other.[161] This accords the lowest level of priority to the tax claim of the grantor's country. To allow foreign tax credit implies a recognition that the other country has a superior claim, but also that the grantor's country has a proper claim of its own. The policy implications of such a setting are of particular interest if the other country is taxing purely on a residence basis.

Where a grantor is resident in one country and other aspects – perhaps the trust, or its beneficiaries or investments – are resident or situated in another, the first country will view the grantor through the prism of its general and outbound grantor rules, while the second consults its general and inbound rules. If both agree that particular trust income is attributable

[161] There may be slightly different explanations. In the context of anti-avoidance, if the grantor's country is concerned with its taxpayers' motivations, and if particular foreign tax is likely to be substantial, a judgment may be made that an arrangement which attracts that tax is unlikely to be motivated by avoidance.

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Table 2.1 *Summary of Grantor Attribution*

	Australia	United States	United Kingdom
General and Domestic			
Scope	Income tax (incl corporations, capital gains)	Income tax (incl corporations, capital gains)	Income tax (not corporations, capital gains)
Grantor concept	Formal	Wide	Wide
Attribution criterion	Benefit, rudimentary	Benefit or control, wide	Benefit, wide
Rate	Grantor's	Grantor's	Grantor's
Taxpayer	Trust	Grantor	Grantor
Indemnity from trust	N/A	No	Yes
Priority	First	First	First
Inbound/Conduit (non-resident grantor)			
Modification of general rule	Turned off for foreign income	Mixed off/on for non-resident grantor	Turned off for foreign income
Outbound (resident grantor)			
Scope	As above	As above	+ capital gains
Grantor concept	Wide	Wide	Wide
Attribution criterion	–	–	Benefit, wide
Rate	Grantor's	Grantor's	Grantor's
Taxpayer	Grantor	Grantor	Grantor
Indemnity from trust	No	No	Yes
International priority/ DTR	Mixed priority: exclusion/ deduction	FTC for foreign taxation of grantor or trust	FTC for foreign taxation of grantor, trust or beneficiary

to the grantor, and if the second country sees itself as the source country of the income, both will want to tax the grantor, but on different jurisdictional bases. This might happen, for example, with a US grantor and a UK-sourced trust income. The avoidance of double taxation in such a case is straightforward.

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Difficulties arise where the countries disagree about attribution, whether because of a rule negating inbound grantor attribution, because of a difference between the outbound and/or general criteria for grantor attribution or because one country does not have a grantor attribution rule. This can lead to double taxation – most obviously if the grantor's country attributes income to the grantor but does not give double tax relief for tax levied by another country on the trust or the beneficiary, whether on a residence or source basis. It can also lead to non-taxation – where one country recognizes inbound/conduit grantor attribution, as the United States sometimes does, but the grantor's country does not have a grantor attribution rule or that rule is not satisfied. For example, a New Zealand grantor capitalizes a trust on terms that qualify for US foreign grantor attribution; the trust derives income in a tax haven; it currently distributes the income to US-resident beneficiaries. New Zealand attributes the income to the beneficiaries; the United States attributes it to the grantor. Neither claims to tax because it is foreign income attributed to a non-resident. These illustrations are based on the tax laws of countries with sophisticated systems of both tax and trust law, each of which has also given detailed consideration to the tax treatment of grantors. Where those features are not present, the potential for double taxation or non-taxation may be expected to be greater.

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3

The Beneficiary

This chapter considers the current attribution of trust-level income to a beneficiary and the current taxation of such income.

Section 3.1 undertakes a comparative overview of the general beneficiary attribution rules in each of the surveyed countries, leaving aside specific inbound or outbound modifications. Section 3.2 examines the inbound and conduit settings of beneficiary attribution and taxation – where a source country attributes trust income to a non-resident beneficiary – and their potential to generate international non-taxation or double taxation compared with corresponding inbound settings applied to non-residents who invest directly. The topic is subdivided by reference to significant classes of income: foreign, business, property, DIR and capital gains. Of these, the taxation of DIR income is found to be the area of weakest international correlation, greatest inconsistency and greatest potential for fiscal anomaly. Section 3.3 examines the outbound settings of beneficiary attribution and taxation – taxation of current beneficiary-attributed trust-level income of a kind that would, in a non-trust situation, only be taxable to a resident.[162] Conflicts of attribution involving beneficiaries resident in different countries are identified as a potential source of double or non-taxation; conflicts of attribution between the residence country of a beneficiary and that of the trust or its grantor are also identified as potential sources of double or non-taxation. Conclusions focusing on international double and non-taxation are set out separately for inbound and outbound taxation at the end of Sections 3.2 and 3.3. Section 3.4 summarizes the findings of the chapter generally.

[162] The taxation of distributions, including distributions referable to trust-attributed income of the current year, supplements the taxation of beneficiary-attributed trust income in an outbound context and possibly, depending on the taxing country's general attribution settings, in a domestic context. Distribution taxation is considered in Chapter 5.

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The discussion in this chapter assumes that grantor attribution has already been excluded from the viewpoint of the country that applies beneficiary attribution. As was pointed out in the previous chapter, grantor attribution generally takes precedence over attribution to beneficiaries or to the trust itself, leaving aside particular international settings which have their own justifications. Absent grantor attribution, the choice between beneficiary attribution and trust attribution is discrete and exhaustive, and any given item of tax-law trust income is fully allocated among those two possibilities.

In order to present the comparative findings of this chapter in a readable fashion, some of the more detailed technical analysis of national tax systems and settings is located in the appendix. Readers who prefer to pursue individual topics in depth may follow cross-references that link the discussion in this chapter to that text.

3.1 General Beneficiary Attribution

Each of the surveyed countries applies a form of beneficiary attribution to current trust income. This section provides an overview of those settings based on the findings of a more detailed country-by-country analysis in the appendix (Section A.1).

The main settings of beneficiary attribution in a general or domestic context are summarized, country by country, in the list that follows. Each country treats capital gains differently from other income. The first paragraph for each country addresses the treatment of income other than capital gains; the second addresses capital gains.

- ***United Kingdom***: Trust income is attributed to beneficiaries to the extent of their trust-law indefeasibly vested interest in possession in that income as it accrues. Trustees are also taxable on behalf of such beneficiaries, who have credit for trustee taxation. The original trust-level character of attributed income is retained, including source. Tracing of particular trust-level items to particular beneficiaries is done by trust-law principles.
- The capital gains tax is separate from the income tax. The United Kingdom does not attribute trust-level capital gains to a beneficiary in a purely domestic context.
- ***United States***: Trust income is attributed to beneficiaries on the basis of their distribution rights and/or timely distribution or crediting as required or permitted under the terms of the trust. Actual payment is

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not necessary, but entitlements must be irrevocable. Current attribution to beneficiaries is capped at the amount of current tax-law income. The entity-level character of attributed income is retained, including source. Tracing of particular items is generally done by trust-law principles (in the case of non-discretionary entitlements, which are accounted for first) or by a tax-law formula in proportion to value. The process of attribution is organized around a statutory concept of 'distributable net income' (**DNI**), the historical purpose of which was to facilitate beneficiary attribution.

- Capital gains are taxed as income, with the benefit of certain concessions. Trust gains that are allocated to trust-law capital account (corpus) and not currently paid or credited to a beneficiary are generally excluded from beneficiary attribution. Otherwise, trust-level gains are included in DNI accounting and are apportioned among relevant distributions in proportion to value.
- ***Australia***: Tax-law trust income is attributed to beneficiaries in proportion to their discretionary or vested present entitlements to current trust-law income or, in the case of franked dividends, on the basis of discretionary or vested streaming of those dividends. Actual payment is not required. The original trust-level character of attributed income is retained, including source. Tracing of particular income items involves a mixture of trust-law and tax-law rules. Particular trust-level franked dividends are usually traced by trust-law principles under the streaming rules. Other trust income is traced in proportion to aggregated trust-law income entitlements under a general tax-law rule.
- Capital gains are taxed as a special class of income, with the benefit of certain concessions. Trust-level capital gains are attributed to beneficiaries by streaming to the extent that they are specifically entitled to those particular gains. Broadly speaking, specific entitlement reflects vested or discretionary trust-law allocations. Any remaining gains are attributed in proportion to beneficiaries' allocations of trust-law income unless the trust entity elects to attract fiscal attribution to itself.
- ***New Zealand***: Trust income is usually attributed to beneficiaries on the basis of timely trust-law vesting or payment of that income, including constructive payment. Attribution is modified by tax-law rules in some cases where a trust with a presently or formerly non-resident grantor distributes trust-law capital or income: broadly, the modification can recharacterize a capital distribution as a payment of current trust income. A small number of tax-law income items cannot be attributed to a beneficiary and are per se attributed to the trust.
- New Zealand does not generally tax capital gains.

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Each of the surveyed countries treats trusts as **differentially transparent** for tax purposes. That is to say, use of the trust form, without more, does not determine whether trust income is attributed to a participant in the trust – in this chapter, a beneficiary, or, as considered in Chapter 2, a grantor – or to the trust itself. The attributed income also retains its original character. Leaving aside grantor attribution, whether particular income of a trust is attributed to a beneficiary or to the trust itself depends on characteristics not just of the trust but of the income in question and the interests of particular beneficiaries in that income and/or in trust income more generally. A trust in itself is simultaneously opaque and transparent for tax purposes because it has the inherent potential to behave or be treated in either way. In respect of particular trust income or a particular share of such income, however, it will be one thing or the other. '**Differential transparency**' of an entity as the term is used in this book connotes the capacity for particular income of the entity to be attributed in whole or part to the entity and/or to participants in the entity from the viewpoint of a particular tax system.

A major point of difference among the surveyed countries is whether beneficiary attribution is confined to vested income, reflecting a pre-existing right of the beneficiary to trust-level income, or whether it also extends to appointed income, which flows to the beneficiary by an exercise of discretion.[163] The United Kingdom takes the former, limited approach; Australia, the United States and New Zealand take the latter, inclusive approach. Another area of difference relates to the precise role of trust-law allocation of income in the tax-law attribution process. The countries that take a wide view of beneficiary attribution each, to varying degrees, introduce tax-law formulae to the attribution process.

The related tax structures in a domestic setting also reflect some diversity. In Australia and the United States, domestic taxation of beneficiary-attributed income usually applies only at the level of the beneficiary. In the United Kingdom, the trust is taxed at the basic rate,[164] and the beneficiary is separately taxed with credit. In New Zealand, the

[163] See Avery Jones et al., *Treatment of Trusts I*, n 8, distinguishing between a life interest trust (under which the relevant beneficiary has a vested life interest in trust income), a discretionary trust and an accumulation trust. Reference to types of trust does not imply that the trust itself must be characterized: what matters is the treatment and destination of particular income.

[164] The basic rate will be replaced by a new 'default basic rate' for non-individual persons. See *Finance Act 2016* (UK) s 6, which provides for a set of default basic, upper and additional rates to be added by new ITA UK s 11C, which section is to commence on a

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trust is usually taxed by assessment as deemed agent for the beneficiary, who (as the agency relationship implies) is taxed with credit.

A common feature, which results from the basic logic of beneficiary attribution in each of the surveyed countries, is the capacity for beneficiary attribution to be repeated through a chain comprising multiple layers of trusts.[165] This appears to be more significant in Australia than in the other surveyed countries. Another common feature is the inability of a trust to transmit losses as such to a beneficiary, although losses may usually be set off against current income or carried forward within the trust to be set against future trust income.

3.2 Inbound Beneficiary Taxation

This section examines source taxation of such trust-level income as the taxing country attributes to a non-resident beneficiary. The first topic to be considered is foreign income: income that the country would regard as outside its claim to tax if derived by a non-resident directly. The focus then moves to significant classes of income derived by trusts: business income, immovable property income, DIR income and capital gains. For each of these, the focus is on the difference that a trust structure makes to inbound taxation and on the potential for international double taxation or, more critically, non-taxation. The trust may be locally or foreign based, resident or non-resident; the relevant inbound feature is that a beneficiary to whom income is attributed is non-resident.

Business and DIR income are more complex than the other topics. It will be concluded that the taxation of business income attributed to a non-resident beneficiary generally proceeds in parity with ordinary inbound taxation, although difficulties arise in relation to non-resident foreign tax credits where the trust carries on a business through a taxable presence in the jurisdiction. Inbound taxation of business income frequently requires recognition of a taxable presence of a non-resident taxpayer. **Taxable presence** in this context connotes a presence in the relevant jurisdiction that attracts net-basis taxation, particularly in circumstances where the taxpayer is non-resident and would otherwise escape local taxation or be taxed on a gross basis. It typically requires

date appointed under FA 2017 (UK) s 6(24) or (25). At least initially, it appears that these rates will be the same as their ordinary equivalents (s 3).

[165] That is, where one trust has another trust as its beneficiary. Each such relationship constitutes a link in the chain of trusts.

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the conduct of a business within the jurisdiction as a basic condition, to which a further requirement may or may not be added, such as the presence of a PE, branch or fixed establishment through which the business is conducted and/or a relevant nexus between the income in question and the local business.

The settings in relation to DIR income reveal a different set of problems, relating particularly to the attribution to the beneficiary of a local business or taxable presence at the trust level, which can be relevant to the choice between net-basis and gross-basis taxation and to the potential for final withholding or gross-basis taxation to be applied to what is, in reality, a net amount. These potentially facilitate international non-taxation. An idiosyncratic loophole is also found in Australia's inbound claim to tax beneficiary-attributed capital gains.

3.2.1 Foreign Income

Each of the surveyed countries excludes trust income attributed to a non-resident beneficiary from its claim to tax on the same basis as if the income were derived by the non-resident directly.[166] Where the claim to tax depends on local source, foreign-sourced income is excluded; where it depends on a taxable presence in the jurisdiction, income that lacks the requisite connection with a taxable presence is excluded. The attribution of a trust-level taxable presence (such as a permanent establishment, the conduct of a business or a branch) is considered in the next section (3.2.2). The mechanisms differ, but the principle is the same: interposition even of a resident trust is not seen as a sufficient basis to tax income attributed to a non-resident beneficiary. The arrangement is treated as a conduit situation, not an inbound one. This is consistent with the principle of character retention: the fiscal character of trust-level income, including its source, is preserved on attribution to a beneficiary.

Although these settings are common to the countries surveyed here, they are not inevitable. Canada taxes income of a resident trust that is

[166] *Australia*: Compare ITAA 1936 ss 97(1)(a), 98(2A) (non-resident beneficiaries) with ITAA 1997 ss 6-5(3), 6-10(5) (non-residents generally, but see n 850 for an exception relating to notional tax-law income). *United States*: The limitations inherent in the primary claim to tax non-US persons in IRC ss 871(a), (b), 881 and 882 apply to beneficiaries' income under ss 652, 662. *United Kingdom*: See n 819 and corresponding text. *New Zealand*: ITA NZ s BD 1(4), (5) with ss CV 13(a), HC 17.

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currently attributed to a non-resident beneficiary, regardless of its original source: the beneficiary's interest in the trust is treated as the source of income, and trust residence supplies the jurisdictional taxing nexus.[167]

3.2.2 Business Income

This section presents a summary of the international tax treatment of active business income of a trust that is attributed to a non-resident beneficiary under the general attribution rules of the surveyed countries (Section 3.1). It would be possible to stipulate different attribution rules for such income, but the surveyed countries do not. The summary in this section is based on the findings of a more detailed country-by-country analysis in the appendix (Section A.2). The main subject considered in this section is the claim to tax beneficiary-attributed business income, including the attribution of the business structure and activities of the trust to the beneficiary and the basis of taxation. A secondary subject is the availability of foreign tax credits where there is a local business presence. The findings for each country are compared for consistency and for their capacity to produce international non-taxation or double taxation.

3.2.2.1 Claim to Tax

In each country, there is a strong correlation between the general jurisdictional claim to tax a non-resident who derives active business income directly and the claim to tax a non-resident beneficiary to whom the active business income of a trust is currently attributed. The source principle that applies to a non-resident in direct receipt of business income applies to a non-resident beneficiary in such a way that the relevant activities of the trust have the same fiscal significance as if they were, pro tanto, activities of the beneficiary. There are, of course, differences between the general international claims to tax of the various countries, and those differences are preserved in a trust context in their respective taxing claims on business income attributed to non-resident beneficiaries.

[167] A non-resident is taxed on income 'of or from' a resident trust: *Income Tax Act 1985* (Can) s 212(1)(c), (11). Attributed trust income is recharacterized by s 108(5) as income from property, being the beneficiary's interest in the trust. See Avery Jones et al., *Treatment of Trusts I*, n 8, 52–53.

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In summary:

- Broadly speaking, the United States, the United Kingdom and New Zealand each tax non-residents on the worldwide income of a business conducted within their jurisdiction. That approach applies to trust income attributed to a non-resident beneficiary, regardless of where the trust itself is based, administered or fiscally resident.
- Australia taxes non-residents on the worldwide business income of an Australian PE if it has a tax treaty with the non-resident's country of residence. A similar approach applies to such income of a trust PE in Australia that is attributed to a non-resident beneficiary if Australia has a tax treaty with the beneficiary's country of residence.
- Australia and (in the case of contract income) New Zealand generally tax non-residents by reference to the source of particular income derived in the course of a business. That approach also applies to trust income attributed to a non-resident beneficiary.
- The United States and the United Kingdom do not tax non-residents on local business income[168] unless the non-resident conducts a local trade and (in the United Kingdom) the income is associated with that trade. Correspondingly, they do not tax non-resident beneficiaries on local business income of the trust in the absence of a local trade or (in the United Kingdom) in the absence of the requisite association with that trade.

The basis of taxation (net-basis individual taxation at progressive rates or corporate taxation) also generally reflects the basis on which a non-resident would be taxed directly, although in some instances the trust also incurs liability to pay tax on a representative or agency basis for the particular non-resident beneficiary. Exceptionally, the United Kingdom taxes a non-resident corporate beneficiary at the basic rate[169] under the income tax rather than the corporate rate under the corporation tax. For the 2018–19 tax year, the basic rate is one percentage point higher than the corporate rate.[170]

[168] In US terms, US-sourced income; in UK terms, income arising in the United Kingdom. See n 934.

[169] Cf n 164.

[170] The basic rate for the 2018–2019 tax year is 20% and the corresponding 2017 corporation tax rate is 19% (FA 2017 s 2; FA (No 2) 2015 (UK) s 7(1)). The corporate rate is set to drop to 17% in 2020 (s 7(2) as amended by FA 2016 s 46).

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3.2.2.2 Foreign Tax Credit

Australia and the United States[171] allow unilateral foreign tax credits to a non-resident beneficiary on a similar basis to a directly acting non-resident, subject to conditions applicable to beneficiaries generally (Section 3.3.3). The United Kingdom allows credit to a non-resident beneficiary if the trust is non-resident, subject to the general requirements of a UK branch (applied at the level of the trust), non-residence in the foreign taxing country (applied to the beneficiary), and that the foreign-taxed income arise in the foreign taxing country. Paradoxically, the UK legislation makes no provision for credit if the trust is resident. New Zealand alone does not allow unilateral foreign tax credits to a non-resident, beneficiary or otherwise, although credit is allowed to a resident beneficiary.

The surveyed countries, if and insofar as they allow foreign tax credits to non-residents acting directly, extend similar treatment to non-resident beneficiaries on a basis that otherwise resembles the treatment of its own resident beneficiaries, subject to the exception just noted concerning a non-resident beneficiary in a UK-resident trust.

3.2.2.3 Potential Non-Taxation or Double Taxation

The premise of this section is that a potentially taxing country perceives particular business income derived by a trust as currently attributable to a beneficiary who is non-resident, and also perceives that income as having a source within its territory and/or as being attributable to a business with a trust-level taxable presence in its territory. International non-taxation arises if that country and others which might be expected to tax omit to do so; international double taxation arises if that country and one or more other countries exert effectively overlapping claims to tax the same income without relief for double taxation. In either analysis, the most obvious other potentially taxing countries are the residence countries of the grantor, the trust or the beneficiary and another source country taxing on the basis of a different source principle.

A possibility of non-taxation arises if one country refrains from taxing local income because it is derived through a foreign business, but the host country of the business refrains from taxing because it sees the income as having its source in the first country. This is not affected by the presence

[171] References here to non-residence in a US context should be understood as connoting non-US person status.

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of a trust and will, therefore, be put aside. Otherwise, inadvertent non-taxation seems unlikely.

The scope for double taxation is more obvious and more complex. In a source–source conflict, the trust is immaterial. In a source–residence conflict, the source country enjoys a natural and practical priority, subject to any applicable treaty. It is unusual for a country – and particularly a source country – to grant unilateral double tax relief by reference to foreign residence taxation, but some of the foreign tax credit rules considered here may have that effect in favour of a non-resident beneficiary where the foreign taxpayer is the grantor[172] or the trust.[173] A large issue in a treaty context is the recognition by each country of the fiscal attribution perceived by the other for the purposes of the treaty (Section 8.3.10); as this chapter is concerned with domestic rules of international taxation and their interaction, the issue of treaty relief will not be explored here.

In each of the surveyed countries, there is a high level of internal consistency between the tax treatment of a non-resident who derives business income directly and that of one to whom business income is attributed through a trust. So far as the country's own tax treatment is concerned, the potential for double taxation is not materially altered by the presence of the trust (except in the unusual case of non-resident foreign tax credits being denied because a trust is UK-resident). Whether the complexities of the trust relationship and its tax treatment provoke double taxation primarily depends on the outbound settings of the residence country of the beneficiary, the trust and the grantor.

3.2.3 *Property Income*

In each of the surveyed countries, rental and similar income derived by a non-resident from land or assets treated as analogous to land is taxable if the income-generating property is situated in the taxing country. In

[172] Foreign taxation of the grantor can support foreign tax credits for a resident beneficiary in the United Kingdom, New Zealand and (in most cases) Australia; the United States contemplates conditional credit in its legislation (IRC s 901(b)(5) second sentence) but has never promulgated the necessary regulations. See Section A.4.2 (n 1066). If a non-resident beneficiary otherwise qualifies for credit, the fact that foreign tax is imposed on a grantor has the same significance as in the case of a resident beneficiary.

[173] Regarding the possibility of credit for foreign residence taxation generally, see Section 3.3.3.1. The possibility of credit for taxation of the trust or a grantor is considered in Section 3.3.3; cf Table 6.1 in Section 6.1.3.

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Australia,[174] the United Kingdom[175] and New Zealand,[176] tax is imposed on a net basis by assessment. In the United States, tax is imposed on a net basis by assessment if the income is effectively connected.[177] US real property income that is not effectively connected is prima facie taxed on a gross basis at the 30% flat rate applicable to fixed or determinable income,[178] but a non-resident may elect to treat all such income as effectively connected.[179]

Essentially the same settings and bases of taxation apply where the income is currently attributed to a non-resident beneficiary in a trust that owns the property and derives the income, regardless of the residence of the trust.[180] In the United States, the 'effectively connected' election is made by the beneficiary.[181] The assessment and collection mechanisms (including the role of the trust) are similar to those which apply to business income.

In contrast to business income, there is no practical scope for foreign tax credit to arise in relation to this class of income,[182] nor is any source–source conflict likely to arise. Each of the surveyed countries taxes local property income at substantive rates by net-basis assessment; regardless of whether a trust is involved, there is little potential for international non-taxation. International double taxation may arise by source–residence conflict, and double tax relief depends on recognition by the residence country of taxation by the country of source/situs. As in all trust situations, complexity is added by the possibility that the residence country may not agree with the source country's attribution and so may refuse to recognize or grant relief

[174] The Australian claim to tax arises under the general jurisdictional rule (ITAA 1997 ss 6-5(3)(a), 6-10(5)(a)) and the application of common law source principles. Net-basis taxation is the default setting.

[175] ITTOIA s 269(1) (territorial scope), s 264 (definition of 'UK property business'), s 271 (person liable).

[176] ITA NZ s YD 4(7) (source rule for income from land); s BC 1(2); s YA 1 (definitions of 'filing taxpayer', 'non-filing taxpayer').

[177] IRC ss 871(b), 882(a).

[178] IRC s 861(a)(4) (source rule for rents and royalties); ss 871(a), 881(a).

[179] IRC ss 871(d), 882(d). The election extends to capital gains on the sale of the US property.

[180] The claim to tax and basis of taxation generally arise in the same way as described in the preceding section in relation to business income, but with reference to the source rule or principle for property income. The conceptual difficulties relating to the attribution of business activities, a branch or a PE do not arise in relation to property income.

[181] 26 CFR s 1.871-10(b)(1).

[182] See the description of foreign tax credit limitations in the preceding section.

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for source taxation. That is an issue for the outbound settings of the residence country and for related treaty relief.

3.2.4 *Dividend, Interest and Royalty Income*

Inbound taxation of trusts and their beneficiaries on DIR income is an area of particular complexity because it involves the intersection of two already intricate areas of law – inbound DIR taxation and fiscal attribution of trust income. This section considers the taxation of local DIR income attributed to a non-resident beneficiary based on the findings of a more detailed country-by-country survey in the appendix (Section A.3). It undertakes a comparative analysis with a particular view to identifying potential for trust structures to contribute to international non-taxation or double taxation. Problems are identified where there is lack of parity with respect to taxable presence and where a gross-basis tax rate may be applied to what is effectively a net amount (net-basis versus gross basis issues), and a solution is proposed.

Four main subjects are addressed.

- The examination begins with the general settings of inbound DIR taxation in a non-trust context. There are significant common features. Depending on the country concerned and the class of income, a non-resident's DIR income is ordinarily taxed on a gross basis (typically by final withholding) or excused from taxation, but may be excluded from that treatment and taxed instead on a net basis if the non-resident has a taxable presence in the source country.
- Next, the primary interaction of inbound taxation with non-resident beneficiary attribution of trust income is considered. A strong correlation is shown between trust-law allocation of particular DIR income and tax-law attribution, bearing in mind that the United Kingdom only regards objectively fixed (non-discretionary) entitlements.
- Thirdly, the subject of taxable presence is examined in a trust context. A diversity of approaches is identified: only the United States maintains parity with non-trust taxation by attributing the taxable presence of a trust to a non-resident beneficiary.
- Finally, a series of net versus gross issues is examined, by which gross-basis tax may end up being applied to what is really a net amount due to the particular interaction between beneficiary attribution rules and inbound DIR taxing rules.

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A simplified comparative overview of the relevant tax settings in the surveyed countries is presented in Table 3.1 on the following page.[183] The data in the table are drawn from the country-by-country analysis in the appendix and are presented in a way that anticipates the analysis that follows in this section.

3.2.4.1 General Settings

Each of the surveyed countries generally removes local DIR income derived by a non-resident from the system of net-basis taxation by assessment that applies to similar residents' income and to source-based taxation of non-residents on active business income, and taxes such income instead on a gross basis at rates ranging (subject to treaty) from 30% to zero. Dividends are typically taxed at 30% (USA; unfranked/non-imputed in Australia/New Zealand), 15% (New Zealand, a largely optional rate premised on offsetting credit in the residence country) or zero (UK; franked/fully imputed in Australia/New Zealand). Interest is typically or nominally taxed at 30% (USA), 20% (UK), 15% (New Zealand) or 10% (Australia), but zero rates are available for certain classes of interest (USA, UK, Australia) or under a broad elective regime (New Zealand). Royalties are typically taxed at 30% (USA, Australia), 20% (UK) or 15% (New Zealand). The higher rates are, of course, subject to reduction by an applicable tax treaty.

Each country draws non-residents' DIR income back into its net-basis assessment system in certain circumstances associated with the taxpayer having a taxable presence in the country: a relevant local PE (Australia,

[183] Abbreviations and shorthand in Table 3.1 are as follows. 'Net basis (investor)' refers to the criteria by which a non-resident investor in a non-trust context is subject to net-basis taxation rather than final withholding on the relevant classes of income. 'Net basis (beneficiary)' refers to the same criteria for a non-resident beneficiary in respect of beneficiary-attributed income. The criteria are expressed in summary form under separate headings for each class of income: dividends, interest or royalties. For further detail, see Section A.3. The symbol '—' indicates that net-basis taxation is not applicable. Red text is used to emphasize points of difference. 'Gross basis' refers to the rate of gross-basis taxation of the relevant class of income. Main variants are indicated in summary form under the respective headings. 'Net versus gross issues' refers to the question whether the attribution of trust income to a beneficiary can effectively result in gross-basis taxation being applied to net income. This is considered in Section 3.2.4.4 and corresponding country entries in Section A.3. 'Gross basis as minimum' refers to whether and in what circumstances New Zealand applies its NRWT as a minimum tax, resulting in final taxation at whichever is higher of gross-basis NRWT or net-basis assessment of the attributable taxpayer.

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Table 3.1 *Taxation of DIR Income Attributed to a Non-Resident Beneficiary*

	Dividends	Interest	Royalties
Australia			
Net basis (investor)	Relevant local PE	Relevant local PE	Treaty PE
Net basis (beneficiary)	–	–	Treaty PE if attributed
Gross basis	30% unfranked 0% franked	10% 0% several categories	30%
Net versus gross issues	Yes generally		
United States			
Net basis (investor or beneficiary)	If DIR income is effectively connected with local business		
Gross basis	30%	30% 0% portfolio interest etc	30%
Net versus gross issues	Yes, if DIR income is derived by a US trust and there is no relevant US trade		
United Kingdom			
Net basis (investor)	Individual: relevant local business + branch / agency Company: relevant local PE		
Net basis (beneficiary)	–	–	–
Gross basis	0%	20% 0% several categories	20%
Net versus gross issues	No generally		
New Zealand			
Net basis (investor)	–	Local business and fixed establishment	Industrial royalties (NRWT as minimum tax)
Net basis (beneficiary)	–	Local business and fixed establishment of beneficiary	Industrial royalties (NRWT as minimum tax)

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Table 3.1 (*cont.*)

	Dividends	Interest	Royalties
Gross basis	30% non-imputed Fully imputed: 15% (usually negated by credit to the company) 0%	15% 0% (if not associated and borrower pays approved issuer levy)	15%
Net versus gross issues	Yes generally, if trustees are resident		
Gross basis as minimum	–	If net basis n/a and parties are associated	Non-copyright royalties

dividends and interest; royalties[184] in treaty cases); a relevant local business (USA); a relevant local branch or agency or a relevant local corporate PE (UK); a local business and fixed establishment (New Zealand, interest only). Exceptionally, New Zealand treats gross-basis taxation as a minimum tax on related-party interest and non-copyright royalties: net-basis assessment applies if it produces more tax.

3.2.4.2 Beneficiary Settings

The principles by which such income is attributed to non-resident beneficiaries tend to defer to trust-law allocation item by item. The United Kingdom follows trust law, but only attributes if the income belongs to the beneficiary as it is derived by the trust. Australia, the United States and New Zealand also recognize discretionary trust appointments, following trust-law income allocations directly (Australia,[185] New Zealand,

[184] See n 972.

[185] See ITAA 1936 s 128A(3). This only applies for the purposes of the final withholding tax regime in Part III Div 11A, including zero rating of franked distributions and some other items as 'non-assessable non-exempt' income. Because Australia does not attribute a trust PE to a beneficiary, general Div 6 net-basis assessment never applies to non-resident beneficiary-attributed DIR income that satisfies the particular source-like test for Australian taxation in Div 11A. The remaining theoretical scope for Div 6 to support taxation of non-resident beneficiary-attributed DIR income is very small and will not be considered further.

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USA first tier unless discretionary) or through the mediation of a proportionate formula (USA first tier discretionary or second tier). Of these general approaches, the most substantial tax-law departure from trust-law allocation is the US formulary treatment. In some circumstances, New Zealand applies a different tracing system based on the order in which income is distributed (appointed) to beneficiaries.

3.2.4.3 Taxable Presence

Where a non-resident investor's taxable presence would ordinarily attract net-basis taxation of local DIR income, a question arises whether an equivalent presence of a trust attracts net-basis taxation if the income is attributed to a non-resident beneficiary. The United States answers in the affirmative and preserves parity of treatment between the two situations by attributing the trust's US business to the beneficiary. Australia generally does the same for trust PE royalties under a treaty with the beneficiary's country of residence.[186] Otherwise, Australia and the United Kingdom generally answer in the negative, and only apply gross-basis taxation to non-resident beneficiary-attributed DIR. New Zealand takes a different approach. The only category of non-resident income that can be excluded from NRWT is interest, and all that is required is a taxable presence (local fixed establishment) of the non-resident taxpayer. No particular nexus is required between the interest and that establishment. A local fixed establishment of the non-resident beneficiary is necessary and sufficient to engage net-basis taxation of attributed interest income from New Zealand sources, regardless of whether the trust has any local presence. The various Australian, UK and New Zealand settings that ignore the taxable presence of a trust do not appear to reflect any particular policy foundation and are better understood as accidents of history.

Whether gross-basis or net-basis taxation is greater depends principally on the differential between the rates of tax and the extent of any expenses that would be deductible on a net basis. This may vary from case to case. Lack of parity between the taxation of directly derived DIR income and similar income derived through a trust creates a tax planning/avoidance opportunity – if gross-basis taxation would be less, the interposition of a trust may attract that result – or a pitfall for the unadvised.

[186] Under IntTAA s 17A(4) (see n 972, 973 and corresponding text in Section A.3.1.1).

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3.2.4.4 Net versus Gross Issues

The non-deductibility of expenses in calculating the amount on which gross-basis tax is levied can be indirectly negated in certain circumstances under the tax systems of Australia, the United States and New Zealand by the use of a locally based trust. The precise mechanism varies from country to country. A common theme is a correlation between the trust-law amount to which the beneficiary is entitled, net of trust-level expenses, and the calculation of the tax-law amount that is attributed to the beneficiary and becomes the object of gross-basis taxation. Where this correlation can be engaged, significant local tax savings are possible compared to investment by a non-resident directly. There are two elements: selection of a net tax base rather than a gross tax base, and (depending on the particular country's tax law) application of a rate which may be lower than would apply on net-basis assessment. The switch to a net tax base is not necessarily anomalous, inasmuch as the use of a gross tax base for DIR income is itself an anomaly, justified by the practical difficulty of calculating net profit corresponding to local cash flow without a local business or branch. The trust, in some fashion, addresses that difficulty for trust-law purposes when it deducts expenses from the income that it allocates to particular beneficiaries as their vested or discretionary entitlement. On the other hand, tax savings attributable to a lower rate of gross-basis taxation than would apply under net-basis taxation may fairly be characterized as anomalous non-taxation.

There is no indication that this gross-to-net alchemy represents a conscious policy choice. It seems more likely to be an accidental artefact of the interaction of two independently complex systems – inbound DIR taxation and trust taxation.

No corresponding issue arises in the United Kingdom due to a range of structural differences between the inbound DIR taxation and the beneficiary attribution rules of that country and of the other surveyed countries.

3.2.4.5 Potential Non-Taxation or Double Taxation

From the viewpoint of a source country, a lack of parity between the taxation of local DIR income of a non-resident who invests directly and similar income attributed to the same non-resident as a beneficiary enables the non-resident to reduce the burden of source taxation. Depending on the factual circumstances and the particular source country involved, this may take the form of preferring gross-basis taxation

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over net-basis taxation and/or applying gross-basis taxation to what is in reality a net income amount. That may be a matter of concern for the source country, but whether it contributes to international non-taxation depends on the attribution and taxation of the income by other relevant countries. Where the involvement of a trust reduces source taxation, this may most obviously contribute to international non-taxation if the beneficiary's residence country taxes on a territorial or remittance basis, grants relevant international double tax relief by exemption, or does not attribute the income to its own resident. The last of these may arise if the beneficiary's country would attribute the income to another person or entity, such as the grantor or the trust.

Double taxation outcomes may also be envisaged as arising from the same non-parity causes, but the ability of investors to choose their structures and their investments makes the issue less significant.

The implicit solution to such anomalies is to attribute the taxable presence of a trust to a non-resident beneficiary for the purpose of choosing between net- and gross-basis taxation of beneficiary-attributed DIR income and, where gross-basis taxation applies, to attribute DIR income on a grossed-up basis that takes account of relevant trust-level expenses. Being a product of national law, a source country can cure such anomalies unilaterally.

While these anomalies remain, they may be exploited and combined with non-taxation outcomes in other countries to produce international non-taxation or less than single taxation.

3.2.5 Capital Gains

Australia, the United States and the United Kingdom each exert a general claim to tax capital gains derived by a non-resident on a source basis which, with local variations, reflects the logic of Art 13 of the OECD Model tax treaty.[187] This turns on whether the capital asset in question is

[187] *Australia*: Australia only taxes non-residents on capital gains from 'taxable Australian property' (ITAA 1997 s 855-10), the main categories of which are assets of the non-resident's Australian PE, land or certain natural resources in Australia, and non-portfolio interests in entities that are rich (more than 50% by value) in Australian land or natural resources. Non-final capital gains tax withholding applies, broadly speaking, where a non-resident sells or grants an option over Australian land or analogous taxable Australian property (TAA Au Sch 1 Sub-div 14-D, applicable to acquisitions from 1 July 2016). *United States*: The United States taxes non-US persons on gains effectively connected with a US business (IRC ss 871(b), 882(a)) and, by deeming them to be

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associated with a PE or similar presence of the non-resident in the taxing country, or is land in that country or an interest treated as analogous to such land, although the United Kingdom has hitherto limited its non-PE taxing claim to UK residential property.

Where a trust is involved, the United Kingdom follows its general approach and does not attribute to a non-resident beneficiary. Australia and the United States apply essentially the same beneficiary attribution rules as in a domestic context; each also requires the same source criteria to be satisfied as a condition of taxing a non-resident beneficiary on trust gains as would be applied to a non-resident directly, with the PE-association test being applied at the level of the trust.

Australia goes further, however, and eschews taxation unless the particular gain from 'taxable Australian property'[188] also meets the test in the general trust rules for taxation of similarly attributed ordinary income, namely that it is attributable to sources in Australia in the sense of case law,[189] which generally follows the situs of the relevant

effectively connected, on gains from US real property interests (including certain resource interests), which in turn extend to interests in a land-rich US real property holding corporation (s 897 and related regulations). Net-basis taxation is supported by non-final withholding (s 1445). *United Kingdom*: For many years, the United Kingdom only taxed non-residents on gains from assets relevantly connected with a non-corporate taxpayer's UK branch or agency (TCGA s 10) or a company's UK PE (s 10B). There are now also separate charges to capital gains tax on 'ATED-related gains' of resident and non-resident companies (s 2B) and on chargeable 'NRCGT gains' accruing to a person, whether corporate or individual, from the disposal of a UK residential property interest by a non-resident that would not otherwise have been chargeable (ss 14D, 188D). The 2017 Autumn Budget included proposals to expand the UK capital gains tax base to cover all types of UK immovable property and indirect interests through 'property rich' entities by extending and rationalizing the capital gains tax and the corporation tax in their application to non-residents with effect from April 2019: see HMRC, HM Treasury, *Taxing Gains Made by Non-Residents on UK Immovable Property: Consultation Document* (22 November 2017). This was followed by a consultation process and the publication of draft legislation and explanatory notes: see HMRC, *Capital Gains Tax and Corporation Tax on UK property gains* (6 July 2018). These measures will bring the United Kingdom's inbound treatment of capital gains closer to the range of taxing rights recognized by OECD Model Art 13. See also n 51.

[188] An omnibus term for an asset capable of producing a capital gain that is taxable to a non-resident (see ITAA 1997 ss 855-10, 855-15).

[189] Brabazon, *Trust Gains*, n 35. This anomalous rule is traceable to a policy setting adopted when Australia first enacted its capital gains tax rules in 1986, evidently without a proper appreciation of the consequences. See Alan Blaikie, 'International Aspects of Capital Gains Tax' (1987) 21 *Taxation in Australia*, 742. The ATO has undertaken public consultations with a view to formulating an opinion on the question. At the time of writing, no published opinion has emerged.

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asset.[190] This extra source requirement is practically negated, however, if the beneficiary is resident in a country with which Australia has a tax treaty:[191] the primary source rule expands to catch everything that Australia could tax under the capital gains tax article of the treaty.

A separate rule relaxes the claim to tax beneficiary-attributed gains of fixed trusts if their assets are predominantly outside the Australian capital gains tax net.[192] This allows Australian-based investment trusts to avoid competitive disadvantage that would otherwise arise from having an Australian PE.

Having regard to differences between the attribution rules in the United Kingdom (Section A.1.1.2), the United States (Section A.1.2.2) and Australia (Section A.1.3.2), the general inbound settings for trust gains may be summarized as follows:

- The United Kingdom does not attribute trust gains to a beneficiary in a domestic or inbound context. They are attributed to the trust and taxed at the top capital gains tax rate.
- The United States only attributes capital gains to a beneficiary in a year when the trust makes capital distributions. Attribution is governed by DNI second-tier accounting and consequently involves formulary apportionment among beneficiaries. Once the gains attributed to a non-resident beneficiary have been identified, the jurisdictional claim to tax applies in the same way as if the gain had been derived directly and leads to net-basis taxation of the beneficiary.
- Australia attributes trust gains under its capital gains streaming rules. Attribution is governed first by specific entitlement, which usually reflects trust-law allocation and may be achieved without actual distribution or a

[190] Brabazon, *Trust Gains*, n 35, 163–164. Gains that satisfy the general statutory test for non-resident taxation usually also satisfy the case-law source test, but not necessarily so. The most obvious example is a gain from the sale of shares in a foreign-based company that is land-rich in Australia such that the shares qualify as 'taxable Australian property' under the quasi-source rule. Foreign situs of the shares may be expected to result in non-Australian case-law source of the gain. The better view is that the place of sale of shares should not materially influence the source of a resulting capital gain, although such a factor may influence the source of profit from a trading transaction.

[191] See n 910. By IntTAA s 4, ITAA 1936 and ITAA 1997 are integrated with and subordinated to that Act and the treaties which it implements. Ordinarily, tax treaties limit the claim to tax; exceptionally, Australia uses tax treaties to expand its ordinary source rules.

[192] There is no claim to tax gains attributed to a non-resident through a fixed trust, the assets of which are at least 90% non-'taxable Australian property', or through a chain of such fixed trusts: ITAA 1997 s 855-40, formerly Sub-div 768-H. See Brabazon, *Trust Gains*, n 35, 150–152, 156, 160.

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present right to demand payment. Absent specific entitlement, attribution is proportional to beneficiaries' present entitlements to total trust-law income, unless the trustees exercise a discretion to have the gain attributed to the trust itself. In order for gains attributed to a non-resident beneficiary to be taxable, they must be such as would be taxable to a non-resident directly and must also be attributable to sources in Australia. The trust is taxed on behalf of the beneficiary, and the beneficiary is taxed with credit for tax paid by the trust.

Double taxation by a source country and a residence country is conventionally addressed by double tax relief in the residence country or by treaty. As in other contexts, the question of double tax relief is complicated if the countries concerned attribute a trust-level gain to different taxpayers.

The involvement of a trust does not contribute to international non-taxation if (regardless of attribution) the source country applies full net-basis taxation to trust gains within its ordinary claim to tax non-residents. That condition is substantially satisfied in each of the surveyed countries, except where the extra Australian source requirement results in non-taxation of gains from taxable Australian property. This may happen, for example, if the attributable beneficiary is resident in a country that does not have a tax treaty with Australia and does not attribute trust gains to beneficiaries or does not do so in the particular circumstances. The beneficiary's country may, for example, attribute the gain to the trust (resident in Australia or a third country). This represents a real, if somewhat specific, opportunity for rules of trust taxation to contribute to international non-taxation.

3.2.6 *Inbound Beneficiary Conclusions*

Leaving aside differences relating to the attribution of trust income to beneficiaries (Section 3.1), the survey of inbound beneficiary taxation in the last five sections demonstrates strong correlations across the surveyed countries between the treatment of non-residents in respect of directly derived income and beneficiary-attributed trust income in most of their fundamental inbound tax settings. It also demonstrates a number of areas where such correlations are absent or break down, and not necessarily for any clearly discernible policy reasons.

Foreign income: The surveyed countries treat the interposition of a trust between a non-resident beneficiary and beneficiary-attributed foreign

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income as fiscally anodyne (Section 3.2.1). If the trust-level income would not be taxable to non-residents directly, they recognize a conduit situation and make no claim to tax.

Business income: Business income of a trust attributed to a non-resident beneficiary is usually taxed on the same basis as if it had been derived directly, although the United Kingdom departs from this by taxing non-resident corporate beneficiaries at the individual basic rate rather than the corporate rate (Section 3.2.2). These settings are unlikely to facilitate international non-taxation.

Some source-taxing countries allow double tax relief to non-residents in respect of taxation in another country. This approach is taken by Australia, the United States and the United Kingdom in respect of foreign taxation of income associated with a locally hosted taxable presence. Those countries allow foreign tax credits on an analogous basis to non-resident beneficiaries, subject (as one might expect) to the constraints applicable both to non-resident direct investors and to resident beneficiaries in respect of foreign-taxed trust income. The latter is primarily an outbound issue, considered in more detail in Section 3.3.3.

Property income: The inbound treatment of beneficiary-attributed property income (Section 3.2.3) generally resembles that of business income, without the complication of source-country double tax relief.

DIR income: DIR income (Section 3.2.4) is the area of weakest international correlation, greatest internal inconsistency and greatest potential for fiscal anomaly.

Each of the surveyed countries prima facie imposes gross-basis taxation on inbound DIR investment income, but may revert to net-basis assessment by reference to a local taxable presence. The United States consistently attributes the taxable presence of a trust to a non-resident beneficiary, and Australia does so on a limited basis for royalties. Otherwise, a trust-level taxable presence does not give rise to net-basis taxation of a non-resident beneficiary, even if it would do so in the case of a partnership or direct investment. This lack of parity under domestic law creates a tax planning/avoidance opportunity, or a pitfall for the unadvised, depending on the applicable tax rates and the level of potentially deductible expenses involved.

The non-deductibility of expenses in calculating the amount on which gross-basis tax is levied can be negated in certain circumstances in Australia, the United States and New Zealand by the use of a locally based trust. The exact mechanism varies from country to country. Where it can be engaged, significant local tax savings are possible compared to

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investment by a non-resident directly, particularly if the rate of gross-basis taxation is significantly lower than that which would apply under net-basis taxation. Whether this net versus gross effect is anomalous is a complex question, in which the most important consideration is any rate differential.

Capital gains: There is considerable diversity between the Australian, US and UK attribution settings for trust-level capital gains (Section 3.2.5), but the inbound interposition of a trust does not contribute to international non-taxation if the source country applies full net-basis taxation to trust gains within the scope of its ordinary claim to tax non-residents. That condition is substantially satisfied in each of the surveyed countries, except where the extra Australian source requirement results in non-taxation of gains from taxable Australian property. The relief of double taxation is an outbound issue for the residence country.

3.3 Outbound Beneficiary Taxation

3.3.1 Income

Each of the surveyed countries applies its general principles of beneficiary attribution, considered in Section 3.1, and consequent net-basis taxation to a resident beneficiary in respect of ordinary foreign-sourced trust income.

In Australia, attribution of such income is proportionate, by reference to the fractional value of the beneficiary's trust-law entitlement relative to total trust-law income.[193] In the United States, attribution is a product of DNI accounting, referable to trust-law apportionment for fixed income entitlements and proportionate allocation otherwise.[194] In New Zealand,

[193] A special outbound attribution regime (ITAA 1936 ss 96B, 96C) known as the deemed present entitlement rules operated from 1993 to 2010 in relation to resident beneficiaries in closely held non-resident trusts. The rules were always problematic with respect to interpretation, application and policy, and were practically ineffective if the trust was discretionary (see Burns and Krever, n 112, 79–84, 107–110). Their repeal implemented a recommendation of the Board of Taxation: Board of Taxation, *Review of the Foreign Source Income Anti-Tax-Deferral Regimes: A Report to the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs* (September 2008), Recommendation 1. The only judicial consideration of the rules confirms their complexity (see *Howard* v *FCT (No 2)* (2011) 86 ATR 753; the point was sidestepped on appeal: *Howard* v *FCT* (2012) 206 FCR 329, 343 [51].)

[194] See n 841, 842, 843.

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attribution follows trust-law entitlement, but this may be modified if the trust is 'foreign' or 'non-complying' for distribution tax purposes, particularly if the trust is discretionary.[195] In each of those countries, the entitlements or benefactions that result in current attribution may represent vested rights or discretionary appointments to the beneficiary. In the United Kingdom, attribution follows trust-law entitlements and is limited to vested equitable proprietary interests attaching to income as it arises to the trust.

The New Zealand modification may result in current trust income being traced with first priority into trust-law distributions of any trust-law character. To take a simple example, if a 'foreign' or 'non-complying' discretionary trust with New Zealand beneficiaries has foreign income in the current year, a capital distribution in that year will be treated as consisting first of income. The mechanism is not fully articulated in the statute.[196] Its operation becomes complex and in some respects ambiguous if the trust has multiple sources of current income or both resident and non-resident beneficiaries.

The result in each country is principal taxation of the beneficiary by net-basis assessment at the beneficiary's usual tax rate. As in domestic situations, the trust may also incur liability in Australia,[197] the United Kingdom[198] or New Zealand, but only on an agency or representative basis resulting in full credit to the beneficiary for tax paid.

[195] ITA NZ s HC 16(2)(a) and related provisions. See n 895 and corresponding text.

[196] Attribution under the modified rule is implicitly to be performed with the benefit of hindsight and with reference to income of the whole year: Interpretation Statement IS 18/01 *Taxation of Trusts – Income Tax* [8.112]; IRD, 'Explanation of Taxation of Trusts' (1989) 1(5A) *Tax Information Bulletin* 1, [13.20]. (The 1989 *Explanation* related to the 1988 version of the statute but remained authoritative in relation to IRD opinion and practice through subsequent versions under the tax law rewrite process. It was superseded by IS 18/01 in June 2018.) There is no need to identify what current year income or gains have been derived before each particular distribution within the year, but once the results for the year are known, the distributions are traced in the order of their occurrence and absorb available income and gains in the order prescribed by ITA NZ s HC 16. Any other approach would be unmanageable. The statute does not prescribe the order in which different items of current income are taken to be distributed or how they are allocated among simultaneous distributions. It appears that the IRD will accept the trustees' allocation in such a case (IS 18/01 [8.121], IRD (1989) [13.9]), but this does not resolve the ambiguity if all the distributions in question are of trust-law capital.

[197] Limited to cases where the beneficiary lacks legal capacity, e.g., due to infancy.

[198] In the case of foreign income, only a resident trust incurs UK tax liability.

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3.3.2 Capital Gains

Australia, the United States and the United Kingdom tax residents on worldwide capital gains. Taxation of resident individuals is generally more favourable than on ordinary income: Australia applies a discount to the taxable amount of most gains;[199] the United States grants rate relief for long term capital gains;[200] the UK capital gains tax rates are generally below the income tax rates for corresponding individual taxpayers.[201] Their general domestic approaches to the attribution of trust gains differ considerably:

- Australia allows streaming of capital gains to beneficiaries based on discretionary trust-law appointments (Section A.1.3.2).
- The United States applies formulary proportionate attribution of gains in a year in which the trust distributes capital (Section A.1.2.2).
- The United Kingdom treats the trust as opaque and taxes it at the higher of the available capital gains tax rates. (Section A.1.1.2).

Further differences emerge in the treatment of foreign gains – gains that would not be taxable on a modified source basis if derived directly by a fiscal non-resident – derived by or through a trust.

In Australia, foreign gains derived by a resident trust are attributed to resident beneficiaries on the same basis as in a purely domestic situation, but foreign gains derived by a non-resident trust are – remarkably – 'disregarded'.[202] Besides being non-taxable to the trust, they are not

[199] ITAA 1997 Sub-divs 115-A, 115-B. The relevant asset must be held for at least a year. Non-residents no longer qualify for discount; for gains on non-residents' assets acquired before 8 May 2012, the discount is proportionately reduced.

[200] IRC s 1(h).

[201] TCGA s 4. See Loutzenhiser, n 53, §32.7 for a brief history of the tax and changes in its rates and structure (cf §40.1.2.2). Progressivity is integrated with progressivity of the income tax.

[202] ITAA 1997 s 855-10. See Brabazon, *Trust Gains*, n 35, 144, 151; TD 2017/23 *Income tax: does the residency assumption in subsection 95(1) of the Income Tax Assessment Act 1936 (ITAA 1936) apply for the purpose of section 855-10 of the Income Tax Assessment Act 1997 (ITAA 1997), which disregards certain capital gains of a trust which is a foreign trust for CGT purposes?* This setting goes back to the inception of capital gains taxation in 1986. There is no apparent policy justification, which raises the question whether it represents an oversight in the statutory design process. It is difficult to imagine that the possibility of a non-resident trust having resident beneficiaries and foreign gains could have been overlooked, but it is conceivable that the impact of the international capital gains rule on the definition of 'net income' in Div 6 was missed. The remaining alternatives – that the designers of the rule consciously intended either non-taxation or fallback taxation of the beneficiary under ITAA 1936 s 99B – seem perverse.

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attributed to any beneficiary. A resident beneficiary to whom such a gain would have been currently attributed, had the trust been resident, will instead almost certainly suffer taxation under an entirely separate provision designed to catch distributions referable to foreign income accumulated in a non-resident trust.[203] That taxation is imposed on the value of the distribution or constructive distribution, and does not provide access to concessional features of capital gains taxation such as the capital gains tax discount.

In the United States, foreign gains pass through a fiscally resident trust in the same way as local gains. Because DNI is defined by reference to taxable income of the trust and because a fiscally non-resident trust is taxable by analogy with a non-resident alien, a technical modification is made so that worldwide gains are attributed through the trust to a resident beneficiary in the same way as if the trust were fiscally resident.[204] In this way, parity is preserved.

In the United Kingdom, the ordinary opaque treatment of trusts would fail to tax foreign gains derived through a non-resident trust but destined for or delivered to a resident beneficiary. In order to close this lacuna, the beneficiary is taxed directly.[205] In broad terms, capital gains of a non-resident trust[206] are attributed to a beneficiary to the extent that they are matched with capital payments[207] to that beneficiary. The beneficiary is

[203] ITAA 1936 s 99B. See Brabazon, *Trust Gains*, n 35; TD 2017/24 *Income tax: where an amount included in a beneficiary's assessable income under subsection 99B(1) of the Income Tax Assessment Act 1936 (ITAA 1936) had its origins in a capital gain from non-taxable Australian property of a foreign trust, can the beneficiary offset capital losses or a carry-forward net capital loss ('capital loss offset') or access the CGT discount in relation to the amount?*.

[204] IRC s 643(a)(6), modifying the general definition of DNI in s 643(a)(3). An anti-side-effect rule prevents this modification from giving the trust unintended distribution deductions referable to foreign income or gains: ss 651(b) second sentence, 661(c).

[205] The main taxing provision is TCGA s 87. Taxation is extended by s 88 to cases where the trust is treated as non-resident by a relevantly applicable tax treaty.

[206] The operative provisions refer to a 'settlement'. Although the usual TCGA definition of 'settlement' (s 68) connotes a trust, that definition is eschewed (s 97(7)) in favour of the wider meaning of 'settlement' in the settlements legislation (ITTOIA s 620). Related concepts (trustees, beneficiary) are correspondingly extended (TCGA s 97(7A)–(10)). The result is that the rules extend beyond trusts to encompass a range of other arrangements outside the scope of this book. The present consideration is confined to trusts.

[207] The concept of 'capital payment' represents a wide range of direct and indirect distributions that have the effect of transferring value out of the entity to the beneficiary (TCGA s 97(1)–(5)). It includes the transfer of assets in specie and, reflecting the fiscal boundary that excludes bare trusts from the trust taxation rules, the vesting of a trust asset in a beneficiary. Income distributions are excluded, reflecting the boundary between

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subject to UK taxation in the year of that attribution if he or she is then resident, but not otherwise.[208] The trust gains and capital payments need not occur in the same year, and may occur in any order. The year of attribution is the year in which the relevant matching is recognized. Attribution to the beneficiary occurs in the year of the trust gain if it is matched with current or previous capital payments, or in the year of the capital payment if it is matched with current or previous trust gains. The matrix of associated rules and their ramifications are technically complex.[209] The matching rules[210] contemplate an historical reconstruction of the non-income gains and distributions of the trust. Following extensive revision of the legislation in 2008,[211] matching is performed on a last-in, first-out basis. In limited circumstances, trust gains may also be traced through an untaxed original beneficiary to a resident subsequent recipient.[212]

The taxonomy adopted in this book distinguishes between current and non-current taxation and between current and non-current attribution (Section 1.3.4). It will be seen that the UK provision does both. Where current trust gains are matched to current or past distributions, attribution to and taxation of the beneficiary occurs in the same fiscal period as the attributed gain itself (current attribution and taxation). Where past trust gains are matched to current distributions, perhaps many years later, the trust-level gain (which was outside the UK claim to tax when it arose) is attributed and taxed to the beneficiary in a throwback manner in the later year (non-current attribution and taxation).

capital gains taxation and income taxation. There are several other definitional and integrity rules.

208 TCGA s 2(2). But gains attributed to beneficiaries are not offset by allowable losses: s 2(4).

209 See Chamberlain and Whitehouse, n 50, ch 23; Loutzenhiser, n 53, §74.5.6. There are several points at which the rules potentially clash or overlap with other rules, including grantor taxation under TCGA s 86 and beneficiary income taxation under ITA UK s 731 in the transfer of assets abroad rules. The priority and adjustment provisions that resolve these conflicts (generally by deferring to those other rules) are not included in the present description. There are also anti-avoidance rules in TCGA Sch 4B and Sch 4C, aimed at 'flip-flop' schemes of the kind considered in *West* v *Trennery* [2005] STC 214; (2005) 76 TC 713. The facts of that case predated the legislation, and the House of Lords held that the scheme did not work. It is not proposed to address the scheme or the statutory antidote any further.

210 TCGA s 87A.

211 FA 2008 s 9, Sch 7 cll 115–127. See now TCGA ss 87–97.

212 TCGA s 87K, another part of the anti-avoidance measures added by FA 2018 s 35, Sch 10. Cf n 82.

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3.3.3 *Double Tax Relief*

Each of the surveyed countries adopts the credit method as its principal form of international double tax relief.[213] Although the surveyed countries also give significant exemption relief to corporate taxpayers for significant classes of income,[214] this section will only consider relief by foreign tax credit, as that is not only the default method but also the most important one in a trust context.

The surveyed countries all make provision for a resident beneficiary to receive credit where beneficiary-attributed income has suffered foreign taxation. There are considerable similarities and a few differences. A particular area of ambiguity relates to the treatment of foreign grantor taxation.

- *Qualifying foreign taxation*: Each of the surveyed countries only recognizes foreign taxation as potentially creditable if it is sufficiently similar to the country's own taxation of income or gains, as the case may be. Ordinary income or capital gains taxation generally qualifies, and the presence of a trust is neutral.
- *Identity of income*: The foreign-taxed income must be sufficiently identified with the locally taxed income. The surveyed countries readily equate current trust-level income or gains with corresponding income or gains currently attributed, from their own viewpoint, to a resident beneficiary. The United Kingdom is more explicit than other surveyed countries in accommodating the possibility that the two taxing countries may differently conceptualize the object of their own taxation: creditability depends on whether tax in both countries is 'calculated by reference to' the same income or gain.[215] The question of identity in this context is approached pragmatically, and it has been held that the

[213] *Australia*: ITAA 1997 Div 770; *United States*: IRC s 901; *United Kingdom*: TIOPA Part 2 ch 1; *New Zealand*: ITA NZ subpart LJ.

[214] The United States extends significant exemption relief to corporate taxpayers from 2018 under amendments made by *An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018*, Pub L 115–97, 131 Stat 2054 (*Tax Cuts and Jobs Act of 2017*).

[215] TIOPA s 9(1), (2). Compare the strict approach in *Bricom Holdings Ltd* v *IRC* [1997] STC 1179, denying treaty benefits on the basis that income attributed and taxed to a UK shareholder in a CFC lacked identity with the income of the CFC. (The shareholder had argued that the Netherlands–UK treaty precluded UK taxation of the shareholder on business profits of its Netherlands CFC; the Court of Appeal held that the object of UK taxation was a notional amount attributed to the shareholder, not the actual profits of the CFC.)

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'source' of the income need not be conceptualized in the same way either.[216]

- *Identity of taxpayer*: Australia and the United States prima facie require the local taxpayer seeking relief to have borne or paid the foreign tax. The United Kingdom[217] and New Zealand[218] do not require identity of taxpayer. Australia and the United States each have special rules for trust situations, further examined in the appendix (Section A.4), which effectively expand the ambit of identity.

  The identity-of-taxpayer rules determine whether tax paid by a trust or by its grantor is capable of supporting foreign tax credits for a

[216] See *Anson* v *IRC* [2015] STC 1777; 17 ITLR 1007. The case was decided under treaty provisions (relating to US federal taxation) and under previous statutory provisions for unilateral relief (relating to Massachusetts taxation), but the principle appears no less applicable under present unilateral legislation. A Delaware LLC conducted a business based in Massachusetts. It had legal personality but was treated as a partnership for US and Massachusetts tax purposes; both those jurisdictions taxed the members of the LLC on their shares of its business income. In determining whether a UK resident member was entitled to UK credit for his US and Massachusetts taxation, it was held irrelevant to consider whether UK tax law regarded the 'source' of his income as his interest in the members' contract by which the LLC was constituted or the business conducted by the LLC. It was also irrelevant that he did not have a proprietary interest in the assets of the LLC or its business income as it arose, but was only contractually entitled to share in its profits. See [114] in relation to the 'pragmatism' with which HMRC approach the question of identity between income subject to UK tax and that which is subject to foreign tax, whereby such matters as different international accounting periods are treated as insignificant.

[217] TIOPA s 9(1), (2) refer to the economic object of taxation, not the identity of the personal subject. Contrast s 63(5) with respect to indirect tax credit for underlying company tax.

[218] ITA NZ s LJ 2(1) similarly gives a New Zealand taxpayer credit 'for an amount of foreign income tax paid on a segment of foreign-sourced income' without stipulating that that person must have been the payer of the foreign tax. The IRD view of a beneficiary's entitlement to foreign tax credits in relation to beneficiary income similarly focuses on whether foreign tax has been paid on the income, not who has paid it (IRD, *Explanation*, n 196, [8.23]–[8.28]; not reproduced in IS 18/01). Craig Elliffe, *International and Cross-Border Taxation in New Zealand* (Thomson Reuters, 2015) §2.8.2(3) comments that 'a shareholder receiving a dividend from a country that uses an imputation system . . . is taxed on the cash dividend amount with only a credit available for tax that they have suffered (i.e. NRWT). They are not eligible for credit in respect of tax paid by the company and not themselves. This reinforces the point that tax actually needs to be paid by the taxpayer in order to be eligible for a credit'. It is clear that tax paid by a company on its own income is not creditable to a shareholder: identity of income is lacking. It is also clear that foreign dividend withholding tax or net-basis taxation of the dividend is creditable, because the object of that taxation is the dividend, which is also taxable in New Zealand. And it is clear that the tax must be paid. These things, however, do not establish that the personal subject of taxation must be the same in both countries.

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beneficiary. For countries that do not impose an identity-of-taxpayer rule (UK, New Zealand), the answer is 'yes', subject to identity of income, etc. The position is more complicated in Australia and the United States. Tax borne by the trust is generally creditable in both countries; tax borne by the grantor may be creditable in Australia,[219] subject to a number of rather technical considerations discussed later, but is not creditable in the United States, despite provision for such credit in the statute.[220]

- *Foreign versus local taxing nexus*: In broad terms, no country wants to give credit for overreaching foreign taxation, having regard to its own concepts of residence and source. Each country limits its recognition of foreign taxation by reference to jurisdictional connections between the foreign taxing country and the relevant income and/or taxpayer and/or the jurisdictional basis of the foreign taxation. Some also limit credit access to resident taxpayers. The rules that give effect to this policy differ considerably in concept and structure, with consequences considered in Section 3.3.3.1.

The United Kingdom also takes the unusual step of excluding unilateral credit if a treaty expressly denies or grants a credit, even if the treaty credit is less favourable than a unilateral equivalent.[221]

The general conclusions of this section regarding a beneficiary's access to foreign tax credits in his or her residence country with respect to qualifying foreign taxation of the grantor, the beneficiary or the trust are summarized in Table 3.2.

3.3.3.1 Foreign versus Local Taxing Nexus

None of the rules that specifically limit credit by reference to the foreign taxing nexus or its comparison with the local taxing nexus are specific to trusts. The present focus of inquiry is on how those general rules affect outbound beneficiary taxation.

- The US foreign tax credit does not depend on the source of the income that attracts foreign tax, but the credit in any year is limited to the

[219] The legislative and parliamentary material considered in Section A.4.1 suggest, by silence, that the question was not was not considered, but the statutory criteria are such that foreign grantor taxation may satisfy them.

[220] IRC s 901(b)(5) second sentence (see Section A.4.2).

[221] TIOPA s 11; Loutzenhiser, n 53, §74.4.1.1.

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Table 3.2 *Foreign Tax Credit and the Resident Beneficiary*

Residence of Beneficiary	Foreign Tax Imposed on		
	Grantor	Beneficiary	Trust
Australia	✓	✓	✓
United States	×	✓	✓
United Kingdom	✓	✓	✓
New Zealand	✓	✓	✓

taxpayer's average US tax rate multiplied by his or her foreign-sourced income.[222] The consequence is that foreign tax is relatively ineffective to produce foreign tax credits unless it is imposed on foreign income.

- The United Kingdom limits credit to foreign tax 'calculated by reference to income arising, or any chargeable gain accruing, in the territory'[223] of the foreign taxing country. The 'arising' criterion is not equivalent to the location of the relevant source of income, although income arising in a country frequently comes from a source in that country. One effect is that a UK beneficiary cannot claim credit for tax imposed by the residence country of a trust on trust income arising in a third country. Likewise, a beneficiary cannot claim credit for tax imposed by the residence country of a grantor on trust income arising outside the grantor's country.

Insofar as a US or UK resident beneficiary who is currently taxable on trust income may claim credit for foreign taxation of the trust or the grantor,[224] these rules do not constrain the credit any more than if the beneficiary had derived the income directly. The New Zealand and Australian rules are differently structured and require closer consideration.

- New Zealand limits credit to foreign tax on income that does not have a source in New Zealand or that is apportioned to sources outside New Zealand.[225] This is the converse of the source criterion for inbound

[222] IRC s 904.

[223] TIOPA s 9(1)(b); cf s 9(2)(b). See also s 9(3) ('arising' rule for personal or professional services).

[224] As outlined earlier, the US provision for crediting grantor taxation to a beneficiary remains inoperative.

[225] ITA NZ ss LJ 1(1), (2)(a), LJ 2(1), YA 1 (definition of 'foreign-sourced amounts'), YD 4, YD 5. The reference in s LJ 1(1) to assessable income from 'foreign-sourced amounts'

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taxation. Under a separate provision, if the foreign tax is paid by the New Zealand taxpayer because he or she is a citizen, resident or domiciliary of the other country, credit is limited to that which would have been paid if the beneficiary were none of those things.[226] The limitation applies directly where the beneficiary is also the taxpayer in the foreign country, but the statute makes no provision for it to be engaged if the foreign tax is paid by someone other than the New Zealand taxpayer by reference to that other person's fiscal residence, etc. – in the context of outbound beneficiary taxation, where it is paid on a residence basis by the trustees or grantor. This differs from the UK rule, which denies credit for residence-based taxation of a trust or grantor on third-country income.

- Australia denies credit for residence-based foreign tax on income from sources outside the taxing country. The general object of this mechanism is to prevent credit for foreign tax on Australian income or third-country income that falls within Australia's claim to tax.[227] Specifically, it precludes credit for foreign tax 'if you paid it to a foreign country because you are a resident of that country for the purposes of a law relating to the foreign income tax . . . in respect of an amount derived from a source outside that country'.[228] The 'you' addressed here is the claimant for credit. This invites the question: what happens where an Australian beneficiary relies on the extended identity of taxpayer rule to claim credit for tax paid by the trust or a grantor? If the conditions for extension of the identity of taxpayer rule are satisfied, the statute applies to the claimant for credit 'as if you had paid' the

being divided into 'segments' indicates that the 'segments of foreign-sourced income' (cf s LJ 4) referred to in the operative provision, s LJ 2(1), represent foreign-sourced amounts, the definition of which engages as its converse the New Zealand source rules in subpart YD.

226 ITA NZ s LJ 2(4).

227 See Explanatory Memorandum, Tax Laws Amendment (2007 Measures No 4) Bill 2007 (Cth) [1.57]–[1.59].

228 ITAA 1997 s 770-10(3). The Commissioner interprets the causal element in a but-for sense. Thus, if the foreign tax is equally justified (from the viewpoint of the foreign taxing country) on grounds of both residence and source, Australia does not deny credit, even if Australia regards the income as having Australian source. See CR 2013/9 *Income tax: foreign income tax offset: employee share scheme interests – ACE Insurance Ltd and ACE Group* [25]; CR 2014/19 *Income tax: foreign income tax offset: Brazilian tax paid on employment income by Vale SA employees* [25]–[28]. It is unclear whether and how s 770-10(3) would apply if the foreign country perceives a taxing claim based on both residence and source, but taxes more heavily on the residence basis. Contrast the clarity of the corresponding New Zealand provision (n 226).

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foreign tax.[229] The deeming relates to the fact of payment by the claimant, not the basis on which the foreign country has imposed tax. If the foreign country has imposed tax because of the residence of the trust or a grantor and not that of the beneficiary, the better view is that the criteria for denying credit are not satisfied. The result resembles that in New Zealand, although the New Zealand rule is much clearer.

The diversity of approaches is readily apparent. The United States is unconcerned about whether the foreign country claims to tax on a residence or source basis but relies on the particular terms and structure of its general credit limitation rules for protection against excessive credit claims. The other countries supplement their credit limitation rules with provisions that specifically address the taxing nexus and connecting factors between their own taxing jurisdiction, the foreign tax claim, the claimant for credit and the double-taxed income. The United Kingdom is unconcerned about the basis of the foreign claim to tax but limits credit to tax on income 'arising' in the other country. New Zealand has the most nuanced rule, limiting credit to tax on foreign-sourced income to the extent that it is or would be imposed on a basis other than the fiscal residence, etc, of the claimant. The Australian rule excludes credit for foreign taxation that depends on the residence of its taxpayer in the other country of income sourced outside that other country.

The better view is that the New Zealand and Australian rules, insofar as they preclude or limit credit for residence-based foreign taxation, are only concerned with the residence of their own taxpayer. That is to say, where a resident beneficiary claims credit for foreign taxation of the trust or grantor, it does not matter whether the foreign country taxes that entity or person on a residence basis. This outcome is by no means irrational. Trust income only reaches a beneficiary by means of the trust and would not arise at all but for the grant of a grantor. Insofar as international taxation allows those countries which lie upstream in the production and delivery of income a first bite by way of taxation, it is rational that the residence country of a beneficiary may defer to taxation including residence-based taxation of the trust or grantor.[230] The point does not, however, appear to have attracted explicit comment in the

[229] ITAA 1997 s 770-130(1).

[230] To the extent that foreign taxation of the grantor may be creditable at all – see the previous discussion in relation to identity of taxpayer rules in the United States and Australia.

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policy documents surrounding the foreign tax credit legislation of the surveyed countries, and it is unclear whether the issue was consciously considered in the drafting process.

In the absence of express consideration of that point, it may be useful to contemplate a thematically related issue. Where a US citizen resident in Australia derives US DIR income, the primary US claim to tax is based on citizenship, applies on a net basis at personal rates, and is not limited by the distributive Articles of the Australia–US treaty.[231] Australia allows its resident credit for US taxation of US DIR income, but only up to the stipulated treaty rates.[232] The United States then allows its citizen credit for Australian taxation of the same income, net of the credit that Australia has allowed.[233] This implies a cascading hierarchy of taxing claims: source; residence; citizenship.

The broad conclusion is that, at least in the four surveyed countries, rules focusing on the taxing nexus of the foreign country and its relationship with the taxing nexus of the primary country do not significantly limit the availability of foreign tax credit to a resident beneficiary. This conclusion also holds where the foreign tax is imposed on the trust or a grantor. It does not hold, however, where the primary country is the United Kingdom and the taxed income arises outside the foreign taxing country – typically, where the foreign country taxes the trust or grantor on a residence basis in respect of third-country income.

3.3.4 Round-Trip Situations

Where local income derived by a non-resident trust is currently attributed to a resident beneficiary, each of the surveyed countries treats it as taxable to the beneficiary.

If the income is of a kind that would be taxable to a non-resident on a net basis, the trust may have an intermediate tax obligation on behalf of

[231] Australia–US 1982 Art 1(3).

[232] Australia–US 1982 Art 22(2). The same view is taken by IT 2568 *Income tax : tax treatment of US sourced dividend interest and royalty income derived by US citizens resident in Australia* (withdrawn); cf IT 2568W – Notice of Withdrawal. The Notice of Withdrawal takes the view that the ruling is redundant because of changes made to the Treaty by the Australia–US Protocol 2001, although it is not clear that the Protocol made any material difference on the point; withdrawal of the ruling does not imply doubt about its correctness.

[233] Australia–US 1982 Art 22(1)(a), (4).

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the beneficiary that is creditable to the beneficiary in the same way as in a domestic situation.

If the income is of a kind that would be taxable to a non-resident on a gross basis or would be disregarded because of the recipient's non-residence, such as DIR income that does not attract net-basis assessment by reference to a taxable presence in the jurisdiction, each of the surveyed jurisdictions ultimately treats the income as assessable to the resident beneficiary in the same way as in a domestic situation. The UK mechanism is the simplest. Attribution to a resident beneficiary precludes the application of 'disregarded' treatment to the trust income.[234] The mechanism is necessarily more complex in those jurisdictions which recognize beneficiary attribution by reference to discretionary appointment of trust income. A payer of income to a non-resident generally incurs an obligation to withhold and remit tax at the time of such payment. The beneficiary's interest in that income may not be in existence or may be unascertainable at that date, or the payer may simply be unaware of it. The solution is to credit or, if appropriate, refund the initial withholding to the resident beneficiary when the final position is known.[235]

Multilayered trusts: Related issues may arise under multilayered trust arrangements. A resident trust may have a non-resident trust as a beneficiary. The non-resident trust may, directly or indirectly, overtly or covertly, serve as a vector by which income of the first trust may then or later find its way back to residents of the same country as the first trust. If that country initially perceives foreign income flowing to a non-resident beneficiary, or if it taxes particular local income more lightly when it is attributed to a non-resident beneficiary, there is a risk of leakage from its tax base. Potential inadequacy of the information and disclosure available to the taxing country is a major factor in this risk.

[234] ITA UK s 812; Chamberlain and Whitehouse, n 50, §10.56. The preclusion also applies with reference to residents who may benefit in the future. See n 1032 and corresponding text. The effect of 'disregarded' treatment is generally to convert non-final withholding to final; to deny that treatment leaves non-final withholding in place.

[235] *Australia*: TR 93/10 *Income tax: whether a resident beneficiary of a non-resident trust estate is allowed a credit for Australian withholding tax*; cf ITAA 1936 s 128A(3). *United States*: See 26 CFR s 1.1441-1(b)(8); IRC ss 6401, 6402. In some permutations, a refund or credit may go to the withholding agent (IRC s 1464; 26 CFR s 1.1464-1). *New Zealand*: See M L Brabazon, 'Ariadne in the South: New Zealand International Taxation of Passive Trust Income' (2017) 23 *New Zealand Journal of Taxation Law and Policy* 279 §5.4.

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The most obvious way to combat such leakage is by taxing distributions from offshore trusts when they return to a resident beneficiary, and the surveyed countries all impose taxation of this kind (Chapter 5). The main weaknesses of this strategy are tax deferral and vulnerability to evasion and non-disclosure. A taxing country may therefore seek to ensure that income attributed to an offshore trust as initial beneficiary is both currently and fully taxed in the hands of the onshore trust, unless it is sufficiently satisfied that the income is destined for an ultimate beneficiary who is non-resident. This is the approach taken by Australia.[236] Similar concerns can be identified in the US FATCA legislation, which requires significant withholding from payments to a foreign entity of US-sourced DIR or other fixed or determinable income or the proceeds of disposition of certain assets capable of generating such income unless it can be demonstrated that the payment is not fiscally attributed to any US person or that a sufficient reporting system is in place to identify any such US person.[237] The main object is to prevent US persons from evading US tax by failing to declare income routed through foreign entities and accounts.

The New Zealand legislation takes a different but no less effective approach.

- Trustees of the first trust are taxable as deemed agents of a beneficiary on income attributed to the beneficiary.[238] This includes income of the first trust attributed to the second trust. Viewed as income of the second trust, the same items are attributed to the second trust and/or its beneficiaries.[239] The process may be repeated indefinitely if the second trust also has trusts as beneficiaries. The trustees of the first trust must ascertain the ultimate disposition of the income originally attributed to the second trust if they are to avoid taxation at the trust

[236] See n 873.

[237] FATCA stands for *Foreign Account Tax Compliance Act* and refers to legislation ultimately enacted as the *Hiring Incentives to Restore Employment Act*, Pub L 111–147, 124 Stat 97–117 (2010) Title V Subtitle A ('HIRE Act'). Inter alia, its substantive provisions enacted new withholding measures as IRC ss 1471–1474.

[238] ITA NZ s HC 32. In New Zealand terminology, income attributed to the second trust is 'beneficiary income' in relation to the first trust.

[239] See Section A.1.4. The first-trust beneficiary income attributed to the second trust becomes trustee income and/or beneficiary income in relation to the second trust, depending on entitlements and appointments of income in that trust. The obligations of the trustees of the first trust under ITA NZ s HC 32 extend to tax on both classes of income of the second trust, so far as it constitutes first-trust beneficiary income.

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rate (equal to the top personal rate), which applies to income attributed to any of the trusts in the chain.

- In addition, the grantor of the first trust may be treated as grantor of the second trust[240] and incur personal liability as deemed agent for tax on trust-attributed income of that trust.[241]

Outbound grantor settings (Section 2.5) provide a further means of current taxation of income routed through an offshore trust.[242]

3.3.5 Outbound Beneficiary Conclusions

A measure of international non-taxation or double taxation may arise where residence countries disagree about the attribution of particular items of trust income, and those items attract different levels of taxation or credit. The overall effect of taxation by different countries needs to be considered, aggregating the effect of the tax systems of the relevant countries on the various potential taxpayers that participate in a particular trust.

Attribution conflicts may arise between the tax systems of a residence and a source country, between those of two residence countries or between a country of both residence and source and a residence country. Where one country attributes to a beneficiary, the other may attribute to a beneficiary, the trust itself or a grantor. Grantor attribution has been considered in Chapter 2. Trust attribution affects the residue of trust income and gains after grantor and beneficiary attribution as perceived by the taxing country (Chapter 4). Beneficiary attribution in the beneficiary's residence country is considered in this chapter (Sections 3.3.1 and 3.3.2).

Beneficiary–beneficiary: The surveyed countries employ a range of methods of outbound beneficiary attribution. Some focus on trust-law proprietary entitlements (UK, income only) or trust-law entitlements and current discretionary allocations (Australia, streamed capital gains;[243] USA, first-tier income only; New Zealand). Others apply

[240] ITA NZ ss HC 27(4), HC 28(5).

[241] ITA NZ s HC 29(2). For further consideration of the grantor's liability, see Section 2.5.3 and Section 4.2.4.

[242] If the first trust or its resident grantor qualifies as grantor of the second trust or is otherwise taxable in respect of its income.

[243] Franked dividends can also be streamed but, leaving aside special trans-Tasman imputation arrangements between Australia and New Zealand (ITAA 1997 Div 220), franking is generally limited to resident companies (ss 202-5, 202-20, 202-15).

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a proportionate formulary allocation with reference to trust-law allocations (Australia; USA, second-tier income and gains; arguably, UK capital gains). A modified version of the New Zealand rule focuses on the chronological order of current distributions. If a trust has beneficiaries in different countries, differences between attribution rules may result in particular items being attributed more or less than once in the various beneficiary residence countries. If different items of trust income have suffered different levels of source taxation, that difference combined with conflicting beneficiary attributions can result in particular taxes being credited twice or uncredited under the foreign tax credit rules of the respective residence countries. This depends on the extent to which particular items of trust-level income or gain are doubly attributed, or doubly unattributed, to beneficiaries in their own home countries.[244]

Given that private parties control the affairs of a trust, non-taxation is a more serious issue than double taxation.

Beneficiary–trust: Double taxation arising from a conflict of attribution between the residence countries of the trust and of a beneficiary, each treating trust income as belonging to its own resident, is generally resolved in the surveyed countries by double tax relief in the beneficiary's country, with the qualification that the United Kingdom denies credit for trust residence country tax on income arising in a third country (Section 3.3.3). Allowing credit for taxation of the trust is consistent with treating the trust as part of the mechanism or source from which the beneficiary derives trust income, although it may be questioned whether a trust structure that does not conduct a business but primarily makes passive investments really creates value in excess of the management fees of its trustees and advisors. The UK qualification is consistent with treating the trust not as a generator of value, but as a means by which the value generated by trust investments is delivered, although the income 'arising' test is arguably too restrictive because it does not allow credit where an

[244] Suppose that a discretionary trust has two items of income: $100 of US portfolio interest, tax free at source, and $100 of other income that suffers source taxation at 15%. Its beneficiaries include B1, resident in Australia, and B2, resident in New Zealand. Assume that the modified version of the New Zealand attribution rule does not apply. The trustees appoint the portfolio interest to B1 and the other income to B2. Australia attributes 50% of each item of trust income to B1, with credit for 50% of the foreign tax ($7.50). New Zealand attributes only the other income to B2, with credit for foreign tax on that item ($15). Foreign tax of $15 potentially produces combined Australian and New Zealand tax credits of $22.50. If the appointments are reversed, the only potential credit is $7.50 to B1.

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active business in the trust country generates sales income from a third country. A more prosaic explanation of the wider non-UK view may be that the beneficiary country acquiesces in the reality that a trust country simply has first bite at income passing through a resident entity. The wider view may be more generous than a tax treaty.[245]

International non-taxation may arise if the residence country of the trust has a wider view of beneficiary attribution than that of the beneficiary, such that each attributes particular current trust income to the other's resident, particularly if the income escapes significant source taxation. Of the surveyed countries, the United Kingdom has the narrowest beneficiary attribution rule. The conventional first line of defence against exploitation of such differences is a distribution-taxing rule in the beneficiary's country (Chapter 5).

Beneficiary–grantor: Whether foreign grantor taxation is creditable to a resident beneficiary has received little explicit consideration in the surveyed countries. The United States has considered the issue, and its Congress has crafted a rule, but steps necessary to implement the rule have never been taken. Analysis of the foreign tax credit rules of the other surveyed countries suggests they would recognize grantor taxation as potentially creditable in most circumstances.

Non-taxation may arise if the beneficiary's residence country takes a wider view of grantor attribution than the grantor's country does. This has been considered in Chapter 2 under the rubric of inbound grantor settings (Section 2.4). The commonest defence against exploitation is a rule in the beneficiary's country selectively limiting or turning off its rules of inbound grantor attribution. The UK[246] and Australian[247] solutions appear preferable to the US approach,[248] which leaves significant scope for engineered outcomes in which foreign-sourced trust income reaches US beneficiaries without attracting substantial income tax in the United States or other countries. It is arguable that the reverse hybrid mending rules proposed by the BEPS Action 2 Report call for the US lacuna to be closed down.[249]

245 See OECD Model Arts 7(1), 21, 24(3).
246 See n 103.
247 See n 104.
248 See n 102.
249 Considered in Section 7.2.2 (see n 442).

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3.4 Summary

This chapter began by identifying a primary distinction between inclusive and limited beneficiary attribution of trust income that is not subject to overriding grantor attribution (Section 3.1). The United Kingdom applies a limited paradigm of beneficiary attribution, which only applies to trust income to which the beneficiary has an a priori trust-law entitlement. The entitlement must also be proprietary; this requirement is explained by legal history and does not reflect any particular fiscal policy. UK beneficiary attribution does not apply to trust-level capital gains. The other surveyed countries follow an inclusive paradigm under which the discretionary appointment of trust income supports current beneficiary attribution. The US treatment of capital gains is mixed between inclusive and limited attribution. New Zealand generally does not tax capital gains.

Countries that apply an inclusive paradigm are exposed to a risk that tax consequences may be manipulated if the discretionary trust-law allocation of particular items carries with it the fiscal attributes of those items, including income classification and source. This is tolerated or counteracted to varying degrees. Australian tax law goes to great lengths to recognize the discretionary allocation of capital gains and (generally Australian) franked dividends but otherwise apportions tax-law trust income on a proportionate basis by tax-law formula. The United States generally follows trust law for fixed entitlements under the terms of the trust and applies a proportionate tax-law formula otherwise. New Zealand generally follows trust law item by item, but switches to a tax-law accounting formula in limited circumstances involving particular international elements.

Differences of attribution may arise between countries that apply limited and inclusive attribution paradigms. Such differences may also arise among countries that apply an inclusive paradigm due to differences in their particular attribution rules, including differences of attribution among beneficiaries. These are in addition to differences of attribution where one country applies grantor attribution. The resulting attribution conflicts may be positive, in the sense that the same income is attributed to different persons or entities in different countries, or negative, where the same item is to some extent attributed to nobody. The former implies double taxation; the latter implies a degree of global non-taxation, at least on a current basis.

Countries that apply a limited attribution paradigm must consider whether to integrate taxation of the trust entity with taxation of beneficiaries. If entity taxation is final, a degree of over- or under-taxation is

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implicitly tolerated, depending on the respective tax rates – this is the general UK position for capital gains, which are taxed to the entity at the top capital gains tax rate. Otherwise, the country must apply a second layer of taxation on distribution from trust to beneficiary and must also decide what model of integration to use. These issues are considered further in Chapter 5.

Regardless of whether a country applies inclusive or limited beneficiary attribution, foreign income accumulated in a foreign trust is not currently taxed, although it may find its way into the hands of a resident beneficiary by subsequent distribution. Such income is generally beyond the reach of taxation based on current attribution of trust income. If it is to be reached in an economic sense, the most obvious strategy is to impose a form of outbound taxation on distributions (Chapter 5). The UK outbound beneficiary rule for capital gains taxation may be seen as an amalgam of current and non-current taxation of trust-level gains (Section 3.3.2).

The second major section of this chapter considered the inbound taxation and conduit relief of beneficiary-attributed income. General conclusions in that area have been summarized in Section 3.2.6. There is considerable differentiation in the general inbound taxation of different classes of income, and corresponding differentiation in a trust context combines with the separate and inherent conceptual complexities of taxing trust income to compound the risk of anomalies arising within a single tax system, as well as in its interaction with other tax systems.

Internal consistency and parity of treatment between non-resident beneficiaries and non-resident investors generally is identified as necessary to avoid international anomalies.

One matter of significance is whether a trust-level business structure – particularly a taxable presence of the trust, corresponding in a treaty context to a PE – is attributed to a non-resident beneficiary in circumstances where income derived through that structure is so attributed. The issue is particularly acute in relation to DIR income (Section 3.2.4). The United States is internally consistent on this point, but the other surveyed countries are not. A related issue is whether beneficiary-attributed DIR income is taxed on a net basis at the same rates as business income where it is derived through a trust-level taxable presence, which would be a rational setting and would generally avoid international anomalies of double taxation or non-taxation, or on a gross basis at the same rates (leaving aside the impact of tax treaties) as if it had been derived by a non-resident without a taxable presence.

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The third major section of this chapter considered outbound beneficiary taxation and round-trip situations, conclusions on which have been summarized in Section 3.3.5. Residence–residence attribution conflicts have been identified as a major issue in this area. They may arise between the residence countries of a beneficiary and of another beneficiary, the trust or a grantor. Negative conflicts, such that no country attributes particular trust income to its resident, result in global non-taxation, save such tax as may be imposed at source or on distribution. If these are to be avoided, countries need to consider the impact of their attribution rules both on their own tax bases and on the tax bases of other countries, identified or unidentified. This is one of the themes of the BEPS project work on hybrids, considered further in Chapter 7.

Outbound beneficiary taxation also raises the question of double tax relief for foreign taxation of the beneficiary, the trust or the grantor. The surveyed countries generally grant credit in the first two cases without difficulty, subject to local variations of a general or trust-specific kind. Their approaches to beneficiary credit for foreign grantor taxation have not been fully articulated. The United States provides for limited credit in its statute but gives no credit in fact because the necessary regulations have never been promulgated. The other surveyed countries appear to allow such credit.

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4

The Trust

This chapter considers the trust as taxable subject. Section 4.1 establishes the trust entity as a taxpayer responsible for trust-attributed income. Section 4.2 propounds a view of trust residence as the essential criterion for worldwide taxation of trust-attributed income by the country in question, examines the conditions for trust residence in each of the surveyed countries, and proposes an explanation for their diversity. It identifies a degree of complementarity between grantor attribution and trust residence. Sections 4.3 and 4.4 consider inbound and outbound settings for the taxation of trust-attributed income, including the availability of double tax relief for foreign taxation of trust participants. Section 4.5 summarizes these findings and their international tax significance.

4.1 The Trust Entity and Trust Attribution

Any claim to tax trust income that is not currently attributed to beneficiaries and/or a grantor and is not taxed on a purely impersonal basis (which is not feasible for all kinds of income) must identify a taxpayer on whom the fiscal obligation is to fall. A claim to tax such income requires a taxpayer who is not just being taxed as a representative for a particular beneficiary or grantor. Each of the surveyed countries recognizes this and identifies a taxpayer that is fiscally responsible for such income. In the United States, it is the trust;[250] elsewhere, it is the trustees collectively.[251]

[250] A trust is defined as a person for US tax purposes: IRC s 7701(a)(1). The primary tax obligation is imposed on the trust as a fiscal person by s 641.

[251] *Australia*: The trustees are conceived as a separate, collective entity: ITAA 1997 s 960-100(2). The trust is also said to be an entity (s 960-100(1)(f)); the rationale for doubling up in this is obscure. *United Kingdom*: The trustees are treated as a notional single person, distinct from themselves in any other capacity: ITA UK s 474; TCGA s 69(1). *New Zealand*: The trustees are treated as a notional single person: ITA NZ s HC 2(2); cf s YA 5.

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In each case, that taxpayer and, directly or indirectly, the revenue authorities have access to trust assets for the satisfaction of the taxpayer's fiscal responsibilities,[252] and it is envisaged that trust assets will fund the payment of tax. In each case, the taxpayer's fiscal obligations fall personally on the trustees for performance, although there is variation on the question whether and how their personal liability is limited by reference to trust assets.[253] In those countries which designate the trustees as the responsible taxpayer, the tax affairs of any particular trust and the trustees' corresponding liabilities are aggregated as such and quarantined from their tax affairs personally or in any other capacity.[254]

From this matrix, it may be concluded that the designated taxpayer, which may also be referred to as the **trust entity**, is made fiscally responsible on behalf of the trust as a whole. Trust income that is not attributed to a beneficiary or grantor, but is the fiscal responsibility of the trust entity on behalf of the trust, is fiscally **attributed to the trust** as a whole. Although the present study only addresses four countries, it is anticipated that these propositions and conclusions will be found to apply generally in countries that recognize the trust in their tax law and make special provision for trust taxation.

[252] General trust law is the starting point, by which trustees have the right to apply trust property to discharge obligations properly incurred in discharging their trust and a corresponding right of indemnity if they have done so from their own assets, and by which the trust creditors of trustees have subrogation to the trustees' indemnity. See, e.g., *Octavo Investments Pty Ltd* v *Knight* (1979) 144 CLR 360, 371; *Levin* v *Ikiua* [2011] 1 NZLR 678, [53]; *Trustee Act 1956* (NZ) s 38(2). The rights of an unsecured trust creditor are stronger in the United States than elsewhere: see Nuncio D'Angelo, 'The Unsecured Creditor's Perilous Path to a Trust's Assets: Is a Safer, More Direct US-Style Route Available?' (2010) 84 *Australian Law Journal* 833; NZLC R130 Recommendations 47, 48. Australia supplements the general law with statutory rights: ITAA 1936 s 254.

[253] Australia and the United States limit the trustees' liability; the United Kingdom and New Zealand do not. This is not surprising – the obvious premise is that the trust has income, which they control. *Australia*: ITAA 1936 ss 99, 99A, 254. By s 254(1)(e), a trustee is liable 'to the extent of any amount that he or she has retained, or should have retained' from trust assets for tax. *United States*: Responsibility falls on the trustees for the application of trust assets to pay trust tax, with personal liability if they default. Trustees are not equated with the fiscal person of the trust, but are each included in the concept of a 'fiduciary' (IRC s 7701(a)(6)) and in that capacity incur personal obligations if they fail to apply trust property in payment of tax (see s 6901(a)(1)(B); 31 USC s 3713(b)). *United Kingdom* and *New Zealand*: See n 251.

[254] *Australia*: ITAA 1936 s 254(1)(b), ITAA 1997 s 960-100(2). *United Kingdom* and *New Zealand*: See n 251.

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4.2 Trust Residence

The international claims to tax asserted by each of the surveyed countries share a number of features:[255]

- Income of a resident is taxable on a worldwide basis.
- Residents are entitled to double tax relief by foreign tax credit.
- Income of a non-resident is only taxable on a source basis.
- Dividend, interest or royalty income of a non-resident is taxable by final withholding unless it is sufficiently connected with a local permanent establishment or similar taxable presence.
- Capital gains of non-residents are taxable on a modified and generally more limited quasi-source basis.[256]

Each country claims to tax income attributed to a trust on either a worldwide basis or a source basis in a way that replicates the residence/source distinction. This requires a criterion that is functionally equivalent to the residence of a natural person. The need for such a connection proceeds from the international paradigm and is independent of whether the trust entity is conceived as the trust or the trustees. It need not be called 'residence', although it is convenient and usual to use that term.[257]

A **trust** may therefore be said to be fiscally **resident** in a country if income attributed to it is taxable by that country on a worldwide basis; conversely, it may be said to be fiscally non-resident if such income is taxable only on a source basis.[258] Countries differ in their enthusiasm to claim a trust as resident and in the criteria by which they do so. The particular settings they choose reflect a diversity of factors – desire to prevent international avoidance, desire to accommodate the commercial

[255] There are variations, of course: the United States includes citizenship as a basis for worldwide taxation, the United Kingdom relaxes residence taxation by allowing a remittance basis in some cases, and corporate taxpayers in a number of countries and situations may have double tax relief by exemption rather than credit. There are many other differences at lower levels of generality.

[256] To the extent that capital gains are taxed at all. Again, there are local variations.

[257] No trust or non-human entity has 'residence', save as a creation of positive law. If a trust is identified as a taxpayer, it makes sense to define its liability for worldwide taxation by reference to something called 'residence', but that concept must then be given content by tax law.

[258] This terminology is usual in both Australia and the United Kingdom, although their statutes generally speak of the residence of the trust estate or of the trustees, and both conceive of the trustees collectively as the entity that is fiscally responsible for income attributed to the trust.

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interests of local professionals who provide trust services, the reach of the country's grantor tax rules and the country's perception of the role of the trust.

4.2.1 Australia

Australia takes a moderately expansive approach to the designation of a trust as resident. Taxation on a worldwide basis applies if the trust estate is resident (in the case of trust-attributed income) or if the trust is 'resident for CGT purposes' (in the case of trust-attributed capital gains).[259] In most situations, fiscal residence of any trustee or central management and control of the trust in Australia qualifies the trust for fiscal residence.[260] If the trust is fiscally non-resident, the claim to tax items attributed to the trust is limited to income with Australian source and gains that would be taxable to a non-resident, but Australian DIR income which would ordinarily attract final withholding if derived by a non-resident is taxable by assessment at trust rates;[261] this implies a higher tax burden, at least in the absence of relevant deductions. The broad residence test dates from a time when Australia had no effective grantor attribution rule and may be seen as a measure to protect the national tax base.[262] The Commissioner has recently had some success in establishing central management and control of companies in Australia despite their ostensible management abroad.

[259] For income, see ITAA 1936 ss 99, 99A. For capital gains, see ITAA 1997 ss 115-222, 855-10.

[260] ITAA 1936 s 95(2) (definition of 'resident trust estate'); ITAA 1997 s 995-1 (definition of 'resident trust for CGT purposes'). A different CGT definition apples in the case of a unit trust. A unit trust is a resident trust for CGT purposes if, within the year, (a) any trust property is situated in Australia or the trust carries on a business in Australia and (b) the central management and control 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. The concept of a unit trust is undefined.

[261] ITAA 1936 s 128B(3)(d), (e), cf s 128D. This setting may be overridden if Australia has an appropriately worded tax treaty with another country that taxes the same income to a resident of that country (most likely the trust or a grantor).

[262] The definition dates from 1979, when Australia had no specifically outbound grantor rule and hence no effective grantor rule at all (see n 74 and corresponding text regarding ITAA 1936 s 102 and *Truesdale* v *FCT* (1970) 120 CLR 353). In order to accumulate foreign income in a trust without Australian tax, an Australian grantor had to incur the greater inconvenience and risk of fully offshore trustees and the absence of central management and control in Australia. More prosaically, the central management and control criterion replicated an alternate element in the definition of corporate residence (ITAA 1936 s 6(1), definition of 'resident').

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This suggests that trust residence may not be avoided so easily as used to be thought possible by the largely formal device of employing a compliant and perhaps related offshore trustee.[263]

4.2.2 United States

The United States takes a moderately restrictive approach to the recognition of a trust as fiscally resident. It designates a trust as a US person and hence as taxable on worldwide income[264] if a US court 'is able to exercise primary supervision over the administration of the trust' and US persons 'have the authority to control all substantial decisions of the trust.'[265] This is referred to as a domestic trust;[266] any other trust is 'foreign'.[267] It is relatively easy to ensure that a trust has foreign status, such as by giving a foreign resident a veto over just one class of substantial decision, even if all its other connections – its proper law, assets, administration and beneficiaries – are in the United States. The rule deliberately creates a bias in favour of foreignness and enables those associated with a US-based trust to ensure that it is foreign.[268] Resident trust status may be seen as desirable because it removes the risk of specifically outbound grantor taxation.[269]

To the extent that entity-level income is attributed to a foreign trust and not to its beneficiaries (i.e., after distribution deductions), it is taxable by analogy with a non-resident alien individual who is never present in the United States.[270]

[263] Compare *Bywater Investments Ltd* v *FCT* (2016) 260 CLR 169 with *Esquire Nominees Ltd* v *FCT* (1973) 129 CLR 177.

[264] 'United States person' (IRC s 7701(a)(30)) or 'US person' is a catch-all term for residents, citizens, domestic corporations and other fiscal persons taxable on worldwide income.

[265] IRC s 7701(a)(30)(E).

[266] 26 CFR s 301.7701-7(a)(2). The term 'domestic trust' is not defined in the principal statute but is the implicit converse of a foreign trust.

[267] IRC s 7701(a)(31).

[268] See Bruce, n 25, 36–42; Carlyn S McCaffrey, Ellen K Harrison and Elyse G Kirschner, 'US Taxation of Foreign Trusts, Trusts with Non-US Grantors and Their US Beneficiaries' (2000) 26 *ACTEC Notes* 159, 159–162.

[269] Contrast IRC s 679 with ss 673–677. A non-grantor trust under the domestic rules becomes a grantor trust under s 679 if the trust is foreign, the grantor is resident, and US persons are not excluded as beneficiaries.

[270] IRC s 641(b). Foreign trust income effectively connected with a US trade or business is taxable by assessment at trust rates (ss 1(e), 641(a)); other fixed or determinable US source income (including dividends, interest and royalties) is taxable on a gross basis at the rate applicable to the hypothesized non-resident alien (s 871), which is 30% unless

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4.2.3 United Kingdom

The overall effect of the UK trust residence rules is not particularly expansive or restrictive, and the outcome is readily controllable by the grantor or others associated with the trust. If all trustees are themselves UK resident, the trust entity is fiscally resident; if they are all non-resident, the entity is non-resident. For that purpose, a professional trustee acting in the course of business carried on through a UK branch office is taken to be resident. If the trustees have mixed residence, they are collectively resident only if a grantor (settlor) meets a further condition. If the relevant settlement arose on the grantor's death, such as by a testamentary trust, the condition is satisfied if he or she was then resident or domiciled in the United Kingdom. Otherwise, the condition is satisfied if a grantor was so resident or domiciled at the time of the settlement.[271] In broad terms, disregarding migration of the grantor and assuming congruence between the grantor's residence and domicile, a trust settled by a UK resident is treated as non-resident if all the trustees are offshore but as resident if there is at least one UK trustee, while a settlement by a non-resident is treated as non-resident if it retains at least one foreign trustee.[272]

Income attributed to a non-resident trust is generally only taxed on a source basis. The United Kingdom ordinarily limits its claim to tax dividends, interest, royalties and other items of 'disregarded income' in the hands of a non-resident trust in the same way as in the hands of non-resident investors generally:[273] no further tax is chargeable than has already been actually or notionally paid, deducted or withheld at source. This relief is subject to an exception for possible round-trip situations: it only applies if the trust has no actual or potential beneficiary that is a resident individual or company.[274]

reduced or eliminated by special concessions (such as the portfolio interest exemption) or treaty. The point of treating the foreign trust as never present is to avoid anomalous outcomes that might otherwise arise or be manufactured under particular rules that can apply to non-resident alien individuals if they are present in the United States. See Bruce, n 25, 37–38.

[271] ITA UK s 476; TCGA s 69(2B), (2C); cf the deemed domicile provision in ITA UK s 835BA and TCGA s 69(2F), added by FA (No 2) 2017 s 29, which also affects these provisions. In the case of a living grantor, the person must not have ceased to qualify as a 'settlor'.

[272] See Loutzenhiser, n 53, §69.9.

[273] ITA UK s 811(1).

[274] ITA UK s 812. The section has its own definition of a beneficiary, wide enough to catch potential discretionary objects that may receive or benefit from trust income, including income that has been converted to corpus. This implies that, if it is intended that a

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4.2.4 New Zealand

New Zealand approaches trust residence in a strikingly different way.[275] Its main criterion for worldwide entity taxation is the current residence of a grantor (settlor). New Zealand taxes income attributed to the trust (trustee income) on a worldwide basis if

(a) a grantor has been resident other than transitionally at any time within the relevant year and did not die in that year, and one of the following is also true: (i) that grantor is not an individual; (ii) that grantor has made a statutory election to pay tax on trust-attributed income which applies at the relevant time; (iii) a trustee has been resident within the relevant year; or (iv) within the period after 17 December 1987, a person has made a settlement on the trust who was resident at the time of the settlement or had previously been resident within that period; or
(b) a grantor has died resident in or before the relevant year and a trustee has been resident within the year.[276]

For brevity, this will be referred to as the **settlor nexus**. New Zealand tax law does not express these criteria as trust residence or residence of the trust entity and has no express concept of trust residence at all.[277] The settlor nexus serves as a test of functional but not explicit trust residence for purposes of current taxation. Income attributed to a trust that satisfies that nexus is generally taxed on a worldwide basis; trust-attributed income of a trust that does not satisfy it is generally taxed on a source basis.

non-resident accumulation or discretionary trust invest back into the United Kingdom, care should be taken to preclude UK residents from potential benefit. If a grantor intends to benefit both foreign and UK residents by UK trust investments, separate trusts should be used.

[275] The present rules generally date from 1988. See Brabazon, *Trust Residence*, n 152, for a fuller account of the subject matter in this section.

[276] Derived from ITA NZ s HC 25(2) as qualified by s HC 25(4) as further qualified by s HC 25(5)(a) in conjunction with ss HC 29 and HC 33; see ibid, §3.2. Section HC 33 permits inter alia a grantor (settlor) to elect to be personally responsible for the trustees' income tax liability. An immigrating grantor who makes a timely election (s HC 31) can avoid adverse tax treatment of subsequent trust distributions to New Zealand beneficiaries.

[277] The original proposal to adopt grantor residence as the criterion for worldwide taxation of income attributed to a trust would have characterized that nexus between the grantor and New Zealand as trust residence. The terminology of trust residence was dropped at a later stage of the design process, but the substance and intent of the rule were retained. See Brabazon, *Trust Residence*, n 152.

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As a matter of fiscal policy, New Zealand regards the trust as an economic agent of the grantor,[278] except to the extent that trust income is currently vested in or distributed to beneficiaries. This idea, or something like it, has motivated other countries to adopt rules of grantor attribution and grantor taxation, particularly in an outbound context (where the grantor is resident and the trust is fiscally non-resident), but New Zealand keeps the focus of its claim to tax on the trust. The problem that the trustees may be offshore and difficult to tax is addressed by imposing liability on the resident grantor as deemed agent for the trust entity, with a statutory right of indemnity.[279]

What other countries achieve by grantor attribution, New Zealand does by functional trust residence.

The New Zealand approach of focusing on the residence of the grantor is more objective and less manipulable than the trust residence rules of the other surveyed countries. It has nevertheless given rise to international avoidance opportunities insofar as a foreign grantor may transfer foreign assets, often in a third country, to New Zealand trustees without attracting a New Zealand claim to tax resulting income and, if the grantor's country does not find out about the arrangement or does not have a rule of grantor taxation or trust residence that claims to tax the trust income, without tax in that country. This outcome does not reflect any manipulability in the rule itself, but a mismatch between tax systems due to differences between the New Zealand rule and corresponding rules in other countries,[280] combined with historically weak disclosure and reporting rules in New Zealand.[281] Legislation tightening

[278] Prebble, *NZ 1999 International*, n 158, 399; Brabazon, *Trust Residence*, n 152.

[279] ITA NZ ss HC 29, HD 5(2), HD 12(2). This paradoxically reverses the direction of the fiscal policy agency.

[280] Specifically, if the other country does not tax its resident grantor or a trust capitalized by a resident grantor on income that is not currently attributed to a beneficiary. The other country could prevent legal international tax avoidance by trust attribution based on grantor residence (as in New Zealand) or by outbound grantor attribution (as in Australia, the United States or the United Kingdom). Where the grantor is resident in one of those three countries, legal avoidance depends on finding a gap in its grantor rules.

[281] See Elliffe, n 218, §2.7.2(1); John Prebble, 'The New Zealand Offshore Trust Regime' [2009] *International Financial Centre Review* 134; Brabazon, *Trust Residence*, n 152, §3.6. It attracted widespread criticism, particularly after the publication in 2016 of the 'Panama papers', a trove of confidential documents of the law firm Mossack Fonseca. See, e.g., Michael Littlewood, *Using New Zealand as a Tax Haven: How Is It Done? Could It Be Stopped? Should It Be Stopped?* (11 April 2016) available at SSRN: http://ssrn.com/abstract=2761993; Mark J Bennett, 'Implications of the Panama Papers for the New

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the reporting rules was passed in early 2017[282] and has already led to a significant reduction in the number of New Zealand-based trusts with foreign grantors.[283] Subsequent policy announcements responding to the BEPS project indicate an intention to expand the scope of functional trust residence and trust attribution with respect to income that would otherwise escape foreign residence-country taxation due to the interposition of those trustees between the income and the beneficiary or grantor.[284]

The general rules for worldwide and source-based taxation of trust-attributed income do not, however, apply to New Zealand–sourced dividend, interest and royalty income. The settlor nexus is not consulted by the non-resident withholding tax rules, which apply wherever such income is derived by a non-resident. That income is taxable by assessment if the trustees are personally resident, even if the grantor is not. If the trustees are personally non-resident, it is taxable by final or minimum withholding as if derived by a non-resident, even if the grantor is resident. Non-resident trustees have access to zero rating of interest withholding or foreign investor tax credits for dividends in the same way as non-residents generally.[285] The position is more complicated if the trustees have mixed residence.[286]

Zealand Foreign Trusts Regime' (2015) 21 *New Zealand Association of Comparative Law Yearbook* 27. The New Zealand government responded by commissioning a review, which recommended changes to the reporting requirements: John Shewan, *Government Inquiry into Foreign Trust Disclosure Rules* (New Zealand, Treasury, June 2016) www.treasury.govt.nz/publications/reviews-consultation/foreign-trust-disclosure-rules.

282 *Taxation (Business Tax, Exchange of Information, and Remedial Matters) Act 2017* (NZ). When the legislation is fully effective, resident trustees who fail to comply with their registration and reporting obligations will be taxable as if the trust were fiscally resident (see ITA NZ s HC 26(1)(c).

283 Michael Littlewood, *Using New Zealand Trusts to Escape Other Countries' Taxes* (13 July 2017) available at SSRN: https://ssrn.com/abstract=3002172.

284 See n 443 and discussion of BEPS Action 2 Report, recommendation 5.2 in Section 7.2.2.2.

285 See Brabazon, *Ariadne*, n 235. The non-resident withholding rules are in ITA NZ subpart RF. If withholding applies on a minimum basis (applicable to interest between associated parties and non-copyright royalties) and the amount withheld is less than would be payable on assessment, the quantum of tax is determined by assessment. In the case of trustees, this is at the trust rate. The foreign investor tax credit arises under subpart LF; the approved issuer levy arises electively under the *Stamp and Cheque Duties Act 1971* (NZ) Part 6B and the TAA NZ s 32M.

286 It appears that joint derivation by persons of mixed residence status prima facie attracts non-resident withholding tax but that, in the case of interest income, a special tax rate applies (s RF 12B), and zero-rating by reference to the approved issuer levy is not

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4.3 Inbound Settings

The treatment of income attributed to a non-resident trust has been described in the previous sections. What follows is a summary.

- Australia taxes on a source basis by assessment. Finality of withholding tax on DIR income is denied.
- The United States taxes on a source basis by assessment or final withholding, by analogy with the treatment of a never-present non-resident alien.
- The United Kingdom taxes on a source basis by assessment or final withholding; the latter can only apply if the trust has no actual or potential UK beneficiary.
- New Zealand taxes general income on a source basis by assessment. It taxes DIR income by assessment if the trustees are personally resident, or by final or minimum withholding (as the case requires) if they are personally non-resident, even if the settlor nexus is satisfied.

4.4 Outbound Settings

In each of the surveyed countries, foreign taxation of income attributed to a resident trust attracts double tax relief by foreign tax credit. In New Zealand, non-resident trustees are deemed resident for foreign tax credit purposes if the settlor nexus is satisfied.[287] In each country, an entity representing a resident trust that has paid foreign tax can claim the credit directly, in the same way and subject to the same restrictions as an ordinary resident.[288]

available (s RF 12(1)(b)(4)). See Brabazon, *Ariadne*, n 235, §5.1. On the question of mixed trustee residence, see Brabazon, *Trust Residence*, n 152, §3.5.3; for a contrary view, see Alison Pavlovich, 'Trustee Tax Residence in New Zealand: Is It Relevant and How Is It Determined?' (2015) 21 *New Zealand Journal of Taxation Law and Policy* 317.

[287] ITA NZ s HC 25(6)(b); Elliffe, n 218, §3.3.2(2). This reflects the logic of the settlor regime. The statute must be read carefully in order to reach the right result. The deeming in s HC 25(6) applies '[f]or the purpose only of calculating the taxable income of a trustee referred to in [s HC 25(2)], and not otherwise'. The foreign tax credit is not granted by sub-s (2), but neither does it contain a calculation of 'taxable income'. It is evidently contemplated that foreign tax credit may be allowed in calculating taxable income resulting from 'assessable income' under s HC 25(2). No other reading of s HC 25(6) makes practical sense.

[288] *Australia*: ITAA 1997 s 770-10 (the general rule). *United States*: IRC s 642(a) (picking up the general rule in s 901). *United Kingdom*: TIOPA Part 2, esp s 9 (the general unilateral rule) subject to s 11 (where there is a tax treaty). *New Zealand*: ITA NZ s LJ 2 (the general rule).

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The general foreign tax credit settings in the surveyed countries have been considered in the context of beneficiary taxation in Section 3.3.3. In Australia, the credit excludes items on which the foreign country taxes the Australian taxpayer on a residence basis if their source is not in the foreign taxing country.[289] In the United Kingdom, the income or gain by reference to which tax is calculated must arise or accrue in the foreign taxing country.[290] In New Zealand, if the foreign tax is imposed on its resident taxpayer on the basis of citizenship, residence or domicile, the credit is limited to foreign tax that would have been payable without those characteristics.[291] The United States limits its foreign tax credit in a different way.[292]

It may happen, however, that a foreign country attributes an item of trust income or gain to a grantor or a beneficiary and taxes that person. It may tax that person on a residence or source basis, depending on the particular facts and its own international trust tax settings. In these circumstances, is the trust entitled to foreign tax credit in its country of residence (or functional residence)? There is little direct authority on the subject.

In the case of grantor taxation, the answer appears to be 'yes' in the United Kingdom and New Zealand, which do not require identity of taxpayer. They focus instead on identity of the item that is taxed or by reference to which the tax is calculated in the countries concerned. Australia requires identity of taxpayer but has a special rule deeming 'you' to have paid foreign tax on an Australian-taxed amount if the foreign tax is 'paid in respect of the taxed amount by another entity … under the law relating to the foreign income tax'.[293] The US legislation

[289] ITAA 1997 s 770-10(3) provides: 'An amount of foreign tax you paid does not count towards the tax offset … if you paid it: (a) to a foreign country because you are a resident of that country … and (b) in respect of an amount derived from a source outside that country.' This is evidently addressed to the taxpayer whose entitlement to credit is in issue.

[290] TIOPA s 9(1), (2).

[291] ITA NZ s LJ 2(4).

[292] IRC s 904. Credit entitlement does not depend on the source of income that attracts the foreign tax, but the tax credit in any year is limited to the taxpayer's average US tax rate multiplied by his or her foreign-sourced income.

[293] ITAA 1997 s 770-130(2). The term 'entity' in Australian tax law includes an individual as well as other legal persons and purely fiscal entities: s 960-100. In contrast to s 770-130 (3), which applies to beneficiaries (see n 1061 and corresponding text), sub-s (2) does not require the 'taxed amount' to be reduced by the foreign tax. (Section 770-130(2) also removes any doubt that might otherwise arise where foreign tax is imposed on the trust

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contemplates beneficiary credit for grantor taxation if the United States would itself have applied grantor attribution in a comparable but purely domestic situation, but (as has been observed earlier) the regulations that would be needed to make the credit available have never been promulgated; if that were to happen, it might be argued that similar credit should be available to a US trust.[294]

In the case of foreign beneficiary taxation, the same rules and reasoning support trust-entity credit in Australia, the United Kingdom and New Zealand, but the Internal Revenue Service takes the view that foreign tax imposed on beneficiaries is not creditable to their trust in the United States.[295]

The granting of trust-level credits in Australia and New Zealand for foreign grantor or beneficiary taxation attracts a further consequence. The statutory limitations of the credit by reference to foreign residence-based or analogous taxation[296] are so worded that they only appear to apply where foreign taxation is imposed on the taxpayer seeking credit. This implies that taxation of the trust in Australia or New Zealand may be ameliorated by credit for foreign residence-based taxation of a grantor or beneficiary. In that sense, Australian or New Zealand residence-based taxation of the trust defers to foreign residence-based grantor or beneficiary taxation. The UK rules imply a similar deferral, but only if the income arises or the gain accrues in the other country. The US rules do not materially distinguish between residence- and source-based taxation in the other country.

entity as conceived by the foreign country, but that conception is not identical to the Australian trust entity concept.)

[294] The United States allows credit to a resident trust on qualifying foreign taxes 'to the extent allowed by section 901' and only to the extent that those taxes are not 'properly allocable . . . to the beneficiaries' (IRC s 642(a)). Trusts are not among the fiscal persons mentioned in s 901(b)(1)–(4), and s 901(b)(5) only deals with the entitlement of a beneficiary in a trust. The second sentence of that provision contemplates credit for grantor taxation, limited as mentioned in the principal text above; see n 1066, 1067 and corresponding text. It seems reasonable to suppose that the approach of both allowing and limiting credit for foreign grantor taxation would be applied to a resident trust. It would not make sense to have different rules for trust-attributed and beneficiary-attributed income.

[295] IRS, Technical Advice Memorandum 9413005 (1994); cf Howard Zaritsky, Norman Lane and Robert T Danforth, *Federal Income Taxation of Estates and Trusts* (Thomson/Westlaw, electronic looseleaf) (at 27 December 2017) [2.11[3]]. Contrast the allowance of credit to US beneficiaries under IRC s 901(b)(5) where foreign tax is imposed on the entity.

[296] See n 289, 291.

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Table 4.1 *Foreign Tax Credit and the Resident Trust*

	Foreign Tax Imposed on		
Residence of Trust	Grantor	Beneficiary	Trust
Australia	✓	✓	✓
United States	×	×	✓
United Kingdom	✓	✓	✓
New Zealand	✓	✓	✓

The apparent general entitlement of a resident trust to foreign tax credits is summarized in Table 4.1.

4.5 Summary

This chapter began by establishing the need for an entity to represent the trust as a whole and to be fiscally responsible for trust income that is not attributed to a grantor or beneficiary. Such income is attributed to the trust itself. Assuming a residence/source paradigm of international taxation, it then identified the need for a criterion by which a claim to tax worldwide trust-attributed income may be asserted, and justified the recognition of that criterion as trust residence.

It next considered the trust residence criteria of each of the surveyed countries and identified a diversity of factors that influenced the different settings that they have each adopted. These include the amplitude of the country's grantor attribution rules, such that trust residence and grantor attribution perform complementary functions. A large claim in one area tends to be accompanied by a smaller claim in the other. This is represented visually in Figure 4.1.

It established that trust residence settings in Australia, the United States and the United Kingdom favour residence or non-residence in varying degrees and refer to criteria associated with the independent fiscal residence of trustees, the management or judicial oversight of the trust or (to a limited extent in the United Kingdom) the historical residence of the grantor. To varying degrees, trust residence in these countries was found to be controllable by trust participants. The New Zealand position was found to be radically different: residence criteria were less manipulable and were principally dependent on the residence of the grantor. Trust residence in New Zealand was found to perform the

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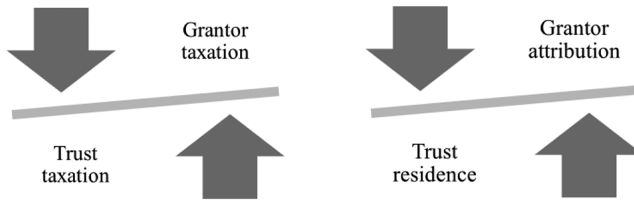

Figure 4.1 Correlation of Grantor and Trust Settings

same function as (outbound) grantor attribution in other countries, although taking effect only after beneficiary attribution.

The findings in this chapter also demonstrate a capacity for dual residence or the converse, fiscal homelessness, of a trust. The latter in particular may be used to produce global non-taxation, leaving aside such tax as may be imposed at source or on distribution.

This chapter also considered inbound and outbound settings for taxation of trust-attributed income. In an outbound context, it found that unilateral double tax relief for a resident trust in respect of foreign beneficiary or grantor taxation is considered not to be available in the United States but appears to be potentially available in the other surveyed countries. A caveat must be added that the point has not been authoritatively determined, nor has it attracted attention in those countries.

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5

Distributions

This chapter considers the taxation of distributions as income from a trust. Section 5.1 provides an overview and introduction to the domestic and international function of distribution taxation. Section 5.2 considers distribution taxation in Australia, the United States and New Zealand, as these countries approach the issue in comparable ways. Section 5.3 considers distribution taxation in the United Kingdom. Section 5.4 summarizes the findings of the chapter.

5.1 Overview

Two considerations dominate a country's settings for the taxation of trust distributions. One is domestic, the other international.

The domestic consideration is whether and how tax imposed on trust-attributed income should be augmented or relieved by reference to the tax rates of beneficiaries who receive distributions from the trust. The importance of this issue is affected by whether the country takes an inclusive or limited view of beneficiary attribution. In the latter case, a larger class of trust income is taxed at the trust rate, and the argument for integration is stronger. It is also affected by the relationship between the trust rate and the top personal tax rate. If the trust rate is at or near the top personal rate, the function of integration is to ameliorate the tax burden where a recipient beneficiary is in a lower tax bracket. If the trust rate is below the top personal rate, the trust offers an opportunity for domestic rate arbitrage unless a second layer of taxation is imposed on distribution and, if there is a second taxing point, for tax deferral. This explains the general preference for high trust rates. A country that takes an inclusive view of beneficiary attribution and also taxes trust-attributed income at the top rate may choose to ignore distribution as a taxing point, based on the self-help assumption that controllers of a trust will ensure that lower-bracket beneficiaries receive trust income in a way that attracts current attribution. This is the general domestic position in

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Australia, the United States and New Zealand. It has the simplifying advantage that income generated by a trust is only taxed at one point.

The international consideration is one of tax base protection. It applies regardless of whether the country takes an inclusive or limited view of beneficiary attribution and regardless of the rate at which it taxes trust-attributed income. If trust income is not attributed to a resident person or entity in the year of derivation but funds a distribution to a resident beneficiary, the only way to prevent erosion of the national tax base is by taxing distributions to the extent that they might represent such income.

If a country takes the view that trust income should be taxed on the basis of current attribution to a grantor, a beneficiary or the trust and that trust-attributed income should be taxed at the top personal rate, there is no need to tax distributions except as a complementary international measure to protect the tax base. If, on the other hand, it takes the view that entity taxation resembles a collection mechanism until trust income works its way through to a beneficiary as the ultimate taxpayer, then the taxation of distributions is integral to its domestic and international trust taxing rules.

Australia, the United States and New Zealand are broadly synoptic in this respect (Section 5.2). They apply distribution taxation as a complementary international measure, recognizing that trust income may be accumulated outside the reach of their primary current attribution regimes but later fund a distribution to a resident beneficiary, which they want to include in their national tax base.

The UK approach is fundamentally different (Section 5.3). It sees the trust as a potential source of income such that the distribution is an ordinary taxing point, not a complementary one. The taxation of distributions is integral to the general tax treatment of trust income. UK taxation of trust income and distributions is an amalgam of policies and concepts which are not clearly reconciled. This is particularly evident with respect to discretionary distributions, which attract heavy entity taxation of underlying trust income, tax imputation domestically and selective 'look-through'[297] treatment internationally. UK capital gains taxation of resident beneficiaries on foreign trust distributions, on the other hand, may be regarded as a form of complementary international distribution taxation.

[297] See n 326.

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5.2 Australia, United States and New Zealand

Australia, the United States and New Zealand adopt broadly similar approaches to the taxation of trust distributions.[298] The dominant paradigm in each of those countries treats trust income as an economic object that should be taxed once only, in the year of its trust-level derivation, on the basis of current attribution to a grantor, beneficiary or trust entity at that person's ordinary rate or, for trust-attributed income, at or near the top personal rate.[299] This leaves open the possibility that a non-resident trust[300] may accumulate foreign-sourced income that cannot be currently attributed to a beneficiary (because the beneficial destination of the income is undetermined) or to a grantor (who may be non-resident or otherwise outside the scope of grantor taxation) and is therefore attributed to the trust entity, but is not taxable to the trust entity because of its non-residence. If distributions are not taxed, the main paradigm can be subverted by a non-resident trust accumulating and capitalizing lightly taxed or untaxed foreign income, then later making equivalent distributions to a resident beneficiary free of tax. This may be done by design – and if the gap is not plugged, it certainly will be done by design – or without specific tax motivation. Corresponding to this concern, a strong anti-avoidance flavour is evident in the distribution taxing rules of the three countries mentioned.

Secondly, if trust income bears foreign taxation when it is derived, there is a lack of horizontal equity between the treatment of a resident beneficiary receiving a distribution of currently attributed foreign-sourced trust income (perhaps with foreign tax credit attached) and that of a similar beneficiary receiving a distribution supported by accumulated trust income unless the distribution is taxed. If the distribution is taxed, it is also necessary to decide whether and how to recognize any earlier foreign taxation of trust income. Analogous issues arise if original trust income came from a source in the beneficiary's country but was treated as income of a non-resident and consequently taxed more lightly.[301]

[298] The principal taxing provisions are ITAA 1936 s 99B, IRC s 667 and ITA NZ ss HC 18, HC 19.

[299] A high trust rate eliminates advantages that could previously be gained by accumulating income under lighter or progressive taxation of the entity and makes a second taxing point unnecessary.

[300] In New Zealand, a trust that is functionally non-resident due to not satisfying the settlor nexus.

[301] For example, by withholding at a lower effective rate of tax than would have applied to a resident, or by the application of a concessional regime for inbound investment.

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Thirdly, if trust-level income is untaxed or lightly taxed when it is derived and only bears substantial tax on distribution, there is a deferral benefit because the trust meanwhile has use of money equivalent to the tax liability. These concerns in different ways inform the distribution taxing rules of Australia, the United States and New Zealand.

5.2.1 *Taxable Distributions*

Australia expressly limits its distribution tax rules to resident beneficiaries. The US and New Zealand statutes have no equivalent limitation, but the practical and policy focus is on resident taxpayers; there seems to be no interest in pursuing non-resident beneficiaries and, in the case of the United States, the other applicable settings virtually negate the possibility of a non-resident incurring tax liability. Capital distributions from a trust are generally not taxable as such,[302] although in some cases the distribution of an appreciated asset may trigger recognition of a trust-level capital gain with its own tax consequences.

The United States generally only taxes distributions from a non-resident or formerly non-resident trust.[303] New Zealand generally[304] only taxes distributions from a trust that has historically derived income that is attributed to the trust entity and which either escaped New Zealand taxation on a residence basis or included New Zealand DIR income derived by personally non-resident trustees.[305] These two categories represent foreign-sourced income attributed to a functionally non-resident trust in the year of derivation and New Zealand–sourced income

[302] An Australian exception is CGT event E4, a complex provision which broadly speaking serves to recapture certain trust-level tax preferences on distribution to a beneficiary (see C John Taylor, 'The Movement of Tax Preferences through Trusts and the Causes of Tax Law Complexity' (2007) 36 *Australian Tax Review* 222), and will not be further considered here.

[303] IRC s 665(c)(A). (A small class of old domestic trusts is caught by s 665(c)(B).)

[304] Distributions from a trust that is not up to date with its New Zealand tax obligations are also taxable, but that consequence abates if the trust's obligations are subsequently met (see IS 18/01 [8.33]; IRD, *Explanation*, n 196, [4.80]; Inland Revenue Department, Policy Advice Division, *Taxation (Annual Rates, GST, Trans-Tasman Imputation and Miscellaneous Provisions) Bill – Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill* (2003) http://taxpolicy.ird.govt.nz/sites/default/files/2003-or-argtimp.pdf 195; Inland Revenue Department, 'Qualifying Trust Status: Section OB 1 of the Income Tax Act 1994' (2004) 16(1) *Tax Information Bulletin* 85, 85). This is a compliance lever rather than a substantive claim to tax.

[305] This is the broad effect of ITA NZ ss HC 18, HC 19 and HC 20 with ss HC 9–HC 12, HC 15 and HC 16.

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of a kind which, in many but not all cases, is taxed in New Zealand on a final withholding basis. Australia has no equivalent limitation, although non-resident and formerly non-resident trust distributions are recognized as the intended target of the distribution tax rule.[306]

Each country limits its claim to tax distributions by a tracing rule that associates the distribution with underlying trust assets or income. In each case, current-year trust income is or can be acquitted first and dealt with under the rules relating to current attribution.[307]

[306] *Traknew Holdings Pty Ltd* v *FCT* (1991) 21 ATR 1478, 1492 (Hill J); Explanatory Memorandum, Income Tax Assessment Amendment Bill (No 5) 1978 (Cth) p 17. It is clear, however, that the rule can have application in a small range of purely domestic circumstances, e.g., where a distribution represents income that a trust has accumulated without – for whatever reason – actually having been assessed on it (see ITAA 1936 s 99B(2)(c)(ii)).

[307] *United States*: The United States applies an historical reconstruction of the trust's accounts on (somewhat modified) US tax-law principles, matching distributions to hitherto undistributed tax-law trust income on a first-in first-out basis for years before the current year (IRC s 667). See Carlyn S McCaffrey and Elyse G Kirschner, 'Learning to Live with the New Foreign Nongrantor Trust Rules: The Rise of the International Trust' (1999) 32 *Vanderbilt Journal of Transnational Law* 613. See also Zaritsky, Lane and Danforth, n 295 (at 18 January 2018), §6.06; Bruce, n 25, 75–91.

New Zealand: New Zealand also applies an historical reconstruction method, subject to a number of qualifications. A distribution is taken to consist of elements determined under a combination of tax-law and trust-law principles. The general absence of capital gains taxation is also reflected in the tracing rule and the scope of the associated claim to tax. Historical trust income is acquitted before gains. If the trust has never had a resident grantor since the commencement of the present rules of trust taxation, the claim to tax is limited to distributions that are taken to consist of historical trust income attributed to the trust entity – broadly, accumulated income (ITA NZ ss HC 15(4), HC 18). If the trust has had a resident grantor for only part of its life (a resident grantor has emigrated; a non-resident grantor has immigrated; a trust with a non-resident grantor has acquired an additional grantor who is resident) and no trustee, beneficiary or grantor has made a timely election to be responsible for tax on worldwide trust-attributed income so that the trust continues or becomes (as the case may be) functionally resident (ss HC 10(1)(ab), HC 26(1)(c), HC 30, HC 33), the claim to tax also reaches distributions that are taken to consist of trust gains (ss HC 15(2), HC 19). For other qualifications, see ss HC 15(6), (7), HC 16(5)–(8).

Australia: Australia approaches the tracing exercise from an opposite perspective. Distributions are prima facie taxable (ITAA 1936 s 99B(1), cf s 99C), except to the extent that they represent items clearly outside the target area (s 99B(2)). The concept of representation is not defined and presumably allows trust-law tracing. Trust-level items that attract Australian taxation of a beneficiary, the trust entity or a grantor on the basis of current attribution generally support exclusion to the extent that they are represented in a distribution (s 99B(2)(c), (d), (e)). Trust corpus attracts exclusion to the extent that it is not attributable to items that would have been taxable to a resident, such as accumulated income or capital gains (s 99B(2)(a)). Trust-level items that would not be taxable if derived by a resident attract exclusion (s 99B(2)(b)).

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5.2.2 *Double Tax Relief*

All three countries recognize that a beneficiary may qualify for foreign tax credit where the foreign tax is imposed on the distribution itself.[308] They differ substantially, however, in their treatment of underlying tax on corresponding entity-level income or gains. The United States recognizes prior foreign taxation of the trust or the grantor under special rules modelled on its foreign tax credit provisions. It also credits prior US taxation, in case the trust has invested back into the United States.[309] In principle, this is the right approach, given the complementary function of distribution taxation. Australia excludes distributions representing trust-level items that have borne prior Australian taxation by current attribution, including (in most cases) attribution to a resident grantor. There is, however, no express relief and no foreign tax credit, for prior Australian withholding or foreign taxation of underlying income or gains; the practical result resembles tax relief by deduction.[310] New Zealand recognizes neither foreign tax nor prior New Zealand tax, even by deduction. No foreign tax credit is allowed for taxation of entity-level items, and the tracing rules make no provision for deduction of tax actually paid.[311] The anti-avoidance flavour of distribution taxation may perhaps explain the more heavy-handed Australian and New Zealand positions.

Australia has a separate rule by which a beneficiary who receives a distribution that is traceable to foreign-sourced trust-attributed income of an earlier period when the beneficiary was non-resident and on which the trust has paid Australian tax may claim a refund of that tax, net of adjustments such as foreign tax credits allowed to the trust.[312]

[308] Credit arises under the general rules in each country. New Zealand expressly limits qualifying foreign tax to that which is analogous to its own non-resident withholding tax (ITA NZ s LJ 6), perhaps because the 'treated as consisting' provision in s HC 16(2) might otherwise open the door to credit for underlying tax.

[309] See US sources cited in n 307.

[310] A distribution can only 'represent' what the trust has left after tax. See Australian sources in n 307.

[311] ITA NZ s LJ 6. This appears to be conceived as a rough and ready anti-deferral measure. See Consultative Committee on International Tax Reform New Zealand, *International Tax Reform, Full Imputation, Part 2 – Report of the Consultative Committee* (Ministers of Finance and Revenue, 30 June 1988) [6.11.9], [6.13.4].

[312] ITAA 1936 s 99D. The section requires that the trustees have been assessed and paid tax on tax-law trust income for a particular year and that they have also 'in accordance with the terms of the trust, paid an amount . . . of the [trust-law] income of the trust estate' for that year to a beneficiary who was non-resident in that year. The distributed amount must have been 'attributable to sources out of Australia' and also 'taken into account in

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Ex hypothesi, the trust must have been resident when it derived the income. The refund effectively converts final taxation of the trust into non-final withholding for the initially unascertained foreign beneficiary. The tax treatment switches from outbound to conduit. If income is derived in a country with which Australia has a tax treaty but the beneficiary's country does not, the rule allows the trust to become a vehicle for treaty shopping[313] unless prevented by treaty rules (Section 8.4) or overriding anti-avoidance principles.

5.2.3 *Throwback Interest*

The United States[314] and Australia[315] both apply calculated interest charges to an amount representing deferred tax. Australia limits this treatment to a subset of represented income – broadly speaking, that which has not been subject to tax in a listed country other than by

calculating' the tax-law income on which the trustees were taxed. The method for tracing particular trust income into the distribution is not further specified. This does not refer to a current distribution (see s 101) or other present entitlement of the beneficiary, for that would engage ss 98 and 98A: the mechanism in s 99D would be redundant in such a case. What is contemplated is trust attribution and taxation under s 99 or s 99A. This is confirmed by contemporaneous extrinsic evidence. Section 99D was conceived as a counterpart to the claim to tax resident beneficiaries on distributions in s 99B. Both measures were inserted by the *Income Tax Assessment Amendment Act 1979* (Cth) s 16. According to the Explanatory Memorandum, Income Tax Assessment Amendment Bill (No 5) 1978 (Cth) p 17: 'Where a non-resident beneficiary receives income paid out of the foreign source *accumulated* income of a resident trust estate that has been taxed in Australia in the trustee's hands, provision is to be made for the tax paid on that income to be refunded. A corresponding amendment is designed to ensure that any amount received by a resident beneficiary from or representing the accumulated foreign source income of a non-resident trust estate which has not been taxable in Australia in the hands of the trustee, but would have been so taxable had the trust estate been a resident trust estate, will be included in that beneficiary's assessable income in the year of receipt' (emphasis added).

313 Suppose an Australian resident trust derives income from S. The income is initially accumulated, attracting trust attribution and taxation under ITAA 1936 s 99A. Under the Australia-S tax treaty, S taxation of the income is prima facie precluded (e.g., as business income) or subject to rate limitation. In a later year, the trust appoints and distributes the income to a beneficiary resident in X, which does not have a tax treaty with S, and the beneficiary obtains a full refund of Australian s 99A tax.

314 IRC s 668. The US rules have been described as artificial, complex and arbitrary (Ascher, n 42, 154), as draconian yet avoidable (McCaffrey and Kirschner, n 307, 657).

315 ITAA 1936 s 102AAM.

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withholding or on certain designated concessional bases.[316] New Zealand originally proposed to apply an interest charge but opted instead for the simpler solution of a special 45% tax rate if the trust at some time had a resident grantor.[317]

5.3 United Kingdom

5.3.1 Income

The United Kingdom attributes trust income to a trust in a wider range of cases than the other surveyed countries. The taxation of trust-attributed income is integrated with taxation of the distributions or accumulations for which it is destined. To the extent that the income is required to support an annuity to which a beneficiary is entitled, it is taxed at the basic rate (currently 20%).[318] The annuity is then separately taxed as income of the beneficiary and attracts basic rate withholding tax which is non-final for a resident beneficiary.[319] To the extent that the income is accumulated or payable at discretion, the trust is taxed at the top rate,[320] and the tax is credited to a 'tax pool'. Discretionary distributions to a beneficiary are taxed as income of the beneficiary, but only if they are recognized as having income character,[321] grossed up (if the beneficiary is resident) with credit for corresponding tax from the

[316] See the definition of 'listed country trust estate' in ITAA 1936 s 102AAE and of 'subject to tax' in s 324 via s 102AAB. As mentioned in note 121, the listed countries are Canada, France, Germany, Japan, New Zealand, the United Kingdom and the United States (ITR 1936 reg 152C, Sch 10, via ITAA 1936 ss 320 and 102AAB), which are recognized as imposing tax on a comparable basis to Australia (Burns and Krever, n 112, 45).

[317] ITA NZ s HC 19(2), s BF 1(b) (special income tax liability), s HC 34, Sch 1 Part A cl 4 (special rate). See New Zealand, *International Tax Reform, Full Imputation, Part 2 – Report of the Consultative Committee*, n 311 (replacement of proposed interest charge with special tax rate). The sometime-resident grantor condition emerges by comparison of ss HC 10, HC 11 and HC 12. The special rate is 12 percentage points above the top personal rate (33%).

[318] ITA UK s 11; cf s 479. This will change to the default basic rate on commencement of the new schedule of default rates for non-individuals (see n 164).

[319] ITTOIA Part 5 ch 7; ITA UK ss 848, 899(3)(a)(iv), (4)(b)(ii), 901. Cf Chamberlain and Whitehouse, n 50, §8.29.

[320] ITA UK s 479. The rates identified by that section are presently equivalent to the top personal rates.

[321] ITTOIA Part 5 ch 7. The notion of an 'annual payment' connotes income, and is much elaborated in case law.

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pool.[322] The tax pool operates as a special tax imputation system for discretionary distributions to resident beneficiaries. Given the high rate of trust taxation, this is apt to deliver a refund to a beneficiary who is not in the top tax bracket.

A distribution automatically has income character in the hands of the beneficiary in the case of an annuity or a distribution that reflects a vested but non-proprietary entitlement of the recipient to trust income. Otherwise, it is necessary to test the particular distribution itself for income character.[323] It does not follow that a distribution funded by or traceable to capitalized trust income has income character. A one-off distribution may have capital character, despite being funded by accumulated trust income that has been capitalized in the trust, in which event it does not attract income tax. Whether a capital distribution attracts capital gains tax depends on whether the trust has unacquitted capital gains (Section 5.3.5). It is possible for a discretionary distribution funded by accumulated income to escape both taxes.

5.3.2 *Inbound Settings*

A non-resident beneficiary with annuity income from a resident trust is treated as deriving disregarded income:[324] the 20% withholding becomes a final tax.

A non-resident beneficiary with discretionary income from a resident trust is in a similar position under the statute; the income is disregarded,[325] no further tax is payable and there is no tax credit although the distribution generates debits to the tax pool. This implies overall top-rate UK taxation, but the statutory position is ameliorated by extra-statutory concession.[326] Distributions are traced to underlying trust

[322] The tax pool and related provisions are in ITA UK Part 9 ch 7. The trustees must, if necessary, pay top-up tax to prevent the pool falling into deficit (s 496).

[323] ITA UK s 493; see Loutzenhiser, n 53, §29.3.3.1, §29.3.4; *Stanley* v *IRC* [1944] KB 255; *Stevenson* v *Wishart* [1987] 1 WLR 1204.

[324] ITA UK ss 813, 826(c). Both annuities and income-character discretionary distributions are taxable to a beneficiary under ITTOIA Part 5 ch 7 and consequently qualify as disregarded income if the beneficiary is non-resident.

[325] See n 324.

[326] HMRC, Extra-statutory Concession ESC B18: *Payments out of discretionary trusts* and HMRC, Statement of Practice SP 3/86 (1986, last revised 2005); the statement of practice refers to this treatment as 'looking through'. The text of the concession still refers to superseded legislation. The concession is subject to conditions, including full information and payment of tax by the trustees and a time limit. Other countries including

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income using a formula. If particular underlying income would have been untaxed or taxed more lightly if derived by a non-resident or, if the United Kingdom has a tax treaty with the beneficiary's country of residence, if derived by a resident of that country, then the beneficiary can claim a refund based on comparing notional tax liability under direct derivation with the tax actually paid by the trust entity. The concession is most likely to affect UK-sourced dividend, interest and royalty income of the trust (taxation of which would be zero or limited to prior withholding/deemed withholding or treaty-limited if derived directly), UK-sourced 'other income' under an appropriately worded 'other income' article in an applicable treaty, or foreign-sourced trust income (which would be untaxed to a non-resident). There is no relief based simply on rate progression (if the particular non-resident would simply have been taxed by assessment at a lower rate than the trust rate).[327]

The concession also applies to a non-resident beneficiary in a non-resident trust with UK-sourced income.

The concession has the effect of applying a transparent quasi-attribution paradigm over the top of the usual entity-attribution paradigm, but only to the extent that the underlying trust income is such as to attract relief based on the beneficiary's residence status. To that extent, taxation of the trust entity on trust-attributed income ceases to be final taxation but begins to resemble non-final withholding. In the case of foreign-sourced trust income, the concession treats as a conduit situation that which the statute would treat as an inbound one.

In very broad terms and for income to which it applies, the concession tends to assimilate the treatment of a non-resident discretionary beneficiary to that of a non-resident interest-in-possession beneficiary.

5.3.3 Outbound Settings

A resident beneficiary can claim foreign tax credit in the usual way for foreign tax on an income-character distribution as such, whether by annuity or by discretion. No credit is available for foreign tax on underlying trust income. If the distributing trust is resident and has claimed foreign tax credits, those credits are washed out on distribution to

common-law jurisdictions may find the use of extra-statutory concessions constitutionally objectionable, but they are of long standing in the United Kingdom.

[327] Loutzenhiser, n 53, §29.3.4 dryly observes that '[t]he question whether the Revenue should "look through" more frequently is an interesting one'.

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beneficiaries.[328] The result is equivalent to relief by deduction – unless, of course, the distribution escapes UK tax on the basis that it is not income, but capital.

5.3.4 Conduit and Round-Trip Situations

A non-resident beneficiary in receipt of discretionary distribution income from a resident trust may benefit from the extra-statutory concession described earlier. The possibility that this may enable treaty shopping if the trust is able to benefit from a tax treaty is considered in Section 8.4.

The concession also allows a resident beneficiary in receipt of discretionary distribution income from a non-resident trust to claim credit for UK tax actually paid on underlying trust income. In this situation also, finality of entity-level taxation is abrogated, and the treatment of the resident discretionary beneficiary is somewhat assimilated to that of a resident discretionary beneficiary in a resident trust.[329]

5.3.5 Capital Gains

The United Kingdom does not tax beneficiaries on current trust-level capital gains as such, but it does tax resident beneficiaries on capital distributions from a non-resident trust if they are supportable by current or past trust gains[330] that have escaped UK taxation.[331] This rule performs a complementary function, responding to the international limitations inherent in a general rule that attributes capital gains to the trust itself. Particularly where the gain precedes the year of UK taxation, there are functional similarities to the taxation of trust distributions in

[328] See n 322; ITA UK s 496.

[329] The mechanisms of the concession and the tax pool are, of course, quite different, but both seek to deliver credit for antecedent entity-level UK taxation of trust-attributed income.

[330] TCGA ss 87 (non-resident trust), 88 (treaty non-resident trust). Whether a distribution is supported by trust gains is determined by tax-law accounting rules (s 87A). Trust gains that are currently attributed to a resident grantor under s 86 (n 137) are excluded from the calculation.

[331] See TCGA s 87(5A), which has the effect of preventing double taxation of NRCGT gains. But as under the companion measure taxing a resident grantor (n 137 and corresponding text), there is no express corresponding exclusion of capital gains referable to a UK branch or agency, which are also taxable to a non-resident trust. The omission is anomalous; perhaps it was assumed that no non-resident trust would have such gains.

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Australia, the United States and New Zealand. The similarity is highlighted by the imposition of an interest charge on tax deferral if the year of the gain precedes the trust distribution by more than a whole tax year.[332]

The general UK approach of attributing the capital gains of a trust to the trust entity means that a resident trust is taxable on its worldwide capital gains.

5.4 Summary

This chapter has identified two functions of distribution taxation. First, distribution taxation is necessary as a complementary international measure to catch the produce of foreign trust-level income that the taxing country has not previously attributed to a resident person or entity or fully taxed to a non-resident. Secondly, distribution taxation may serve as an integral second taxing point in a country's trust rules.

The adoption of inclusive rules of beneficiary attribution and top-rate taxation of trust-attributed income favours a stand-alone system of distribution taxation limited to the complementary international function. It may be inferred from the approach in Australia, the United States and New Zealand that countries following this approach will directly or indirectly limit the taxing claim to resident beneficiaries receiving income from non-resident or formerly non-resident trusts and to distributions that are traceable – or are not shown not to be traceable – to trust income that has escaped substantive taxation in the taxing country due to that non-residence. They may also increase the tax burden to reflect the benefit of tax deferral. In principle, they should recognize prior taxation of such trust income by credit. The actual approach to double tax relief, however, is found to be variable, perhaps due to a view that distribution taxation has an anti-avoidance flavour. Internationally focused distribution taxing rules are typically complex. A measure that is robust against circumvention is likely to be overly broad; one that avoids overreach is likely to be vulnerable to circumvention. The tax design challenges are considerable, and anomalies are difficult to avoid. The corresponding benefit is the simplicity of a single taxing point for most trust income.

Alternatively, a country may accept two-stage taxation as a standard feature of its trust rules, in conjunction with which it may adopt whatever

[332] TCGA s 91.

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integration rules it considers appropriate to avoid domestic economic double taxation. This gives rise to different complexities and difficulties in an international context. Economic double taxation is prone to arise in practically all international configurations because underlying trust income is not equated with a distribution as a separate item of income. The perceived undesirability of these outcomes is emphasized by a UK extra-statutory concession which superimposes a non-current beneficiary-attribution paradigm in a range of inbound, conduit and round-trip situations. More generally, if distributions are only taxable by reference to the characteristics of the distribution and not by reference to the trust-level assets or income that support it economically, underlying foreign income may escape taxation if a distribution to a resident beneficiary is not seen as income; conversely, foreign taxation of underlying income will not be creditable.

As countries may adopt a single-stage taxing approach supplemented by an international distribution taxing rule or a two-stage taxing approach, any general principles of international trust taxation must accommodate the exigencies of both structures.

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6

International Taxation

This chapter serves as a bridge between Part I, which so far has focused on and compared the international tax settings in national laws of the surveyed countries, and Part II, which is concerned with the interaction of national laws in treaty and non-treaty situations. It does so by considering the interaction between settings for the taxation of trust-related income in the surveyed countries in order to identify more generally how double taxation and non-taxation may arise internationally. Section 6.1 summarizes key findings of earlier chapters by reference to the international perspective of the countries concerned. Sections 6.2 and 6.3 identify the particular kinds of interaction that give rise to double taxation and non-taxation respectively. Section 6.4 considers a structural issue of tax policy: where a trust is taxed as proxy, for whom is it so taxed? Section 6.5 summarizes this chapter.

6.1 International Trust Tax Settings

Previous chapters have considered trust tax settings of the surveyed countries by reference to the taxpayer who is the subject of attribution and taxation (grantor, beneficiary or trust) and to the economic object of taxation (trust income or distributions). This section re-presents the main findings by reference to the inbound (source) or outbound (residence) perspective of the taxing country on the overall arrangement and economic activity. It begins with a summary of general attribution and tax settings that apply in a domestic context then considers how those settings are varied or supplemented in inbound or conduit situations, where the attributable taxpayer is non-resident, and in outbound or round-trip situations, where the taxpayer is resident and some other element is foreign. It also reprises the different national perspectives on trust residence.

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6.1.1 Domestic and General Taxation

The general and domestic trust tax settings of the surveyed countries may broadly be summarized as follows:[333]

- The United States[334] and the United Kingdom[335] have relatively strong grantor attribution regimes by which trust income is currently attributed and taxed to a grantor who has not adequately parted with any potential reversion or de facto benefit or (in the United States) potential control over the trust. The UK rules provide for indemnity and adjustments between the grantor and the trust or a recipient of taxed income. The cognate Australian rule is a dead letter in practice[336] but employs a device that is notable from the viewpoint of tax design and policy: affected income is not taxable to the grantor, but to the trust entity at the rate that would have applied to the grantor – this may be compared with the New Zealand settlor regime (Section 4.2.4).
- New Zealand[337] and (absent grantor attribution) the United States[338] and Australia[339] attribute current trust income to a beneficiary who is entitled to it under the terms of the trust or to whom it is currently distributed, whether or not it is actually paid over. Any other current trust income is attributed to the trust as a whole and taxed at or about the top personal rate. Subsequent distributions are free of income tax.
- Where grantor attribution does not apply, the United Kingdom attributes current trust income to a beneficiary who has an indefeasibly vested interest in possession in trust income as it arises.[340] Other trust income is attributed to the trust itself and taxed at the top rate (except to the extent that it supports an annuity, which attracts special treatment). Discretionary distributions are taxed as a separate species of income, but only if they are recognized as having income character for

[333] With respect to trust income, see Section 2.3 (grantor), Section 3.1 (beneficiary), Section 4.1 (trust); with respect to distributions, see Section 5.3.1 (UK).

[334] IRC ss 673–677 (subpart E).

[335] ITTOIA Part 5 ch 5 (ss 619–648), the settlements legislation.

[336] ITAA 1936 s 102 is avoided by the universal practice of procuring an unrelated person to ‘create’ a trust by settling an insignificant sum. The section has no substantive grantor concept – see *Truesdale* v *FCT* (1970) 120 CLR 353. Its other criteria (reversionary rights and benefaction of grantor’s infant children) are rudimentary compared to the US and UK rules.

[337] ITA NZ ss HC 6, HC 17.

[338] IRC ss 652, 662.

[339] ITAA 1936 ss 97, 98A, 100; ITAA 1997 ss 115–215, Sub-div 207-B.

[340] See n 819.

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the beneficiary. They are grossed up with credit from a tax pool for corresponding tax paid by the trust, which operates as a special tax imputation system for discretionary distributions.[341]

- Australia and the United States integrate the taxation of capital gains with the taxation of income.[342] The United Kingdom attributes capital gains to the trust alone and taxes at the top capital gains rate; it has no domestic grantor or beneficiary attribution rule. New Zealand does not tax capital gains.[343] Capital distributions from a trust are generally not taxable as such,[344] although in some cases the distribution of an appreciated asset may trigger recognition of a trust-level capital gain with its own tax consequences.

6.1.2 Inbound and Conduit Settings

These general principles are translated to inbound and conduit situations – where the attributable taxpayer is non-resident – with relatively few modifications:[345]

- The United States turns its grantor rules off if they would result in attribution to a non-US person, subject to a small number of exceptions which remain exploitable as tax planning opportunities.[346] The United Kingdom turns its grantor rules off where, broadly speaking, they would result in attribution of foreign income to a non-resident.[347] The general Australian rule takes a similar approach but also switches from inbound withholding tax on DIR income to net-basis assessment if the grantor is non-resident.[348]

[341] See Section 5.3.1.
[342] Australia goes to considerable lengths to facilitate the current attribution of trust gains to a beneficiary (see ITAA 1997 Sub-div 115-C, ITAA 1936 s 102UX; cf Brabazon, *Trust Gains*, n 35); the US position is more prescriptive and may result in attribution to beneficiaries or to the trust.
[343] A small number of provisions treat particular gains as tax-law income, regardless of whether they otherwise have capital character (ITA NZ subpart CB). These will not be considered here.
[344] See n 302 and corresponding text.
[345] With respect to trust income, see Section 2.4 (grantor), Section 3.2 (beneficiary), Section 4.3 (trust); with respect to distributions, see Sections 5.3.2 and 5.3.4 (UK).
[346] IRC s 672(f). See n 102. A foreign grantor can secure the benefits of US grantor attribution by sound lawyering of the trust settlement to bring it within one of the exceptions (Bruce, n 25, 117–128).
[347] ITTOIA s 648(2); cf s 577(2).
[348] ITAA 1936 s 102(3); cf s 128B(3)(e) (n 104).

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- Non-resident beneficiaries are taxed on a source basis. If a country applies source-character retention to beneficiary-attributed income, as the four surveyed countries do,[349] there is no claim to tax foreign-sourced trust income attributed to a non-resident beneficiary. The trust is treated as an international conduit.
- The application of final withholding and disregarded inbound investment income regimes to beneficiary-attributed DIR income is inconsistent. Of the surveyed countries, the United States alone clearly and consistently attributes a trust-level taxable presence in the source (host) country to a non-resident beneficiary to whom corresponding trust income is attributed for the purpose of engaging net-basis taxation by assessment.[350]
- A non-resident trust is taxed on trust-attributed income in much the same way as a non-resident person.[351] Where net-basis assessment applies, the trust is assessed and taxed at trust rates.
- A discretionary distribution by a UK trust to a non-resident beneficiary generates debits to the tax pool but no corresponding credits for the beneficiary. No additional tax is imposed on the beneficiary.[352] The overall statutory result is final taxation on the trustees at the top rate. This is ameliorated by extra-statutory concession.[353] The concession applies a quasi-attribution paradigm, and is most likely to affect UK-sourced DIR income and foreign income. It traces distributions to underlying trust income and gives tax relief referable to the beneficiary's residence status.
- An unusual Australian rule provides for a refund of tax on trust-attributed foreign income of a resident trust that is subsequently traced into a distribution to a non-resident beneficiary.[354] This converts ostensibly final outbound taxation of the trust into non-final withholding and ultimately tax-free conduit treatment of the beneficiary.

[349] Contrast Canada, which taxes a non-resident on income 'of or from' a resident trust: *Income Tax Act 1985* (Can) s 212(1)(c), (11). See n 167.
[350] *See* Table 3.1 and corresponding discussion in Sections 3.2.4, 3.2.6 and 3.4.
[351] There is an exception to this in New Zealand. Although a trust with resident trustees that fails the settlor nexus is ordinarily treated as functionally non-resident, trust-attributed New Zealand DIR income of such a trust attracts net-basis assessment rather than the NRWT rules that apply to non-residents. See Brabazon, *Ariadne*, n 235.
[352] Contrast annuities paid to a non-resident beneficiary, which are subject to final withholding at the basic rate, the trust having also been taxed at that rate on underlying income needed to support the annuity.
[353] ESC B18; cf SP 3/86.
[354] ITAA 1936 s 99D. See n 312 and corresponding text.

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6.1.3 *Outbound and Round-Trip Settings*

Modifications are more extensive in outbound and round-trip situations:[355]

- Resident beneficiaries are taxed on worldwide income, including trust income currently attributed to them.
- Australia[356] and the United States[357] each has special outbound rules of grantor taxation under which income of a non-resident trust can be fiscally attributed to a currently resident grantor. The rules express policies of anti-avoidance and base protection. The criteria for engaging them are wide but not without exceptions. The United Kingdom also has an outbound rule for capital gains which may result in attribution to a resident grantor[358] and outbound rules for income which may apply to grantors;[359] the latter are not trust specific and are not considered further here.
- To complement its domestic approach to capital gains, the United Kingdom taxes a resident beneficiary who receives a capital distribution that can be matched with trust-level gains of a non-resident trust.[360] Current or past gains can be matched with current or past distributions.[361]
- Resident trusts are taxed, as might be expected, on worldwide trust-attributed income.[362]
- A resident taxpayer to whom trust income is attributed has access to unilateral double tax relief by credit for foreign taxation of that income.

[355] With respect to trust income, see Section 2.5 (grantor), Section 3.3 (beneficiary), Section 4.4 (trust); with respect to distributions, see Section 5.2 (Australia, United States, New Zealand), and Sections 5.3.3 and 5.3.4 (UK).

[356] ITAA 1936 Part III Div 6AAA Sub-div D, commonly referred to simply as Div 6AAA or the transferor trust rules.

[357] IRC s 679. The rule requires US beneficiaries, either in fact or as a possibility not excluded by the terms of the trust.

[358] TCGA s 86.

[359] The transfer of assets abroad rules in ITA UK Part 13 ch 2 (ss 714–751).

[360] TCGA ss 87, 88.

[361] If current gains are matched with current or past distributions, the attribution of a deemed capital gain to the beneficiary resembles current attribution of trust gains. If past gains are matched with a current distribution, it resembles the taxation of a trust distribution. See Section 5.3.5.

[362] Exceptionally, where trustees are personally non-resident, New Zealand taxes trust-attributed New Zealand DIR income in the same way as if derived by a non-resident, even if the trust satisfies the settlor nexus and is in all other respects taxed in the manner of a resident. See n 351; Brabazon, *Ariadne*, n 235.

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Entitlement to relief is relatively clear where the subject of the foreign tax is that same taxpayer or the trust. The position is less well established in other cases.[363] Table 6.1 summarizes these settings.

- A resident beneficiary who is taxed on a trust distribution may claim the usual double tax relief for foreign tax on the distribution itself. The United States alone gives credit for foreign tax on traceable underlying income.
- As noted in the last two bullet points of the preceding section, outbound UK and Australian taxation of a trust on trust-attributed foreign

Table 6.1 *Double Tax Relief for Foreign Taxation of Trust Income*

Taxpayer Residence	Foreign Tax Imposed on		
	Grantor	Beneficiary	Trust
Grantor (Section 2.5)			
Australia	*	*	*
United States	✓	×	✓
United Kingdom	✓	✓	✓
—			
Beneficiary (Section 3.3.3)			
Australia	✓	✓	✓
United States	×	✓	✓
United Kingdom	✓	✓	✓
New Zealand	✓	✓	✓
Trust (Section 4.4)			
Australia	✓	✓	✓
United States	×	×	✓
United Kingdom	✓	✓	✓
New Zealand	✓	✓	✓

* The Australian outbound grantor tax rule contains its own provision for relief. Depending on the class of income and whether the foreign taxing country is a listed country, foreign-taxed income may be excluded from grantor attribution or the foreign tax may be deductible from the amount attributed to the grantor.[364] Relief is respectively stronger or weaker than a foreign tax credit.

[363] See discussion of this issue in Sections 2.5, 3.3.3 and 4.4.
[364] ITAA 1936 s 102AAU(1)(c)(viii), (d) (n 120).

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Table 6.2 *Trust Residence Criteria*

Country	Trust Residence Criteria
Australia	Any trustee resident OR central management and control
United States	Control test (US persons have authority to control all substantial decisions) AND court test (US court can exercise primary supervision)
United Kingdom	All trustees resident or acting through UK branch OR any trustee meets that test and grantor was resident or domiciled at time of settlement
New Zealand	Settlor nexus

income can in some circumstances be reversed in favour of conduit treatment of a beneficiary who receives a corresponding distribution from the trust.

6.1.4 Trust Residence

The most generally applicable criteria for trust residence in the surveyed countries[365] are summarized in Table 6.2.

The US and UK criteria and, to a lesser extent, the Australian rules give the settlor and actual controllers of a trust considerable discretion to determine whether a trust will be fiscally resident in those countries. The New Zealand rules follow a different design logic and fiscal policy. They seek to achieve by trust residence what other countries attempt by grantor attribution, albeit without subordinating beneficiary attribution. The New Zealand trust residence rules are considerably less manipulable than their counterparts in other surveyed countries, although they make it easy for a foreign grantor to establish a trust in New Zealand that is not fiscally resident there.

6.2 Double Taxation

It is inevitable that national taxing claims overlap. This section draws on the summary in the previous section and the analysis in preceding chapters to identify factors in the interaction of national trust taxing

[365] See Section 4.2.

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rules that can produce international double taxation. The purpose of the analysis is to facilitate a structural consideration of double taxation and non-taxation generally, not just between the surveyed countries. For that reason, the effect of tax treaties is not considered in this section.

Double taxation of trust income can arise in a number of ways.

- *Source versus residence*: The same income may be taxed by a source country and a residence country of the trust, a grantor or a beneficiary. The two countries may agree on attribution of the income, both taxing the same taxpayer, or they may disagree, in which case there is a source–residence attribution conflict. Appropriate double tax relief commonly depends on the residence country recognizing source-country taxation, possibly of a different taxpayer, under its foreign tax credit or other double tax relief measures. In a treaty context, it also depends on the source country in its application of the relevant treaty recognizing the trust, grantor or beneficiary as a person, as a resident of the other treaty country, as deriving the item in question and (depending on context) as its beneficial owner (see Chapter 8).
- *Source–source conflict*: Double taxation may arise by conflict of source regarding the trust income itself.[366]
- *Residence–residence attribution conflict*: Double taxation may arise by conflict of attribution among the residence countries of the grantor, a beneficiary and the trust itself. If two or more of those countries each attribute the same trust income to its own resident, there are overlapping claims of residence-based taxation. If such a conflict is to be resolved, one or more of those countries must yield priority of taxation to the other, such as by allowing foreign tax credit or exemption of income taxed by the other country. This may be done unilaterally, such as in the country's foreign tax credit rules or in the terms of a specialized outbound taxing regime. The present scope of treaty relief is very limited (Section 8.3.13). Clear international principles for prioritizing such taxing claims have not yet been developed, although the seed of such development may be present.

[366] If a trust residence country recharacterizes the source of trust income currently attributed to a beneficiary by reference to the residence of the trust (as Canada does) instead of retaining the source character of entity-level income under current beneficiary attribution (as the four surveyed countries do), both the original source country and the trust country will claim to tax as a source country.

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- *Dual residence*: Double taxation may arise by conflict (duality) of fiscal residence, particularly of the trust entity. There are significant differences in the trust residence criteria of different tax systems.

Each of these either necessarily or potentially involves issues of trust residence.

The claims of one country to tax current trust income and another to tax trust distributions can also produce international economic double taxation. In some respects, this resembles double taxation of corporate and shareholder income, but the trust context introduces additional complications.

- *Washout*: If a trust residence country attributes foreign income that has been taxed at source to the trust, double tax relief obtained by the trust may be washed out on subsequent taxable distribution to a beneficiary in the same country as the trust.[367]
- *Two-layered assessment*: One country may tax a trust (or perhaps a grantor) on trust income on a source or residence basis, at a high substantive rate, and a beneficiary's country may separately tax a corresponding distribution. The result is economic double taxation. Double tax relief depends on what recognition, if any, the beneficiary's country allows unilaterally for earlier foreign taxation of underlying trust income (Sections 5.2.2 and 5.3.3). Treaties generally provide no relief (Section 8.4).
- *Withholding plus assessment*: Double taxation may also occur if a distribution is taxed as such by the country in which the trust is based or resident (source taxation) and by the beneficiary's country (residence taxation). This is a simple instance of source versus residence double taxation affecting the distribution itself as income from a trust. Double tax relief in such cases is conceptually straightforward and unlikely to present practical problems.

The risk of international double taxation is usually, though not always, obvious to the participants in a trust. Self-help is consequently the most effective means of avoiding double taxation, whether by pre-planning in the design of a trust, or by careful selection or change of its investments, trustees or beneficiaries. To varying degrees, trust residence can be controlled, as has been described earlier. The availability of self-help

[367] Trust-level foreign tax credit is effectively washed out on income-character distribution to a UK beneficiary (Section 5.3.3). The issue only arises if the distribution itself is taxed.

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qualifies the importance of double taxation as a matter of international tax policy. Some people will nevertheless fall foul of double taxation by accident, misfortune or supervening events. Double taxation in a trust context also restricts cross-border investment and cross-border mobility of persons to some degree in cases where use of the trust form is preferable for non-tax reasons.

6.3 Non-Taxation

Trust-related income can also escape taxation internationally if a particular arrangement or series of actions finds a taxing gap in each of the countries that might plausibly exert a taxing claim. Several classes of international correlation between national tax laws may be identified in which taxing gaps may align in this way.

Homeless trust: Income may escape current taxation (other than purely on a source basis) if it is accumulated in a trust that no country claims to tax on a worldwide basis and no country attributes the income to a resident beneficiary or grantor. This contemplates that all countries would attribute the income to the trust, but none claims the trust as its resident – it is a fiscally homeless trust.[368] This is the converse of dual residence. Such negative conflicts appear to be more likely and more readily devised in the case of a trust than in the case of an individual or corporation, having regard to the nature and diversity of trust residence rules.

Negative attribution conflict: Trust income may also escape current taxation (other than purely on a source basis) if the countries that could plausibly tax on a residence basis all attribute the income in question to different persons or entities, each being a non-resident of the country

[368] A trust may achieve fiscal homelessness in a number of ways (Section 4.2). For example, it may have all US trustees (and thus be UK non-resident), but reserve a right of veto over some significant class of decision to a non-US person (thus US non-resident). The veto-holder may be the grantor, or have some other title such as protector or appointor, or no particular title at all. The trust would also ordinarily be Australian non-resident: a mere right of veto, even belonging to an Australian resident, would not without more establish central management and control in Australia. Alternatively, the trust may have mixed UK and non-UK (but not Australian) trustees and have been settled by an originally non-UK grantor: the trust will be UK non-resident. It is likely to be US non-resident (this can easily be ensured, e.g., by requiring the agreement of non-US trustees to significant decisions). On the other hand, New Zealand residence of the grantor will satisfy the settlor nexus in that country unless he or she was non-resident at the time of the settlement and immigrated without making a s HC 33 election.

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concerned. This could be regarded as a negative residence–residence attribution conflict; in such cases, the trust functions as a reverse hybrid.[369]

These lacunae are exacerbated if source taxation is light or non-existent – a situation which is not confined to tax havens. Many countries tax income from inbound passive investment by non-residents more lightly than other forms of income, even in the absence of treaty relief, and may tax particular classes of such income at a zero or near-zero rate. Some examples of this (and exceptions to it, where inbound tax lightening is denied to non-resident trusts) have been identified earlier.

Distribution tax lacuna: If income is attributed to a homeless trust or if the country of trust residence attributes the income to a beneficiary or grantor who is resident elsewhere, the only remaining potential taxing point is the distribution from the trust to a beneficiary. If the beneficiary's residence country does not see a distribution from the particular trust as income of the beneficiary and the distribution is supported by untaxed or lightly taxed trust income, global non-taxation or less-than-single taxation is perfected in the hands of the beneficiary.

Superfluous tax relief: Non-taxation will result if two countries are each persuaded to give double tax relief for the other's taxation. This is somewhat speculative.[370] The possibility of its occurrence arises from the failure of domestic double tax relief rules clearly to address the multiple bases on which other countries may claim to tax trust income – residence or source taxation of grantor, beneficiary or trust – and the priority that should apply between taxing claims of different kinds. Non-taxation will also result if one country gives relief on the unstated assumption that another will tax without making that fact a condition of relief and the other country does not in fact impose such taxation.

Some scenarios may help to make the discussion more concrete.

- A US grantor settles property on New Zealand trustees on terms that sufficiently exclude reversion or control to avoid classification as a

[369] Reverse hybrids are further considered in Section 7.2.2 (see esp n 437).

[370] A duplicated relief claim was advanced unsuccessfully in the *Bayfine* litigation, both under treaty and under the UK unilateral foreign tax credit. The conclusion in the Court of Appeal on the taxpayer's claim for unilateral relief was that, because the *treaty* required the United States to give double tax relief to its taxpayer (the parent of the UK taxpayer), the unilateral relief provision in the UK statute implicitly did not apply: *Bayfine UK Ltd* v *HMRC* [2011] STC 717; (2011) 13 ITLR 747 [66], [67]. The treaty claim also failed (cf n 718). The reasoning in this case may not easily translate to other countries' tax laws, but similar judicial reluctance to facilitate arbitrage may be expected.

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grantor trust under the ordinary US grantor rules and that sufficiently exclude the possibility of a US beneficiary to avoid the US outbound grantor rule. Income sourced in a low-tax or no-tax jurisdiction is accumulated in the trust. From a US perspective, the trust is foreign. From a New Zealand perspective, the settlor nexus is not satisfied. Neither country taxes the accumulating trust income.

- An offshore grantor transfers property to New Zealand trustees of an existing trust created by a nominal settlor. The grantor later immigrates to Australia, and the trust satisfies one of the exceptions to Australia's outbound grantor rule. Income sourced in a low-tax or no-tax jurisdiction is subsequently accumulated in the trust. Assuming that the grantor has lost his or her original tax residence, a grantor rule based on current residence (such as the UK settlements legislation or transfer of assets abroad rules) no longer applies. Australia sees the trust as non-resident if it is actually managed and controlled by the trustees in New Zealand. From a New Zealand perspective, the settlor nexus is not satisfied. Neither of these countries nor the grantor's former residence country taxes the accumulating trust income.
- An offshore grantor transfers property to New Zealand trustees. The grantor later immigrates to New Zealand but does not make a s HC 33 election to assume personal liability for tax on trust-attributed income. The consequences are similar to those in the previous item, disregarding references to Australia.
- A New Zealand grantor settles property on trustees, some of whom are resident in the United Kingdom and others in the United States. Decision-making rights of the UK trustees prevent US trust residence; the mixed residence of the trustees and UK non-residence of the grantor prevent UK trust residence. The trust invests back into New Zealand and derives (exclusively) interest income, which it accumulates in the trust. The interest income qualifies for zero-rating on the basis of the trustees' New Zealand non-residence and the borrower's engagement of the approved issuer levy. Although the settlor nexus is satisfied, New Zealand disregards it and sees only the non-residence of the trustees.
- Continuing any of the preceding scenarios, suppose that the trust has UK beneficiaries and that the trust residence country, if any, does not tax distributions by a resident trust. After some time, the trust makes a small number of large ad hoc capital distributions that do not qualify as annual payments from a UK perspective. The trust has not realized any

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capital gains. The distributions are not recognized as income in the United Kingdom, and they are untaxed.

- A New Zealand grantor settles property on Australian trustees. The trust is revocable, and therefore a foreign grantor trust from a US perspective.[371] The trust derives lightly taxed or untaxed income from a source in another country, which is all currently distributed to US beneficiaries. New Zealand and Australia both attribute the income to the beneficiaries,[372] who are non-resident. Both recognize the income as retaining its original foreign source and do not claim to tax. The United States attributes the income to the grantor, who is non-resident, and regards the distributions to US beneficiaries as gifts.

Non-taxation in all of these scenarios arises exclusively from the interaction of national laws. Tax treaties adjust national taxing rights by subtraction; they do not fill up a non-taxing lacuna. If countries wish to avoid opportunistic non-taxation outcomes of the kind identified earlier, corrective measures must be applied first in the taxing claims of national tax laws.

A treaty-based scenario may be added at this point due to its close connection with the particular approach of New Zealand to trust residence:

- It has been argued that the personal residence in New Zealand of trustees of a trust that has no other connection with that country and does not satisfy the settlor nexus is sufficient to attract treaty benefits with respect to trust-attributed income sourced in a country with which New Zealand has a tax treaty that is based on the OECD Model and does not contain a transparent entity clause.[373] The better view is that the argument is unsound where the definition of residence follows

[371] IRC s 672(f)(2)(A)(i), preserving the operation of s 673.

[372] If the income were instead accumulated, both countries would attribute it to the trust, which both would claim to tax: Australia, on the basis of the residence of the trust estate (ITAA 1936 ss 95(2), 99A); New Zealand, on the basis of the settlor nexus (ITA NZ s HC 25(2)) with a supplementary claim to tax the grantor as statutory agent with right of indemnity (ss HC 29(2), HD 5(2), HD 12(2)).

[373] John Prebble, 'Accumulation Trusts and Double Tax Conventions' [2001] *British Tax Review* 69; John Prebble, 'Trusts and Double Taxation Agreements' (2004) 2 *eJournal of Tax Research* 192; John Prebble, 'Trusts and Tax Treaties' (2008) 8 *International Tax Planning Association Journal* 75, 76–77. The transparent entity clause is considered further in Chapter 8).

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the Model.[374] It is more plausible, however, if the treaty simply defines residence by reference to domestic law (Section 8.2).

The four surveyed countries on whose laws these scenarios are based all have highly developed tax systems and rules of trust taxation. If one of the participants in a trust is based in a country that is less familiar with trusts or has not taken steps to protect its tax base, perhaps by an outbound grantor rule or by looking through trust distributions to underlying income, a wider range of non-taxation outcomes may be envisaged.

The discussion here has assumed full disclosure and the possession of all relevant information by revenue authorities. The existence of lawful tax gaps in one or more countries may coexist with and exacerbate tax evasion in another country. Non-taxation in fact but contrary to law is outside the scope of this book. It is a separate problem, but not an unrelated one. It remains to be seen to what extent the enhanced international exchange of information coupled with national reporting rules and, perhaps, the closure of lawful tax avoidance opportunities, all of which are goals of the BEPS project, may work to prevent illegal tax avoidance in the context of international trusts.

6.4 Trust as Proxy

This section considers a structural issue that affects how the taxation and fiscal residence of the trust itself should be perceived with reference to the residence of the beneficiaries or the grantor.

Legal and fiscal entities may pay tax, but only people bear tax. Taxation of a trust entity on trust-attributed income provides a way of collecting tax without having to pursue an ultimate human taxpayer and without even having to identify that person, but prevents the fiscally important characteristics of such a person (residence, taxable capacity, etc) from being taken into account unless some other adjustment is made

[374] Jeremy Beckham and Craig Elliffe, 'The Inconvenient Problem with New Zealand's Foreign Trust Regime' (2012) 66(No 6) *Bulletin for International Taxation* refute the argument on the basis of treaty jurisprudence. The refutation is convincing in itself; it is also consistent with the writer's analysis of the settlor nexus as functional trust residence (Brabazon, *Trust Residence*, n 152). The argument has also been rejected by the Australian Taxation Office: TR 2005/14 *Income tax: Application of the Australia/New Zealand Double Tax Agreement to New Zealand Resident Trustees of New Zealand Foreign Trusts*. Treaty residence of trusts is considered in Section 8.2.2.

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later. If the tax is final, the trust is taxed as a proxy – for whom? The answer must be the grantor or the beneficiaries or some combination of them. If so, to what extent is their residence taken into account, how do the criteria for trust residence relate to the ultimate burden of taxation, and what priority is recognized between the taxing claims of different countries? At the same time as trying to allocate a tax burden correctly, each country is also concerned to protect its national tax base from international erosion. This factor, too, may contribute to the concept of trust residence and the taxing claims imposed on a resident or non-resident trust and may tend to confound inferences that might otherwise appear logically attractive.

It is convenient to break the analysis into two parts corresponding to residence and source taxation: first, the claim to tax a trust on foreign-sourced income and, secondly, the claim to tax a non-resident trust on local income.

Resident trust: In the case of resident trust taxation, several general factors may be thought to be indicative with respect to the proxy question, the ultimate incidence of the tax burden and the priority of taxing claims.

- The surveyed countries' criteria for trust residence (Section 4.2) are not uniform. Except for New Zealand, they rely on the separate fiscal residence of particular trustees combined with other factors relating to management, administration or judicial oversight or, under the UK rules where the trustees have mixed residence, the historical residence of the grantor. These factors are largely equivocal. In New Zealand, however, it seems fairly clear that the trust is taxed as proxy for the grantor.
- The presence of substantial domestic grantor attribution rules in the United States and the United Kingdom suggests that those countries have codified the cases in which they regard the trust as a representative of the grantor and that the trust should consequently be viewed as representing the interests of beneficiaries.
- The indeterminacy of ultimate beneficial enjoyment of accumulated trust income precludes accurate attribution to an ultimate beneficiary but does not affect the identification of the grantor whose purposes are served by the trust. Unless (as in New Zealand) trust residence is based on the grantor's residence, this suggests that trust-attribution of accumulated income is adopted because the trust is seen as proxy for the beneficiaries to whom that income will flow.

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- The rate of tax (now[375] usually at or near the top personal rate, except in the United Kingdom to the extent that trust-level income is needed to support an annuity) maximizes collection at the entity level and makes a second taxing point unnecessary, unless for the purpose of granting relief. This factor is equivocal.
- Distribution tax settings (Chapter 5) shed further light. The provision of tax relief in the United Kingdom on distribution to a beneficiary under the tax pool provisions or by extra-statutory concession implies that the trust is treated as having previously been taxed as proxy for the beneficiary.[376] It may be said that the trust is not taxed as proxy, but as a withholding agent for an initially unidentified principal taxpayer. The UK provisions distinguish in some respects between resident and non-resident beneficiaries. The Australian tax refund on distribution to a non-resident beneficiary by reference to prior taxation of the trust on foreign-sourced income[377] implies that the trust is treated as having previously been taxed as proxy or withholder for the then-unidentified beneficiary.

Non-resident trust: The inferences that can be drawn from the treatment of non-resident trusts are more limited. Where a resident beneficiary receives a distribution from a non-resident trust that can be traced to underlying income on which the trust has already been taxed in the beneficiary's own country, Australia, the United States and the United Kingdom each, by different means and to differing degrees,[378] refrain from taxing the distribution or grant relief from double taxation. This implicitly regards the trust as a representative of the beneficiary in respect of income previously sourced in the taxing country. The United States takes a similar approach in relation to underlying foreign taxation.[379] New Zealand is alone in denying recognition to any prior entity-level taxation.

There may not be a complete answer to the question of whether a trust is seen as proxy for the grantor or for the beneficiaries, but the available indications point to the beneficiaries in Australia, the United States and the United Kingdom, and to the grantor in New Zealand. In the first

[375] Each of the surveyed countries previously applied lower or progressive rates to trust-attributed income.
[376] See Sections 5.3.1, 5.3.2 and 5.3.4; ESC B18; SP 3/86.
[377] ITAA 1936 s 99D (see n 312).
[378] See Sections 5.2.2 and 5.3.4.
[379] See Sections 5.2.2 and 5.3.3.

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three countries, the rules of trust residence make no attempt to reflect the residence of beneficiaries. This reflects the indeterminacy of the ultimate beneficial enjoyment of trust income and assets, which created the original problem of attribution (once the grantor is excluded). Australia (in outbound situations), the United States and the United Kingdom each also have significant rules of grantor taxation; New Zealand pursues a similar objective to grantor taxation, but does so through a rule of functional trust residence and top-rate taxation in a domestic or outbound context.

6.5 Summary

From the perspective of a particular taxing country, trust residence determines the claim to tax foreign-sourced trust income that is not currently attributed to a grantor or beneficiary. It also affects whether and how the country taxes a trust distribution to a resident beneficiary. International double taxation may arise inter alia from a conventional overlap between source and residence taxing claims, from a residence–residence attribution conflict, from dual trust residence, or from the separate substantive taxation of trust income and distributions (Section 6.2). Non-taxation may arise from a negative residence conflict where the trust is fiscally homeless, from a negative attribution conflict where the trust is a reverse hybrid, from a lacuna in the taxation of foreign trust distributions, or from duplication of relief (Section 6.3). Where residence taxation of trust-attributed income is concerned, some light can also be shed on the policy basis of the taxing claim by considering whether the trust is taxed as proxy for unascertained and presumptively resident beneficiaries or, as in New Zealand, for a resident grantor (Section 6.4).

Having identified the nature and causes of these outcomes, the next step is to ameliorate those which are found to be anomalous and problematic. The analysis so far has attempted to understand the problem insofar as it arises from the interaction of national laws and to lay a foundation for the development of solutions. Double non-taxation outcomes are inherently the result of overlapping gaps in national tax laws: any remedy must therefore be sought in the prophylactic design and, it will be suggested, the cooperative design of national tax laws. Double taxation outcomes may also be addressed unilaterally, but in many cases are more conveniently addressed through treaties. These issues will be considered in Part II.

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PART II

Global Taxation

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7

The International Tax Order and the Interaction of Tax Laws

This chapter considers the interaction of domestic laws relating to the international taxation of trust-related income as part of an international tax order and in the context of cooperative measures against tax arbitrage propounded by the OECD and G20 through the BEPS project.

Section 7.1 describes the international tax order, the objection to tax arbitrage and the work of the OECD on that topic that is relevant to trusts. Those subjects involve consideration of the role of tax treaties as well as interactions between domestic tax laws, and Section 7.1 also serves as an introduction to Chapter 8, dealing with treaties. Section 7.2 considers the interaction between national tax laws. Based on the findings of previous chapters, it identifies particular areas in which mismatches causing double taxation or non-taxation are prone to arise in a trust context. It also considers the potential operation of relevant recommendations of the BEPS project, if carried into effect in domestic laws. Section 7.3 proposes an ordered overview of trust-related taxing claims, their claims to priority and their interaction, and suggests a method for the cooperative prevention of trust-based tax arbitrage that balances fiscal sovereignty, the results obtained from analyzing international trust tax interactions and international taxing norms. This section is also material to the discussion of treaties in Chapter 8.

7.1 International Tax Order

Previous chapters have considered the design and interaction of domestic rules of international taxation as they bear upon trust-related income. Those rules are only part of the international tax order. A network of more than 3,000 tax treaties modifies countries' primary taxing claims with a view to eliminating double taxation without facilitating unintended double non-taxation. In more recent times, the OECD has proposed that countries should also take action to coordinate their domestic taxing rules with a view to preventing double non-taxation. Neither goal – eliminating

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double taxation nor preventing double non-taxation – is unqualified, either in its conception or in the manner of its implementation.

7.1.1 Tax Treaties

The foundations of the modern treaty network were laid by work done under the auspices of the League of Nations in the 1920s. There had been double income tax treaties since the nineteenth century, but tax rates were then relatively low, treaties were few in number and their impact was consequently limited. When income tax rates increased at the time of the First World War, double taxation became a more significant impediment to international trade and commerce. The League, through its Financial Committee and subsequently its Fiscal Committee, undertook extensive research and consultation on the issue. The Committees produced a body of work which included model tax treaties and substantial other literature.[380] Their work was based on a combination of economic analysis, existing state practice, and the input of tax administrators.[381] The primary distinction between source taxation and residence taxation and the general architecture of international taxation, not only in tax treaties but also in the domestic tax laws of most countries, reflect a consensus developed within the League in the 1920s.[382]

After the Second World War, the League's work on international taxation was ultimately[383] taken over by the Organisation for European Economic Co-operation and its successor, the OECD. The OECD produced its first model tax treaty as a draft with accompanying

[380] Key League of Nation documents are included in an online repository, OECD et al., 'History of Tax Treaties Database' www.taxtreatieshistory.org (at 20 December 2017).

[381] Vann, Richard J, *Writing Tax Treaty History* (24 March 2011), Sydney Law School Research Paper No 10/19, available at SSRN: https://ssrn.com/abstract=17886036; John F Avery Jones et al., 'The Origins of Concepts and Expressions Used in the OECD Model and their Adoption by States' [2006] *British Tax Review* 695.

[382] 'From that seminal work grew the structure of the tax principles that we know today: residence taxation, permanent establishments, reduced source taxation, credit and exemption methods for relief of still existing double taxation, and the like.' (Hugh J Ault, 'Some Reflections on the OECD and the Sources of International Tax Principles' (2013) 70 *Tax Notes International* 1195, 1195.) The League's work is considered in depth by Sunita Jogarajan, *Double Taxation and the League of Nations* (Cambridge University Press, 2018).

[383] The United Nations initially proposed to take over the work of the League of Nations and engaged in some activity in the area from 1946 to 1954, principally through its Fiscal Commission.

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commentaries in 1963[384] and as a final document in 1977.[385] The OECD Model and Commentaries have been published in ambulatory form incorporating successive amendments since 1992.[386]

Actual income tax treaties are overwhelmingly based on the OECD Model, and almost all are bilateral. Other models are generally derivative. The United Nations has published a model treaty for use between developed and developing countries since 1980. The current edition, with accompanying commentaries, dates nominally from 2017.[387] The United States has published a model for the negotiation and drafting of its own bilateral treaties since 1976.[388] Later versions followed, most recently in 2016.[389] Until a Technical Explanation is published for the 2016 US Model, guidance by way of commentary may be judiciously inferred from the 2006 version.[390] The UN and US Models are both based on the OECD Model, from which they depart according to their respective priorities and policies.

Tax treaties based on the OECD Model serve the purposes of eliminating double taxation and preventing fiscal evasion,[391] but they seek to achieve these goals in different ways. Treaties address double taxation by constraining taxation by the contracting parties under their respective domestic laws. They state an agreed allocation of taxing rights between the parties in a series of distributive rules and require the residence

[384] OECD, *Draft Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital* (1963); OECD, *Commentaries on the Draft Convention* (1963).

[385] OECD, *Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital* (1977); OECD, *Commentary on the Model Double Taxation Convention on Income and Capital* (1977).

[386] See n 3.

[387] United Nations, *United Nations Model Double Taxation Convention between Developed and Developing Countries 2017* (UN, 2018). The 2017 update was not finalized until 2018.

[388] See Rosenbloom and Langbein, n 6, for consideration of the first US Model and earlier treaty policy.

[389] *United States Model Income Tax Convention* (2016).

[390] *United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006.*

[391] The 1963 and 1977 versions of the OECD Model included in the treaty title a reference to the elimination of double taxation. A shorter form of title was adopted in 1992, with the explanation that the treaty also dealt with other issues, such as the prevention of tax evasion and non-discrimination (OECD Comm Intro [16], as added in 1992). Many countries adopted the practice of referring to the elimination of double taxation and prevention of fiscal evasion in bilateral treaty titles and/or preambles.

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country to relieve against remaining juridical double taxation[392] by an agreed method of exemption or credit. They address fiscal evasion by providing for the exchange of information and, in more recent times, other forms of administrative assistance, which may include the collection of tax. A tax treaty may contain provisions directed against its use or interpretation in a way that would lead to double non-taxation in order to prevent the treaty from becoming an instrument of tax avoidance, but a tax treaty is not itself the source of a taxing claim.[393] It generally does not close gaps in the relevant countries' domestic tax laws where a conjunction of those gaps would produce double non-taxation. The closing of such gaps requires other action, generally in the form of domestic legislation.

7.1.2 Coordination of Tax Laws

Coordination of national tax laws to prevent double non-taxation or otherwise lawful tax avoidance remains contentious.

It is common for countries to take account of foreign taxation in the conditions they impose on unilateral double tax relief by credit or (if a subject-to-tax test is used) exemption. They may also take account of foreign tax in defining the scope or operation of CFC and other outbound anti-deferral rules or offshore investment regimes. Specifically outbound grantor rules may or may not be sensitive to the incidence of foreign tax; where they are so, they may be explained conceptually as measures against deferral and/or measures against avoidance, depending on the terms of the rules and the inferences that lie behind them (Section 2.5). The policy focus in all these cases remains on the national tax base and its protection.

[392] Juridical double taxation occurs 'where the same income . . . is taxable in the hands of the same person by more than one State': OECD Comm Art 23 [1]. The extension of treaties beyond such purely juridical double taxation is considered in Sections 8.1, 8.3.2, 8.3.9 and 8.3.13.

[393] Klaus Vogel and Alexander Rust, 'Introduction' in Ekkehart Reimer and Alexander Rust (eds), *Klaus Vogel on Double Taxation Conventions* (Wolters Kluwer, 4th edn, 2015) m. no. 54; *GE Capital Finance Pty Ltd* v *FCT* (2007) 159 FCR 473; 9 ITLR 1083; *Chevron Australia Holdings Pty Ltd* v *FCT (No 4)* (2015) 102 ATR 13, 40–44 (Robertson J). But the terms of a treaty may be given the effect of expanding what would otherwise be a country's taxing claim indirectly, at least in Australia, if a provision of domestic law adopts or incorporates what is said in the treaty in such a way as to produce that consequence: *Tech Mahindra Ltd* v *FCT* (2015) 101 ATR 755; 18 ITLR 239; n 910.

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Some OECD projects have gone further and have sought to enlist countries in cooperative actions targeting international avoidance and non-taxation as such, in circumstances where the avoidance or saving of tax is not clearly at the expense of a particular country or of the country whose action is sought to prevent it. The 1998 report on harmful tax competition justified its recommendations (including those concerning domestic tax laws) on a cooperative basis and identified the altruistic denial of deductions or imposition of withholding tax as a subject for further study.[394] More recently and relevantly, so do the 2012 Hybrids Report[395] and the BEPS project. Although the main focus of the BEPS project is on corporate taxation of multinational enterprises, some of its proposals may affect the domestic tax treatment of trusts or transactions involving trusts as hybrid entities. Other BEPS measures, which affect the treatment of trust income under tax treaties, are considered in Chapter 8.

7.1.3 *Some Themes and a Brief Timeline*

The international documents of the past 20 years that have greatest bearing on trust taxation are the OECD Partnership Report of 1999,[396] the 2012 Hybrids Report and material relating to BEPS Action 2 (neutralizing hybrid mismatch arrangements), and material relating to BEPS Action 6 (preventing inappropriate treaty benefits). Particular milestones are noted in Figure 7.1.

7.1.4 *The Partnership Report*

The Partnership Report was produced by a working group formed by the OECD Committee on Fiscal Affairs in 1993 to study the application of the OECD Model treaty to partnerships, trusts and other non-corporate entities. The Report addressed only partnerships directly, although the

[394] OECD, *Harmful Tax Competition: An Emerging Global Issue* (OECD, 1998). The report focused on tax havens and preferential tax regimes. Its positive recommendations concerning domestic substantive law and the avoidant use of tax havens focused on CFC, FIF and equivalent rules and on qualification for participation exemption (recommendations 1, 2 and 3). That is to say, they still related to base erosion in the country being invited to change its tax law, albeit that the recommendations were premised on the desirability of cooperative international action. Part V of the report addressed topics for further study.

[395] OECD, *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (2012).

[396] OECD, *The Application of the OECD Model Tax Convention to Partnerships* (OECD, 1999) (Partnership Report).

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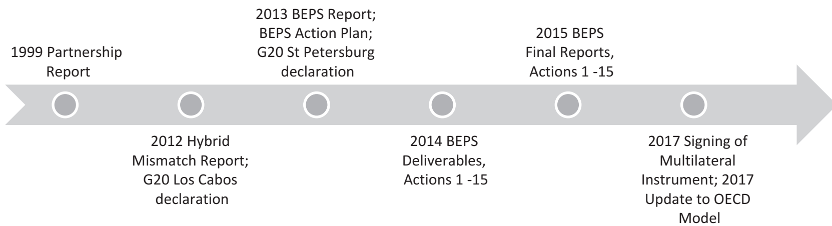

Figure 7.1 Timeline – BEPS and OECD

Committee recognized that 'many of the principles discussed in its report may also apply with respect to other non-corporate entities' and expressed the intention 'to now examine the application of the Model Tax Convention to these other entities in light of this report'.[397]

The foreshadowed follow-up work focused on widely held/portfolio investment entities – collective investment vehicles[398] and real estate investment trusts[399] – which in some countries are structured as trusts; the BEPS project has also picked up some loose ends in a manner that recognizes trust issues. There has, however, been no similar concerted study of donative trusts or of trusts as such.

The Partnership Report dealt extensively with problems in the interpretation and application of tax treaties arising from the classification of partnerships as fiscally transparent or opaque by different countries, with resulting conflicts of attribution. It also considered conflicts of qualification relating to dealings between partner and partnership or dealings concerning interests in a partnership. Despite recognizing numerous differences of national opinion on the correct treaty outcome, it recommended only one change to the OECD Model and otherwise sought to achieve consistency by amendments to the Commentaries.[400] The recommended changes to the OECD Model and Commentaries were implemented in 2000. The Partnership Report itself remains important for its discussion of policy and principles, its treatment of competing

[397] Partnership Report [1].
[398] OECD, *The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles* (2010) (*CIVs Report*).
[399] OECD, *Tax Treaty Issues Related to REITs* (2008).
[400] Addition to the OECD Model of Art 23A(4) (precluding residence exemption under Art 23A(1) where the source country considers that the treaty forbids or limits source taxation) and changes to the Commentaries on Arts 1, 3, 4, 5, 15 and 23 (Partnership Report, Annex 1).

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views and its application of preferred and dissenting views to the numerous scenarios which it used as a framework to analyze how the model treaty ought to work.

7.1.5 The BEPS Project

Early in the present decade the planets of public opinion, international political will and tax policy analysis aligned in a way that led to the OECD/G20 BEPS project.[401]

In the aftermath of the global financial crisis of 2007–08 and following a series of exposés in the general and financial press focusing on how little tax was being paid by prominent multinational enterprises,[402] the 2012 G20 summit at Los Cabos asserted 'the need to prevent base erosion and profit shifting' and undertook to 'follow with attention the ongoing work of the OECD in this area'.[403] The OECD drew together a number of previously separate areas of work to undertake an ambitious project addressing base erosion and profit shifting as such.

By February 2013, the OECD had produced the initial BEPS Report, which concluded that BEPS was a serious problem for tax revenue, sovereignty and fairness in all countries and should be addressed by holistic and coordinated international action.[404] The key pressure areas identified in the report included international hybrid mismatches and arbitrage and the effectiveness of anti-avoidance measures. In July it produced the BEPS Action Plan, which outlined 15 'Actions' to be taken against BEPS.[405] Action 2 was to neutralize the effects of hybrid mismatch arrangements. Action 6 was to prevent treaty abuse, and was to be coordinated with the work on hybrids. Action 15 was to develop a multilateral instrument (**MLI**) to kick-start the amendment of bilateral tax treaties to incorporate treaty measures recommended under other

[401] Hugh J Ault, Wolfgang Schön and Stephen E Shay, 'Base Erosion and Profit Shifting: A Roadmap for Reform' (2014) 68 *Bulletin for International Taxation* 275.

[402] See citations and commentary ibid and by Yariv Brauner, 'What the BEPS?' (2014) 16 *Florida Tax Review* 55, 57–58; Pascal Saint-Amans and Raffaele Russo, 'What the BEPS Are We Talking About?' (8 April 2013) OECD www.oecd.org/ctp/what-the-beps-are-we-talking-about.htm. Press reports, public opinion and pressure from non-governmental organizations are acknowledged in the BEPS Report itself, n 404, Chapter 1 and Bibliography.

[403] G20 Leaders' Declaration (Los Cabos, 19 June 2012, www.g20.utoronto.ca/2012/2012-0619-loscabos.html [48].

[404] OECD, *Addressing Base Erosion and Profit Shifting* (2013).

[405] OECD, *Action Plan on Base Erosion and Profit Shifting* (2013).

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Actions. In September, the G20 summit at St Petersburg endorsed the Action Plan and adopted the BEPS project as a joint G20–OECD endeavour.[406]

In 2014, the OECD published '2014 Deliverable' interim reports on several of the BEPS Actions, including Actions 2, 6 and 15.[407] In October 2015, it published a full set of final Action Reports.[408] Work on the project continues. Negotiation of the MLI concluded at the end of 2016, and the instrument was signed by 68 countries on 7 June 2017.[409] Changes to the OECD Model and Commentaries in the 2017 Update were approved by the OECD Council on 21 November 2017; fully revised versions were published in December 2017.[410]

Success of the BEPS project is likely to increase source taxation of privately owned groups doing business in high-tax jurisdictions and, therefore, to make fiscally transparent entities including trusts more attractive as cross-border business entities.[411]

7.1.6 *Coherence of International Taxation*

It has been provocatively argued that an international tax system is imaginary.[412] Just as provocatively, it has been counter-argued that

406 G20 Leaders' Declaration (St Petersburg, 6 September 2013, www.g20.utoronto.ca/2013/2013-0906-declaration.html [50].

407 Accessible via OECD/G20 BEPS Project, 'BEPS 2014 Deliverables' (2014) www.oecd.org/ctp/beps-2014-deliverables.htm.

408 Accessible via OECD/G20 BEPS Project, 'BEPS 2015 Final Reports' (2015) www.oecd.org/tax/beps-2015-final-reports.htm. The G20 endorsed the package the following month: G20 Leaders' Communiqué (Antalya, 16 November 2015, www.g20.utoronto.ca/2015/151116-communique.html) [15]. See also OECD/G20 BEPS Project, *Explanatory Statement 2015*, n 2.

409 *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*, adopted 24 November 2016, opened for signature 31 December 2016, initial signatures 7 June 2017 (entered into force 1 July 2018). Signatories include Australia, the United Kingdom and New Zealand. The United States did not sign; its model treaty and treaty practice were the source of much of the content of the instrument, and US treaties already incorporate corresponding provisions. Philip Baker, 'The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting' [2017] *British Tax Review* 281, 282 describes the signing of the instrument as the 'end of the beginning' of the BEPS project.

410 OECD, n 3.

411 Robert Gordon, 'Increasing Use of Tax-Transparent Entities by Private Groups Due to BEPS' (2016) 19 *The Tax Specialist* 136.

412 H David Rosenbloom, 'The David R Tillinghast Lecture: International Tax Arbitrage and the International Tax System' (2000) 53 *Tax Law Review* 137.

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such a system not only exists, but has definable underlying principles, is embodied in both tax treaties and domestic laws, and forms a significant part of treaty-based and customary international law.[413] The latter view proposes the existence of a single tax principle 'that income from cross-border transactions should be subject to tax once (that is, not more but also not less than once)'.[414] The concept of singularity refers to whether the imposed tax represents complete taxation consistent with the treatment of a resident, not how many countries impose taxation. One-country taxation may be less than single, and two-country taxation may or may not exceed single taxation. The rate of single tax is said to be determined by a benefits principle, which assigns primary taxing rights to a source country in the case of active business income and to the residence country of individual investors in the case of passive investment income.[415] If the primary jurisdiction refrains from taxation, residual taxation by the other 'is possible, and may be necessary to prevent undertaxation'.[416]

Debating the existence of an international tax system, or order, or regime, turns into a semantic exercise. Its reality is really not in issue: there is a large network of tax treaties of generally similar nature; there is a kinship in the domestic laws of many countries dealing with international taxation; and a country designing its tax laws must follow the norms of those systems or suffer adverse consequences[417] – unless perhaps it is a tax haven trying to support a local industry that arbitrages the rules of other countries. The real issue concerns the nature and content of the norms that are observable in the international tax order. The essence of the issue is exposed by considering the relationship between tax arbitrage and international fiscal coherence.

[413] Most fully developed in Reuven S Avi-Yonah, *International Tax as International Law: An Analysis of the International Tax Regime* (Cambridge University Press, 2007).

[414] Reuven S Avi-Yonah, 'Commentary on Rosenbloom, International Tax Arbitrage and the "International Tax System"'(2000) 53 *Tax Law Review* 167, 169.

[415] It is not necessary to adopt this particular quantification of single tax in order to understand the general argument that, leaving aside special taxpayers and special kinds of income that may warrant concessional treatment, it should not be possible to avoid a substantive level of taxation somewhere by using specifically international structures or transactions.

[416] Reuven S Avi-Yonah, 'International Taxation of Electronic Commerce' (1997) 52 *Tax Law Review* 507, 517.

[417] Paraphrasing H David Rosenbloom, 'Cross-Border Arbitrage: The Good, the Bad and the Ugly' (2007) 85 *Taxes* 115, 115.

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The international tax order is coherent in the sense that each country sets its international tax rules and policies based to some extent on an expectation of how other countries will tax the foreign elements of a given situation.[418] A residence country may refrain from taxing in the expectation that a source country will do so, or a source country may impose low or no tax in the expectation of residence taxation. Some tax-limiting rules (such as a subject-to-tax exemption or a foreign tax credit) respond expressly to the fact or extent of other-country taxation, and so provide for the possibility that the other country's behaviour may differ from the expectation. Others do not, and it may be difficult to determine whether such a rule reflects an unstated expectation of foreign taxation or some quite different consideration.[419] If expectations – particularly unstated ones – are not met, coherence breaks down. If taxpayers can engineer a situation in which limitations or gaps in the taxing claims of all potential taxing countries line up, they may achieve an overall saving of tax compared to alternative scenarios of domestic investment or international investment in a manner consistent with the expectations of one or more of those countries. This – 'taking advantage of differences among country tax systems, usually differences in addressing a common tax question' – is international tax arbitrage.[420]

If one is simply concerned with exposition of the law and not with what the law should be, a fundamental weakness of any doctrine precluding tax arbitrage or unintended double non-taxation arising from the interaction of domestic laws is the absence of any means to enforce it between countries or, except to the extent that it is embodied in positive law of a taxing country, against taxpayers.[421] But if one is concerned with what the law should be or may become, the question 'Is arbitrage evil?' or 'Should double non-taxation be prevented, and in what circumstances?' remains a substantial one.

The normative question deserves a generally affirmative answer in a treaty context.[422] A treaty relieves against double taxation and should not

[418] Charles I Kingston, 'The Coherence of International Taxation' (1981) 81 *Columbia Law Review* 1151, 1153.

[419] The issue arises where a source country exempts or only lightly taxes particular kinds of income or where a residence country exempts a class of foreign income, either generally or from the application of a special outbound attribution regime, without direct reference to the fact or extent of foreign taxation.

[420] Rosenbloom, n 412, 142.

[421] Rosenbloom, n 417, 115.

[422] Ibid, 117. ('[I]t is appropriate for the country making a treaty concession to tailor that concession to what is happening in the other country.')

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be made an occasion of non-taxation unless the contracting parties really have that intention for the kind of taxpayer or income concerned; nor is it necessary to look beyond the tax systems of those countries, the non-treaty impact of at least one of which will be evident before the question of treaty application is considered. Changes arising from the BEPS project increase the difficulty of treaty-based arbitrage.

In a non-treaty context, the normative question remains more contested. The OECD view is best appreciated from its work in the context of hybrid mismatch arrangements – 'arrangements exploiting differences in the tax treatment of instruments, entities or transfers between two or more countries'.[423] This concept is equivalent to international tax arbitrage,[424] which it describes by reference to the mechanism whereby the tax outcome is effected. The Hybrids Report identified five policy issues as negative consequences of such arrangements. The first of these was

> a reduction of the overall tax paid by all parties involved as a whole. Although it is often difficult to determine which of the countries involved has lost tax revenue, it is clear that collectively the countries concerned lose tax revenue.[425]

Others related to distortion of competition, impact on economic efficiency, lack of public transparency, and the question of fairness between taxpayers deriving capital and labour income.[426] The Report drew what was then a preliminary conclusion that

> hybrid mismatch arrangements that apparently comply with the letter of the laws of two countries but that achieve non-taxation in both countries, which result may not be intended by either country, generate significant policy issues. The same concern that exists in relation to distortions caused by double taxation exists in relation to unintended double non-taxation.[427]

The work of the Hybrids Report was taken over by the BEPS project, and its policy conclusions have been adopted in the BEPS Action 2

[423] OECD, *Hybrids Report*, n 395, [3].
[424] Reinout de Boer and Otto Marres, 'BEPS Action 2: Neutralizing the Effects of Hybrid Mismatch Arrangements' (2015) 43 *Intertax* 14, 14.
[425] OECD, *Hybrids Report*, n 395, [23].
[426] Ibid [24]–[27]; see also Ault, *Some Reflections*, n 382; Brauner, n 402.
[427] OECD, *Hybrids Report*, above n 395, [28].

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Report.[428] The policy analysis in the Hybrids Report remains contestable,[429] although some former sceptics now accept the view that cooperative international action against tax arbitrage may be warranted.[430] This book proceeds on the basis accepted by the OECD that tax arbitrage is harmful and that it is desirable for countries to take countermeasures.

7.2 Interaction of Domestic Laws and the BEPS Project

7.2.1 Trust-Based Mismatches and Arbitrage

Previous chapters have identified a number of more or less distinctive features of trust taxation that make trusts different from other entities and have potential to generate double taxation or double non-taxation:[431]

- *Grantor attribution*: Some countries attribute the income of a donative trust to its grantor, to the exclusion of the trust and beneficiaries. The criteria by which they do so vary. They may also impose attribution in an outbound situation by reference to different (and generally broader) criteria. The relationship between grantor taxation and foreign taxation of entity-level income differs between countries and is not always clearly defined. The grantor of a trust has no corporate or partnership analogue.
- *Differential transparency*: Many countries treat trusts as both opaque and transparent at the same time, such that the trust is transparent for some of its income and opaque for the rest. The criteria for attribution to the trust versus the beneficiaries differ between countries. A major point of difference is the recognition or otherwise of discretionary appointments of current income.
- *Item allocation*: The rules by which particular income items are allocated among beneficiaries or between beneficiaries and a trust differ between countries.
- *Entity classification*: The class of entities that are subject to a country's rules of trust taxation may not include all trusts and may include some

[428] OECD/G20 BEPS Project, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report* (2015) [2].

[429] See counterarguments canvassed by de Boer and Marres, n 424, 37–39.

[430] See, e.g., H David Rosenbloom, Noam Noked and Mohamed S Helal, 'The Unruly World of Tax: A Proposal for an International Tax Cooperation Forum' (2014) 15 *Florida Tax Review* 57, 82.

[431] This section appears in modified form as an introduction to the main analysis in M L Brabazon, 'BEPS Action 2: Trusts as Hybrid Entities' [2018] *British Tax Review* 211.

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entities that are not trusts. The boundaries of such fiscal trust treatment differ from country to country. A trust may be perceived as a trust for tax purposes by one country but as something else (a company, a partnership, a mere agency) by another. The classification of business trusts and collective investment trusts, in particular, may differ between jurisdictions.[432]

- *Internal coherence*: The international tax rules of particular jurisdictions do not always apply consistently or maintain parity of treatment between a beneficiary in respect of transparently attributed trust income and a direct investor in the position (pro tanto) of the trust.
- *Trust residence*: Trust residence criteria differ between countries. A trust may be regarded as fiscally resident by multiple jurisdictions or by none. Fiscally homeless trusts create opportunities for tax avoidance or deferral.[433]
- *Distribution taxation*: The settings in a beneficiary's residence country for taxation of international trust distributions have particular potential for double taxation (if current taxation of entity-level income has been substantial and is disregarded when a distribution is taxed) or non-taxation (if current taxation has been light or absent and the distribution is not recognized as income). The rate of trust entity taxation in a trust residence country may be aligned with the top personal rate rather than the company rate, so corporate analogies may be inappropriate.

7.2.1.1 Conflicts of Attribution

Differences in any of the first four areas – grantor attribution, differential transparency, item allocation and entity classification – can lead to conflicts of attribution in relation to the same items of current entity-level income. Deliberately to engage a mismatch of this kind to produce double non-taxation qualifies as tax arbitrage and as a hybrid mismatch arrangement in the sense described earlier, although it may be difficult to say which country has lost revenue or that the arrangement had the purpose of avoiding a particular country's tax. A failure in the fifth area, internal coherence, may lead to analogous consequences of over- or

[432] The issue of trust entity classification has conceptual parallels in the fiscal recognition of other kinds of entity, such as partnerships, as transparent or opaque with respect to all their income.

[433] See Section 1.4. Similar consequences arise if a company achieves fiscal statelessness, but the issue has received less attention in the context of trusts.

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under-taxation without necessarily involving an international mismatch. Its deliberate engagement may be more readily associated with avoidance of tax in the country concerned.

7.2.1.2 Conflicts of Residence

The sixth area, trust residence, involves a mismatch or conflict of residence if the trust is fiscally resident in two countries. If a trust escapes the residence criteria of all the countries with which it has connections, there is not necessarily a mismatch or conflict *between them*. In contrast to the attribution conflicts mentioned in the previous section, where there is no doubt that income is owned but disagreement about who owns it so as to be taxable in his or her country of residence, the question is whether the trust has a country of residence at all. It is not the case that each country points to another as the residence, but that each answers the binary question 'Is this trust resident or non-resident here?' in the negative. There is no principle that an individual must be resident somewhere, although the fabled perpetual globetrotter is a rare creature – but what may we say of a trust?

Such a situation exploits overlapping gaps in national tax systems. Arguably, it is not within the semantic concept of tax arbitrage or a hybrid mismatch arrangement because there is no necessary point of disagreement between tax systems, but that does not address the policy arguments. The policy objections to tax arbitrage identified in the Hybrids Report apply with no less force to the use of a homeless trust to accumulate income to the extent that the income is untaxed or under-taxed[434] in the source country and escapes attribution to a grantor or beneficiary in a country where the grantor or beneficiary is resident. The achievement of homelessness implies that the connections of the trust (grantor residence, trustee residence, place of central control/effective management, residence of decision-makers, proper law, jurisdiction of legal administration or oversight) have been distributed in such a way as to avoid fiscal residence anywhere, yet those connections all exist and those functions are all performed in real places. The mismatch is global rather than binary. It is also unlikely that a trust would be homeless by accident or, more to the point, that the consequences of homelessness would not be an important part of its economic strategy.

[434] Relative to notional single taxation such as might be applied to a resident.

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The only countries that may be identified as losing residence-basis revenue from such an arrangement are the grantor's country and the country of the beneficiaries (if that country can be identified before distribution). It seems too tenuous to say that the residence of the trustees, the location of their activities or the jurisdiction of administration of a trust are truly analogous to residence of an individual owner of income, other than as a rough and ready predictor of the residence of the grantor or beneficiaries.

7.2.1.3 Distribution Taxation

The final area, distribution taxation, involves the relationship between taxation of current trust-level income and taxation of distributions from a trust whenever they occur. These are not the same tax question,[435] but there may be a mismatch in the sense that a relatively high level of current taxation assumes no distribution tax, while a distribution tax may fail to recognize how the distributed value was assembled in the hands of the trust and what tax it may have borne. A tax strategy that sidesteps distribution taxation has some elements in common with tax arbitrage, but only the revenue of the beneficiary's residence country is in issue.

7.2.2 BEPS Action 2 and Domestic Laws

'This section considers Action 2 of the BEPS project and its impact on national tax laws concerning trust income.[436] The BEPS Action 2 Report makes a series of recommendations with a view to neutralizing the effect of hybrid mismatch arrangements. Broadly speaking, these are arrangements that exploit differences in the tax treatment of an entity or instrument in different countries to produce double non-taxation. Part I of the Report is concerned with double non-taxation arising from the interaction of national laws. The arrangements considered in that part include trusts. In broad terms, the most significant ways in which trusts can be used to produce such non-taxation involve particular trust income

[435] Cf n 420.

[436] This section draws on the writer's analysis of the application of Part I of the BEPS Action 2 Report to trusts in Brabazon, *Trusts as Hybrids*, n 431. The terminology of the Report is complex and detailed. The account presented here summarizes particular aspects of the Report that are considered significant to the subject of this book without full analysis of the terminology. More detailed consideration of the Report and its terminology may be found in that article.

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being attributed to a beneficiary or grantor in a country where the trust would be fully taxable on that income, were it attributed to the trust, and being attributed to the trust in any country where a beneficiary or grantor would be fully taxable on it, were it attributed to the beneficiary or grantor. In the terminology of the Report, they are reverse hybrids.[437] Fiscally homeless trusts generate similar concerns. The focus is consequently on overlapping gaps in residence taxation in the absence of comparable full-rate source taxation (such as may apply to the income of a local PE or other taxable presence).

Two recommendations of the BEPS Action 2 Report warrant particular attention: recommendation 5.1 with respect to offshore investment regimes and recommendation 5.2 with respect to entity residence and limiting transparency. Recommendation 5.3 is significant to trusts by strengthening the gathering and exchange of information but does not propose any change of substantive taxing rules. Other recommendations may apply in some trust situations,[438] but their significance to the taxation of trust income is more limited and they will not be considered here.

7.2.2.1 Outbound Grantor Attribution

Recommendation 5.1 is concerned with offshore investment regimes which, broadly speaking, require an investor's accrued income to be currently included in that person's fully taxable income. General and outbound grantor attribution regimes are of this character, if one may recognize the grantor as an 'investor' and the fulfilment of the grantor's donative purposes as sufficient justification to treat the income as accruing for the benefit of the grantor for tax purposes. Subject to their various parameters and conditions, that is the approach of the grantor regimes considered in Chapter 2.

Recommendation 5.1 asks countries to enact or amend offshore investment regimes to prevent 'D/NI outcomes' from arising in respect

[437] In a trust context where it is common for an entity to be differentially transparent, the concept of a **reverse hybrid** needs to be related to the particular income in question and its fiscal attribution rather than to whether an entity as such is treated as transparent or as a separate taxpayer in particular jurisdictions. In broad terms, an entity may be seen as a reverse hybrid with respect to particular income if that income is not attributed to it in a country (if any) where it is resident and is not attributed to any participant in the participant's residence country.

[438] Recommendations 3, 4 and 6 proposing denial of deductions to payers of income in certain circumstances are considered in Brabazon, *Trusts as Hybrids*, n 431 and mentioned briefly in Section 7.3.5.

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of payments to a reverse hybrid. Broadly, a D/NI outcome involves deductibility to the payer and non-inclusion in fully taxable income of the payee or its investors. In a trust context, tax arbitrage is successfully achieved if income derived by a trust is not included in the income of the trust, its beneficiaries or grantor. No element of common interest or collaboration with the payer is required. If the objective of neutralizing hybrid mismatch arrangements is to be achieved in a trust context, recommendation 5.1 should be applied without regard to deductibility in a trust context. Alternatively, one might say that a comparable principle should be applied, jettisoning the D/NI requirement in a context where it is inappropriate.[439]

Grantor attribution and taxation is a key strategy that countries can use to combat trust-based tax arbitrage. The uncertain destination of accumulated trust income makes beneficiary attribution impracticable. The trust itself may be based in a tax haven or may have no fiscal residence. Or the residence countries of beneficiaries and of the trust may each consider that particular trust income is not derived by their resident. Source taxation may be limited or zero, and a source country is not well placed to know or investigate the nature of taxation in residence countries. The grantor's country has an interest in protecting its own tax base, which may rationally be extended to the cooperative protection of a global tax base. Grantor attribution in the grantor's residence country is an effective antidote to trust-based arbitrage during the life or existence of the grantor.

There are, to be sure, some countervailing considerations: higher compliance costs for grantor-taxpayers; corresponding costs of administration; and the need to avoid overreach and inappropriate double taxation, particularly given that a person now resident may have capitalized a foreign trust or a local trust that derives foreign income without a purpose of avoiding tax. The last in particular needs to be considered in the design of outbound grantor attribution rules. It should also be considered in the negotiation of tax treaties by and with countries that have grantor tax regimes.

The New Zealand settlor regime achieves most of the objectives of recommendation 5.1 by a different route. Broadly speaking, it attributes

[439] See ibid, 224–226. The focus in the BEPS Action 2 Report on payments and their treatment for transactional counterparties reflects an emphasis on multinational enterprises and their associated entities, which is not necessarily the way that arbitrage works in a trust context.

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accumulated trust income to the trust of a resident grantor. It does not address the possibility that a beneficiary's country may not agree with New Zealand's attribution to its resident of particular trust income, but that possibility is more remote and would involve greater compliance cost for the grantor.

7.2.2.2 Trust Residence and Limiting Transparency

Recommendation 5.2 is concerned with limiting transparency of a reverse hybrid entity where its income is not otherwise fully taxed to the entity or to participants to whom the income accrues. Broadly speaking, it calls on the establishment jurisdiction of the entity – a country where the entity is based or has connections such that the country might justifiably claim it as resident[440] – to treat the entity as resident and so tax income (generally sourced in another country) that would otherwise slip the global tax net because those countries where investors to whom the income accrues are fully taxable do not attribute that income to those persons. The concept of an establishment jurisdiction is needed because an entity that is wholly transparent in a country usually cannot be said to be resident or a taxpayer there – in contrast to a differentially transparent entity, which does have fiscal residence and is in itself simultaneously transparent and opaque. The challenge of defining that concept has some features in common with the challenges of defining corporate residence or, in a treaty context, the existence of a PE. A further condition is that the entity and investor be members of the same control group, but this requirement appears unnecessary in the case of a donative, closely held or fiscally homeless trust.[441]

Although the recommendation is drafted in terms of residence, it is really concerned with the taxability of particular entity income. In a trust context, its application should be recognized as having three potential aspects, one or more of which may affect a particular situation. One is to switch off beneficiary attribution in the trust country in favour of trust attribution if attribution to a non-resident beneficiary would result in the

[440] The concept of 'establishment jurisdiction' in the BEPS Action 2 Report needs some refinement in order to carry out its purpose effectively. See Brabazon, *Trusts as Hybrids*, n 431, 220–223.

[441] In the first two cases, the trustees may be expected to know their beneficiaries, and a mismatch involving attribution to a beneficiary who escapes taxation (other than on subjective grounds, such as status as a charity or pension fund) is unlikely to be accidental. In the third case, a trust is unlikely to be homeless by accident or, being homeless, to ignore that fact in its economic strategy.

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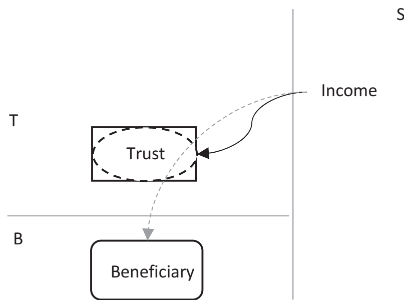

Figure 7.2 Beneficiary Attribution Switch-Off (Recommendation 5.2)
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income escaping residence taxation in any country. A second is to switch off grantor attribution in the trust country if attribution to a non-resident grantor would result in the income escaping residence taxation in any country.[442] A third is to assign fiscal residence to an otherwise homeless trust in respect of trust-attributed income. These are represented in Figures 7.2, 7.3 and 7.4 from the perspective of the trust residence or establishment country (T). Fiscal attribution before application of the recommendation is indicated by a grey dashed line; attribution in accordance with the recommendation is shown by a solid line. The participants' residence countries, B and G, do not attribute the income to their residents. If, however, there is a clear association between current trust income and a distribution treated as taxable to a beneficiary in the beneficiary's country, the anti-BEPS justification is not satisfied and there is no need to tax the trust. This might happen if the beneficiary's country takes a narrow view of beneficiary attribution and therefore taxes

[442] As may happen where IRC s 672(f)(2) preserves US attribution of trust income to a non-resident grantor and the grantor's country does not have a corresponding attribution rule. This provision is an important international tax-planning tool. As mentioned earlier (n 102 and corresponding text), foreign income of a foreign grantor trust, which may be free of residence taxation in any other country, can be delivered to a US beneficiary free of US income tax. That said, the loss of tax revenue does not appear to affect any country other than the United States itself.

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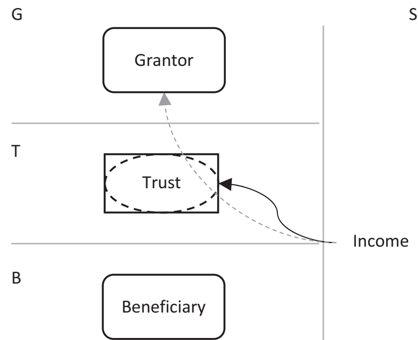

Figure 7.3 Grantor Attribution Switch-Off (Recommendation 5.2)
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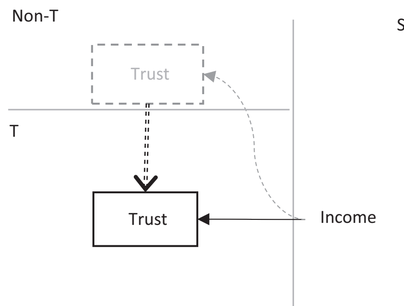

Figure 7.4 Reassignment of Trust Residence (Recommendation 5.2)
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distributions widely and a taxable distribution gives effect to an appointment to the beneficiary of particular current trust income.

The third aspect has its strongest justification and effect where a country's trust residence rules permit a trust to be substantially operated within its territory without acquiring trust residence, either because it has a low threshold for foreignness (or a high one for trust residence) or

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because it follows the New Zealand approach and determines trust residence on the basis of grantor residence (Section 4.2).

The New Zealand government announced in July 2017 that it would implement recommendation 5.2 with modifications for the local context, including the imposition of taxation of foreign-sourced trust income where the interposition of resident trustees would otherwise result in non-taxation of a grantor or beneficiary due to the interposition of the trust.[443] The policy is politically bipartisan and continues undiminished despite a change of government at the September 2017 general election.[444]

It is obvious that the BEPS Action 2 Report was not driven by considerations of trust taxation. Those aspects of the hybrid mismatch work that are potentially applicable to trusts are included in a summary way in the next section, which considers the interaction of trust-related tax claims.

7.3 Synthesis

7.3.1 Overview

If countries were individually and cooperatively to combat the exploitation of gaps and mismatches in national systems of trust taxation, what would that look like? This section proposes an ordered overview of domestic claims to tax trust income that helps to identify where overlapping tax claims may produce unintended double taxation, where overlapping gaps may produce unintended non-taxation, and how cooperative or self-protective measures may avert those outcomes. To do this, it draws upon a consideration of the areas of potential trust-based mismatch identified earlier in this chapter (Section 7.2.1) and the hybrids work of the BEPS project, together with the findings of earlier chapters concerning trust-

[443] New Zealand, Cabinet paper: BEPS – Addressing Hybrid Mismatch Arrangements (13 July 2017, http://taxpolicy.ird.govt.nz/publications/2017-other-beps/19-cabinet-paper-hybrids); see also Minister of Finance, Bill English, Minister of Revenue, Michael Woodhouse, *Addressing Hybrid Mismatch Arrangements: A Government Discussion Document* (IRD, September, 2016) [7.28], [7.29]; Inland Revenue Department, 'Base Erosion and Profit Shifting – A Summary of the Key Policy Decisions' (2017) http://taxpolicy.ird.govt.nz/sites/default/files/2017-other-beps-decisions.pdf (at 27 December 2017) p 7.

[444] Implementation of recommendation 5.2 is not due to take effect until April 2019. At time of writing, legislation has not been drafted for that purpose. The first tranche of anti-BEPS legislation (*Taxation Neutralising Base Erosion and Profit Shifting Act 2018* (NZ)) does not address the issue.

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related taxing claims in the surveyed countries and generalizations that may be inferred from them.

The goal of avoiding unintended double taxation and at the same time avoiding unintended global non-taxation in a complex area like international trust taxation presents particular challenges, largely due to the protean character of the trust, the diversity of national tax theories applied to it and the frequent difficulty of identifying an individual who can fairly be identified as the owner of particular trust income for tax purposes. Countries may make wide taxing claims to prevent avoidance; it is inevitable that some claims overlap; and it is to be expected that some overlapping gaps will remain unless conscious action is taken to close them. This implies that particular taxing claims of the same country have greater or less fiscal priority.

Those which express a primary claim to tax a resident ultimate owner or to tax income on a source basis have the strongest basis in fiscal policy. A country will not lightly yield or compromise such a claim but may do so if confronted with another country's claim which, in light of international taxing norms, it recognizes as superior, or in return for reciprocal treatment of its residents under a tax treaty. On the other hand, a taxing claim that is only lightly connected to those interests and serves an international cooperative purpose against base erosion should more readily be given up if another country exercises a more substantive taxing right. Between these extremes lies a range of taxing claims that are essentially self-protective from the viewpoint of the taxing country: the ultimate owner may not be identified, but there is a sufficient likelihood that the person will be one whom the country wants to tax on a residence basis, and a taxing measure is put in place to prevent deferral, avoidance or evasion. This covers a wide area, and the willingness of countries to compromise such claims differs from country to country and case to case. It may be said in principle, however, that a country should be more willing to compromise these claims than its clearly primary ones. It will also be seen that some such claims are more strongly or closely aligned with primary claims than others.

This implies a hierarchy of taxing claims.[445] Stronger claims should not be expected to yield to weaker ones, but, if a potential stronger claim is not asserted or if all stronger claims are avoided, the goal of preventing unintended non-taxation supports the exertion of a weaker claim. The avoidance of double taxation implies that weaker claims should generally

[445] The importance of such a hierarchy is recognized by Wheeler, *Missing Keystone*, n 39, §4.7.1.

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yield if there truly is a relevant overlap. That is not to say that a country with a weaker claim, perhaps of a self-protective kind, is legally obliged to yield – the country is fiscally sovereign – but the economic self-interest, policy and expectations by reference to which countries deal with each other, both in treaties and in many instances unilaterally, tends toward that result.

The principles by which taxing claims are ordered need to respond to the fiscal logic of the international tax order and the practicalities of administration and international relations. Questions of non-tax legal title should not predominate in such a context because the goal of taxation is primarily economic and social.[446]

Tax treaties may prove a useful though not comprehensive vehicle for developing hierarchies of taxing claims. They already perform a function of selectively reducing overlapping tax claims in a context that is consensual between the countries concerned and facilitates verification by one country of the corresponding tax treatment in the other.

In addition to an order of taxing claims, internal coherence of taxing rules is required, e.g., by consistently attributing the taxable presence of a trust to beneficiaries in a trust or other participants in a transparent entity if corresponding income is attributed to those persons, and a workably consistent approach to the avoidance of fiscal homelessness and resolution of dual residence of trusts.

The proposed overview of taxing claims on trust income is summarized in general terms in Table 7.1 and discussed further in Section 7.3.2. The characterization of claims is indicative, not strict. They have been organized into four groups: source-based taxing claims, which generally may be taken to have the highest priority; general residence-based claims, which generally reflect primary taxing claims but are not necessarily as compelling as source taxation; specifically outbound residence-based

[446] The international ranking of trust, grantor and beneficiary attribution should respond to a range of considerations. Wheeler's treatment of the question (ibid) gives greater weight to legal ownership than is proposed here, particularly in relation to grantor taxation. This is at odds, however, with the history and object of general grantor attribution rules, at least in the United States and the United Kingdom (Section 2.2). The horizontal equity and economic efficiency of a tax system depend on its economic and social operation. A tax that operates purely by reference to legal facts is displaced from its proper object (Prebble, *Income Taxation*, n 38; John Prebble, 'Philosophical and Design Problems That Arise from the Ectopic Nature of Income Tax Law and Their Impact on the Taxation of International Trade and Investment' (1995) 13 *Chinese Yearbook of International Law and Affairs* 111); Prebble, *Ectopia*, n 38.

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Table 7.1 *Overview of Taxing Claims*

Item	Taxing claim	Area / BEPS Action 2	Role
Source (inbound)			
1.	Source		Primary
2.	Taxable presence	Internal coherence	Primary
3.	Trust as source		Primary
Outbound Application of General Taxing Claim			
4.	Grantor	Grantor attribution	Primary
5.	Beneficiary	Differential transparency (cf Distribution); Item allocation; Entity classification; Grantor attribution	Primary
6.	Trust entity	(See above)	Self-protective/ Primary
Specifically Outbound Taxing Regimes			
7.	Beneficiary	CFC; FIF; Recommendation 5.1	Self-protective
8.	Grantor	Grantor attribution; Recommendation 5.1	Self-protective
9.	Trust entity	Trust residence; Recommendation 5.2	Cooperative
Other Anti-BEPS Measures			
10.	Denial of deduction	Recommendation 4; Recommendations 3 & 6	Cooperative/ Self-protective

claims, which are often defensive and may reflect anti-avoidance or anti-deferral considerations; and anti-BEPS measures that do not fall within any of the other categories. These represent a generally decreasing progression in the strength of taxing claims, subject to the qualification that a country may be reluctant to forego anti-avoidance taxation rights in the absence of satisfactory assurance and confidence that the situation is not in truth one of avoidance, or may in fact refuse to compromise such claims at all. The ordering of particular claims within each group does not imply a conclusion about their relative priority. In some cases, there is no capacity for conflict, and therefore no question of priority; in others, the appropriate order of priority is contestable.

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7.3.2 Source Taxation

Source taxation of non-residents[447] comes first in a practical sense because a source country always has first bite at taxing international income, unless it is bargained away in a treaty.

1. Source: Income may be taxed on the basis that it has a primary source in the taxing country. This is typically the case with respect to DIR income and income that is taxed by reference to the situs of an asset that produces it (such as income from immovable property or land and corresponding classes of capital gain). Some countries also tax sales income by reference to its primary source without requiring a taxable presence.

DIR income is typically taxed on a gross basis unless it is associated with a taxable presence in the source country. Particular classes of DIR income may be taxed more lightly than if derived by a resident, in some cases at a zero or near-zero rate. In the terminology of the BEPS Action 2 Report, income taxed in this way is not 'included in ordinary income'.[448] The source country may or may not identify the particular attributable foreign taxpayer, depending on the circumstances, such as whether the trust is resident and whether treaty relief is in issue. The surveyed countries typically provide for attribution of DIR trust income to a particular beneficiary.[449]

Other classes of income (such as rent or sales income, if the latter is taxed on a source basis without requiring a taxable presence) are commonly taxed on a net basis and may be attributed in the source country to a particular non-resident beneficiary or grantor. Capital gains are generally taxed net, and often by reference to limited source criteria reflecting the OECD Model capital gains article.[450]

2. Taxable presence: Source taxation of income associated with a local taxable presence of a non-resident is generally imposed on a net basis. This applies most obviously to sales income and capital gains

[447] See generally Section 2.4 (grantor), Section 3.2 (beneficiary) and Section 4.3 (trust).
[448] BEPS Action 2 Report recommendation 12.
[449] See the comparative summary in Section 3.2.4.
[450] Note also the domestic/inbound UK approach of taxing capital gains only to the trust (Sections 3.2.5 and A.1.1.2) and the Australian anomaly in its international capital gains tax settings (Sections 3.2.5; Brabazon, *Trust Gains*, n 35). The latter is at the expense of Australia.

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relating to the local business but often includes other items such as related DIR income. It may include income from a third country that has already suffered source taxation, which the host country may or may not recognize by unilateral double tax relief. Anomalies of internal coherence can arise if the host country attributes income to a non-resident beneficiary but not a trust-level taxable presence: taxation of DIR income may then revert to the basis and rate applicable to a non-resident without a taxable presence.[451] This is only an issue for the host country, unless the income escapes residence taxation by some other mismatch.

3. **Trust as source:** In some cases the trust itself may serve as a source.

If a country regards distributions from a resident trust as tax-law income, which is likely to be the case if it adopts a narrow paradigm for beneficiary attribution of trust income, it may also be expected to tax distributions to non-resident beneficiaries on a source basis. This implies a two-stage model of taxation, such as the United Kingdom uses to the extent that distributions are recognized as having income character and do not represent the delivery of trust income that is attributed to an interest-in-possession beneficiary. If that country has also taxed trust income on a source basis, its subsequent taxation of distributions to non-resident beneficiaries are likely to involve substantial economic double taxation if it does not modify its claim to tax such distributions, even before any consideration is given to taxation in the beneficiary's country. UK statute law has this effect, but much of the statutory treatment is undone by an extra-statutory concession that applies a transparent quasi-attribution paradigm over the top of the usual entity paradigm for several classes of underlying trust income.[452]

A country may also characterize beneficiary-attributed income of a resident trust as having local source where the beneficiary is non-resident, as Canada does.[453]

At least if resident beneficiaries are treated in a similar way to non-residents, these may be regarded as primary taxing claims.

[451] See Sections 3.2.4 and 3.2.6 and *GE Capital Finance Pty Ltd* v *FCT* (2007) 159 FCR 473; 9 ITLR 1083.

[452] See Sections 5.3.2 and 5.3.4, referring to ESC B18 and SP 3/86.

[453] See Section 3.2.1 and n 167.

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7.3.3 Outbound Application of General Taxing Claims

A country's general taxing rules – those which it applies in a purely domestic situation – have an outbound effect when combined with the general proposition that residents are taxable on worldwide income. The foreign income of a trust may be taxable on the basis of attribution under such general rules to a resident grantor, beneficiary or trust.

4. General grantor taxation, outbound: The outbound application of general grantor taxing claims may be considered by reference to the tax systems of the United States and the United Kingdom. A general grantor attribution rule takes priority over and displaces attribution to a beneficiary or to the trust in both those countries. This reflects the notion that trust property and other economic value conferred on the trust, although alienated by the grantor, should be treated as if it still belonged to the grantor for the purpose of taxing its economic yield. That is to say, it reflects a primary residence taxing claim of the highest priority.[454] On the other hand, those two countries have reversed this order of priority in the present tax treaty between them.[455] It should also be observed that UK grantor taxation is accompanied by a right of indemnity which has the effect of allowing the grantor to cast the burden of taxation at the grantor's rate and by reference to the grantor's residence upon the trust or (in some cases) a beneficiary who has received the grantor-attributed income. More significantly, if a country makes no claim to tax by reference to the grantor or ranks such claims after beneficiary attribution, that country cannot be taken to consider such taxation as having first priority.[456]

A priority question is implicit in the availability or otherwise of double tax relief for foreign taxation of grantor-attributed trust income, particularly if that taxation is imposed on the trust or a beneficiary. The United States and the United Kingdom both approach this through their foreign tax credit rules, but the settings differ:

[454] See Sections 2.1, 2.2 and 2.3.

[455] UK–US 2001 Exchange of Notes re Art 24, requiring the residence country of a beneficiary to give credit for residence taxation of a grantor on the same trust income. The provision is considered further in the context of residence–residence attribution conflicts in Section 8.3.13.

[456] Compare the New Zealand settlor regime (Section 2.5.3), which gives first priority to beneficiary attribution.

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- The United States allows foreign tax credit for foreign taxation of the trust or the grantor, but there is no provision to credit the grantor with tax paid by a beneficiary.[457]
- The UK unilateral foreign tax credit rules do not require identity of taxpayer and may be satisfied if tax in both countries is 'calculated by reference to' the same income or gain so that strict identity of income is not required, although the income must arise or gain accrue in the territory of the other country.[458] It seems that taxation of the trust, beneficiary or grantor is potentially creditable.

Where one country would apply grantor attribution and another would apply beneficiary attribution to the same income, it is desirable that the question of priority between those claims should be answered consistently by both countries in the combined operation of their domestic laws and an applicable treaty. What priority those countries choose is less important, however, than the consistency of their choice.

If a general grantor attribution rule applies to a *non-resident* grantor in respect of foreign income, no taxation results: the trust is treated as a conduit. If beneficiary and trust attribution are also displaced[459] and if the grantor's country does not have a corresponding grantor attribution rule that is engaged by the same facts, double non-taxation ensues (apart from any source taxation). Conversely, if a grantor's country applies grantor taxation and the beneficiary or trust country attributes the same income to its resident, double taxation results unless one of the countries gives exemption or credit. Two responses are therefore suggested: to turn off grantor attribution to a non-resident in respect of foreign income (Section 2.4) and to consider double tax relief, whether unilateral or by treaty, for a resident beneficiary or trust in respect of foreign taxation under a general grantor attribution rule (see Sections 3.3.3, 3.4 and 4.4).

5. General beneficiary taxation, outbound: This is the dominant paradigm for current taxation of trust income by a country that applies a wide paradigm of beneficiary attribution (Australia, United States, New Zealand), and it is not insignificant in a country that applies a narrow paradigm. Attribution conflicts can result in international double taxation, unless relieved by treaty; what have been referred to as negative

[457] See Section 2.5.1, n 119 and IRC s 901(b)(1)–(4).
[458] See Sections 2.5.2.3 and 3.3.3 and TIOPA s 9(1), (2).
[459] As is the case where IRC s 672(f)(2) preserves US attribution of foreign income to a foreign grantor.

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attribution conflicts (Section 6.3) can result in double non-taxation, with the trust serving as a reverse hybrid. It is also important that treaties not be used to suppress taxation in one country where the other treaty country does not regard the subject income as taxable by it.[460]

A country that applies a narrow beneficiary attribution paradigm is also likely to regard a wide class of trust distributions received by resident beneficiaries from resident and non-resident trusts as tax-law income, but whatever view is taken in a domestic situation, and regardless of whether a wide or narrow beneficiary attribution paradigm is used, it is important that distributions to a resident beneficiary from a non-resident or formerly non-resident trust be recognized as income if they are supported by trust income that has hitherto escaped substantial taxation in any country[461] – otherwise, there is an opportunity to repatriate trust income without recognition as such by the beneficiary's country and without taxation in the beneficiary's country. On the other hand, if trust income has already suffered substantial current taxation, economic double taxation results if a supported distribution is fully taxed without recognition of that earlier taxation. These propositions, which are also material to point *7*, support an argument that residence taxation of distributions should recognize both income and taxation at the trust level.

6. General trust taxation, outbound: Attribution of trust income to the trust itself under a country's general trust tax rules ranks after grantor attribution, if present in those rules, and after beneficiary attribution. Particularly if a wide beneficiary attribution paradigm is used, trust attribution only applies to those items of income that cannot satisfactorily be dealt with by transparent attribution. It is thus a fallback. In Australia and the United States, a resident trust is taxed as proxy for unascertained and presumptively resident beneficiaries; in New Zealand, it is taxed as proxy for a resident grantor (Section 6.4). Entity taxation of a UK-resident trust, although imposed on a legally final basis, approximately resembles non-final withholding for beneficiaries because of adjustments that are made at the point of distribution via the tax pool system or the extra-statutory concession.[462]

[460] This is avoided by the OECD Model transparent entity clause: see Chapter 8.

[461] The UK view that a distribution must have income character in the hands of a recipient beneficiary in order to qualify as tax-law income of the beneficiary does not achieve this.

[462] See Section 6.4, n 376.

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These features suggest that, in an international context, taxation of income by attribution to a trust represents a weaker taxing claim than taxation by attribution to a grantor or beneficiary. On the other hand, if one country attributes particular income to a trust and another attributes the same income to a grantor or beneficiary, the first country has already decided against grantor or beneficiary attribution. That country may reasonably require some persuasion that it should defer its taxing claim because the second country has attributed the income differently. There is also the 'first bite' argument: trust income is derived by the trust in the first instance, and the trust country's opportunity to tax is antecedent in a practical sense to that of a beneficiary's or grantor's country. In the small number of treaty cases that have dealt with residence–residence attribution conflicts between transparent entities and their participants, some have given priority to entity taxation and some to participant taxation, although those provisions which have addressed transparent entities generically have given priority to entity taxation.[463]

7.3.4 Specifically Outbound Regimes

A country may adopt a specifically outbound attribution rule to protect its own tax base against deferral or evasion where income abroad represents an indirect or potential benefit to a resident that may not be currently attributable to a resident under the country's general domestic tax rules. These concerns are significant in a trust context because decisions about ultimate benefaction can be placed in the hands of fiduciaries, such decisions can be deferred for significant periods, and original trust income can be capitalized and transformed within the trust so that a later benefaction is difficult to identify with earlier trust income that supports it economically. A specific outbound rule, particularly one of grantor attribution, may also be justified where the general trust tax rules of the grantor's country include an attribution anomaly that is unimportant domestically because the income is thought to be sufficiently taxable, even if it is not attributed to exactly the 'right' person from a policy perspective: the anomaly becomes important where the

[463] UK–US 2001 Exchange of Notes re Art 24; Australia–New Zealand 2009 Art 23(3), cf Explanatory Memorandum, International Tax Agreements Amendment Bill (No 2) 2009 (Cth) [2.318]–[2.322]. The issue is further considered below in the context of providing treaty relief for double taxation due to residence–residence attribution conflicts (Section 8.3.13).

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income is foreign and the 'wrong' taxpayer to whom the general trust tax rules would attribute it is non-resident and the 'right' taxpayer (the subject of the special outbound rule) is resident.[464] The latter case resembles a primary taxing claim, although other countries may be reluctant to recognize it as such if it is not incorporated into general rules that apply domestically.

7. Outbound beneficiary attribution: Outbound beneficiary attribution of current trust income may be achieved or attempted in a number of ways. CFC rules[465] and FIF rules are within this space; they are outside the scope of the present work. Outbound beneficiary attribution may be attempted through specific trust rules, but no way has been found to reach discretionary beneficiaries beyond what can be achieved in a clearer and simpler way by a wide beneficiary attribution rule. BEPS Action 2 recommendation 5.1 operates in this area, but it is doubtful that specific outbound attribution rules for trusts can have any useful effect that could not more conveniently be achieved by CFC or FIF rules.[466]

Outbound beneficiary attribution may also apply to trust distributions characterized as tax-law income. Particularly where the beneficiary's country refrains from taxing domestic trust distributions because it applies a wide beneficiary attribution paradigm to current trust income and taxes the trust at a high rate, distribution taxation serves as a necessary international backstop by taxing a resident (broadly speaking) on distributions that are referable to foreign trust-level income that has previously escaped taxation by the beneficiary's country (Chapter 5). This form of taxation has a real though imperfect capacity to neutralize the benefit of tax arbitrage. It also inclines toward complexity and has a clear tendency to produce economic double taxation unless the original

[464] This can be seen, e.g., in the original parliamentary explanation of the UK transfer of assets abroad rules (n 130).

[465] Most obviously, where interests in a foreign company are held through a trust and the company's income is not otherwise recognized as trust income.

[466] See Section 3.3.1. Australia's outbound attribution rules for beneficiaries in closely held foreign trusts (the deemed present entitlement rules in ITAA 1936 ss 96B, 96C) were abandoned in 2010 (see n 193) along with its FIF rules. The government had proposed to replace the FIF rules with foreign accumulation fund rules aimed at roll-up funds which would have included interests in trusts (see M L Brabazon, 'Tolerating Deferral: Australia's Proposed Foreign Accumulation Fund Rules' (2010) 39 *Australian Tax Review* 205). The replacement rules were poorly designed and the proposal quietly perished.

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income is derived in a low- or no-tax environment. National attitudes to double tax relief for underlying foreign tax are inconsistent.[467]

8. Outbound grantor attribution: Grantor attribution rules are an important means of preventing deferral, avoidance or evasion of residence taxation that may otherwise be achieved by accumulating income in a trust in a low-tax environment out of the reach of beneficiary attribution. Specifically outbound grantor rules may be seen as tax base protection measures founded on a probabilistic inference, which is not usually expressed in the statute but may be evident from other sources, that the value of the trust and its income will eventually come home to somebody in the grantor's country.[468] As mentioned earlier,[469] they may also be seen as reflecting a primary claim not adequately captured by general attribution rules.

BEPS Action 2 recommendation 5.1 advocates the use of offshore investment regimes, which may include grantor attribution regimes. If this is implemented in the manner suggested in Section 7.2.2.1, a grantor's country would attribute and tax trust income that would not otherwise be attributed to a trust or beneficiary in any country where it would be fully taxable. Outbound grantor attribution regimes in the surveyed countries are not typically structured in this way; in some respects, they may be broader, but in others (particularly the concern with tax treatment in other countries) they may be narrower.

Outbound grantor rules inevitably carry a risk of double taxation, particularly where another country applies its general beneficiary attribution rules to tax the same income or taxes a distribution funded by that income. There is considerable diversity among the surveyed countries in their recognition of foreign taxation. The US and UK positions have been mentioned earlier.[470] Australia takes a different approach. Its transferor trust rules contain their own provisions for relief. Depending on factors including the class of income and whether the other country is one of Australia's seven listed 'good' countries, foreign-taxed income may be excluded from attribution (which is more favourable than a tax credit), or

[467] Sections 5.2.2 and 5.3.3.
[468] See Section 2.5.1 (Australia, United States), esp n 112 and corresponding text.
[469] Note 464 and corresponding text.
[470] Notes 457, 458 and corresponding text.

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foreign tax may be deducted from attributable income (which is less favourable); the rules are agnostic about the identity of the foreign taxpayer.[471]

9. Outbound trust attribution: If no country claims a trust as resident, trust-attributed income escapes residence taxation. This is the issue of the fiscally homeless trust (Section 6.3). No particular country can be identified as losing revenue, but tax is avoided globally. BEPS Action 2 recommendation 5.2 proposes a cooperative countermeasure (Section 7.2.2.2). The essence of the proposal in a trust context is that, with respect to trust income that otherwise escapes full net-basis taxation, a country with which the trust has a certain residence-like connection short of what it would normally require for residence should regard the trust as resident, attribute the income, and tax it in the ordinary way.[472]

Trust residence arbitrage may be combatted in a number of ways. Hitherto, the most promising have been grantor attribution rules (which cannot cover all cases and are inoperable after a grantor's death) and distribution taxation (which is difficult to police, can often be sidestepped and cannot reach unremitted accumulations). The proposed cooperative rule is a major contribution of the BEPS project.

7.3.5 Other Anti-BEPS Measures

Other measures proposed in BEPS Action 2 may affect trust-driven mismatches by denying deductions that would otherwise be available. Recommendation 4 is a cooperative measure which targets a witting or related payer of income to a trust in the jurisdiction where the deduction would be allowed. Recommendations 3 and 6 may also have some limited application. These are relatively peripheral to the subject of this book and will not be examined further here.[473]

7.3.6 Conclusion

The overview identified in this section (7.3) suggests a method for the cooperative prevention of trust-based tax arbitrage. At each level,

[471] See Section 2.5.1, n 120 ff and ITAA 1936 s 102AAU.
[472] As discussed earlier (Section 7.2.2.2), the requirement expressed in the recommendation that the parties to the mismatch be members of the same control group appears redundant in the context of a donative, closely held or fiscally homeless trust.
[473] For further consideration of these issues, see Brabazon, *Trusts as Hybrids*, n 431.

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consideration may be given to whether a country has rules that are adapted to prevent unintended double non-taxation, compatible with the rest of the country's tax system, and suitably qualified to avoid creating unintended double taxation having regard to the nature and relative priority of potential taxing claims by other countries.

The overview serves as a guide rather than a prescription. Does the country have a rule of the relevant kind? If not, should it have such a rule, having regard to the principles of its own tax system and the risks of base erosion in the country itself and globally? Does the present rule or a proposed one apply coherently to income derived by or through a trust? Does it adequately protect the country's primary interest in taxing on a source basis, or in taxing its residents directly or indirectly on income that serves their purposes or enures to their benefit? Does it adequately protect the country's own tax base from erosion by arbitrage in trust-related risk areas? Does it adequately provide a cooperative backstop against global arbitrage? And, where another country also claims to tax the same income or underlying income, are the overlapping tax claims adjusted, whether unilaterally or by treaty, in a way that is appropriate to the relationship between the countries and their taxing claims and the integrity of the international tax order and the tax system of the country concerned? In the balancing of taxing claims, it may be more important that countries arrive at a workable solution and hierarchy that is rational and robust than that their solution is the best one from a theoretical viewpoint. Tax treaties may prove useful for this purpose.

The proposed method is less prescriptive than the recommendations in the BEPS Action 2 Report, which is a product of international consultation and implies a degree of consent and consensus between the countries that participated in it. It seeks to balance a recognition of national fiscal sovereignty, the results obtained on analysis of how tax systems interact in relation to trusts, and international taxing norms including the proposition that tax arbitrage is harmful and that it is desirable for countries to take countermeasures.

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8

Treaties

This chapter considers the effect of tax treaties on the international taxation of income derived by, through or from trusts against the background of recent developments in relation to income derived by, through or from hybrid and transparent entities generally.[474] In doing so, it seeks to identify to what extent double taxation (which may be juridical or economic) is or could usefully be relieved in a treaty situation, and to what extent treaties may be used to produce unintended non-taxation.

Section 8.1 outlines the historical and policy background to the transparent entity clause and related provisions added to the OECD Model in 2017. Section 8.2 considers the preliminary issue of treaty access and the qualification of a trust as a resident person for treaty purposes. The main part of the chapter, Section 8.3, considers the effect of tax treaties on the current taxation of trust income by attribution to the trust, a grantor or a beneficiary. It approaches the issue in the context of the transparent entity clause of the OECD Model, giving particular consideration to its interaction with grantor attribution regimes and the differential transparency of trusts. It also considers particular trust issues concerning the attribution of trust PE and business structures, beneficial ownership of trust income, and the recognition of corporate participation dividends. It finally considers treaty relief in a residence country and the hitherto unresolved problem of residence–residence attribution conflicts. Section 8.4 considers the

[474] See M L Brabazon, ‘Application of Treaties to Fiscally Transparent Entities’ in Richard Vann (ed), *Global Tax Treaty Commentaries IBFD* (IBFD, last updated 2018). The present chapter complements the writer’s analysis of that broader topic in the Global Tax Treaty Commentaries by considering trust issues in sharper focus and with particular reference to the law and treaties of the surveyed countries. The treatment in this chapter is consequently narrower and, within its own scope, more detailed. The treatment in the Global Tax Treaty Commentaries is more extensive in relation to issues that bear upon transparent entities generally.

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Table 8.1 *OECD Model (2017) Arts 1(2), (3), 23 Parenthetical*

Article 1

2. For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.
3. This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23 [A] [B], 24, 25 and 28.

Article 23 A (1), (2), 23B (1)

. . . (except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State [or because the capital is also capital owned by a resident of that State]) . . .

effect of treaties on taxation of distributions as income from a trust, including the capacity for certain unilateral tax relief upon cross-border distribution to create opportunities for treaty shopping and unintended non-taxation. The main conclusions of this chapter are summarized in Section 8.5.

Much of this chapter relates to the transparent entity clause, the saving clause and/or the parenthetical qualification of a resident's right to relief under the double tax relief article added to the OECD Model in the 2017 Update, the text of which is set out in Table 8.1.[475]

8.1 History and Background

International taxation involves the interaction of national taxing perspectives, taxpayer roles and potentially applicable treaty provisions. A country may see itself as the residence (R) of a person or entity deriving income or as the source country (S) of particular income. Trust-level income may be attributed to the trust itself or to a participant, who may be a grantor or a beneficiary, and is conceived as being derived *by* or *through* the trust. If the trust is treated as fiscally opaque,

[475] Respectively, Art 1(2), Art 1(3) and additions to Art 23A (1), (2) and 23B (1). The words in square brackets are only present in the provisions that address taxation of capital, Art 23A(1) and 23B(1).

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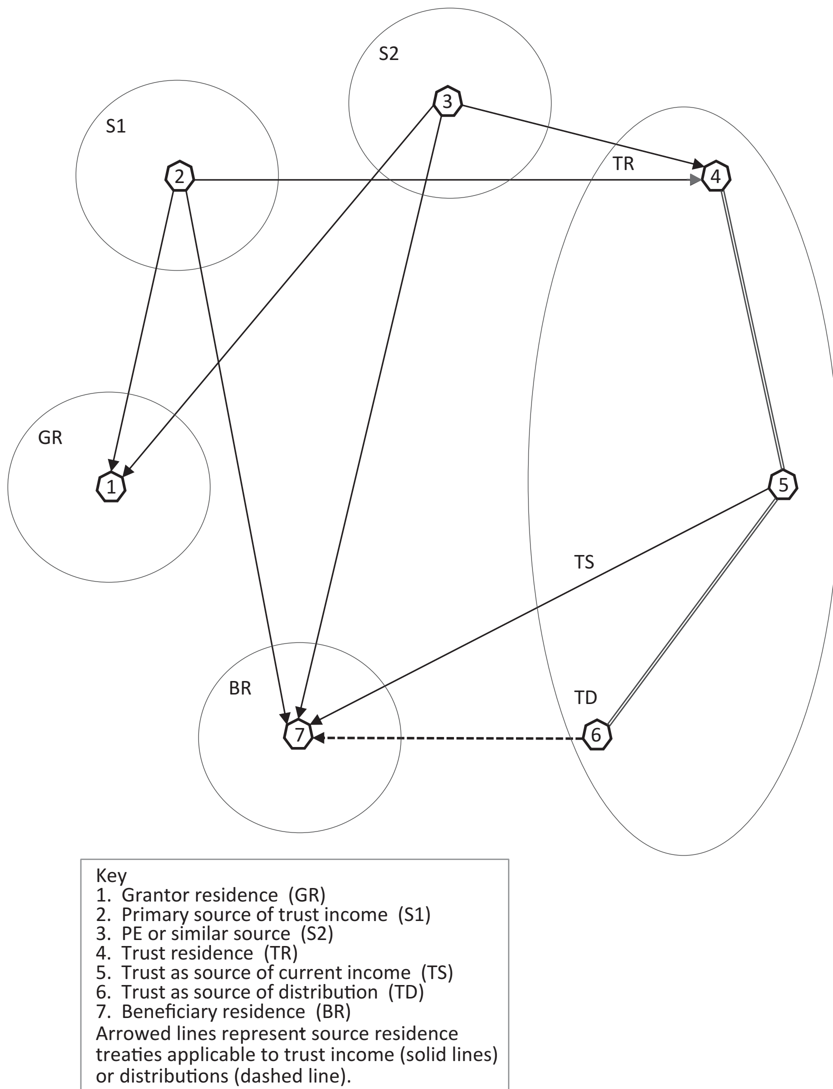

Figure 8.1 Source–Residence Treaties

its distributions may be perceived as income *from* the trust and taxed as income of a beneficiary.

The range of possible source–residence relationships, and therefore of potential tax treaties between source and residence countries, is represented in Figure 8.1. Of eight potentially relevant treaties, seven relate to

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current trust income and one relates to distributions.[476] There are also three residence–residence country relationships and potential treaties (Figure 8.2).[477]

The tax policy and design choices that apply to trust-related income are a subset of the choices relating to entities interposed between individual beneficiaries or participants and economic activities that produce income, and the same is true in a treaty context.[478] Trusts are not ordinarily treated like companies for tax purposes, but neither are they perfectly transparent. The surveyed countries generally treat them as differentially transparent or, in some situations, attribute their income to a grantor. Differences between countries, particularly in relation to attribution, create the potential for hybridity. The proper function of tax treaties in these cases is to avoid or relieve double taxation without occasioning unintended non-taxation.[479]

The role of transparent and hybrid entities in international investment and commerce has greatly increased over the past three decades. It has posed significant challenges to the international architecture of tax treaties, leading to the addition of a transparent entity clause to the OECD

[476] S_1 and S_2 correspond to cases 1 and 2 in Section 7.3.2. The possibility of an S_1–S_2 treaty applying to a PE as a quasi-resident of S_2 has been discounted here. Non-discrimination provisions of a tax treaty between a residence country and S_2 may however require S_2 to give the same double tax relief for S_1 taxation as it would provide to its own residents: OECD Model Art 24(3); cf OECD Comm Art 23 [10], Art 24 [67]–[72]. OECD Comm Art 23 [11] also contemplates that the competent authorities may voluntarily engage the mutual agreement procedure under Art 25(3) of a treaty between S_1 and S_2 in respect of the taxation of a PE whose owner is not resident in either country. The position is more complex under EU law, where freedom of establishment requires a member country to treat a local PE of a resident of another member country no less favourably than a resident of the host country (see Marjaana Helminen, *EU Tax Law – Direct Taxation – 2017* (Online Books IBFD, 2017) §2.1.3.4, §2.2.5.2.1; *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland* v *Finanzamt Aachen-Innenstadt* (Case 307-97) [1999] ECR I-6181).

The number of possible source–residence treaties is reduced by three if S_1 and S_2 are combined.

[477] Without the grantor, the number of potential S–R treaties would be six (or four) and the number of R–R treaties would be one.

[478] For consideration of the policy and history of tax treaties in relation to non-corporate entities generally, see Brabazon, *Treaties & Transparent Entities,* n 474, §1.1 (policy), §1.2 (history).

[479] See Section 7.1.6; ibid §1.1. The BEPS project, particularly the OECD/G20 BEPS Project, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6: 2015 Final Report* (2015), has reinforced the view that tax treaties should not serve as vectors for unintended international non-taxation; cf OECD Model preamble (2017 Update).

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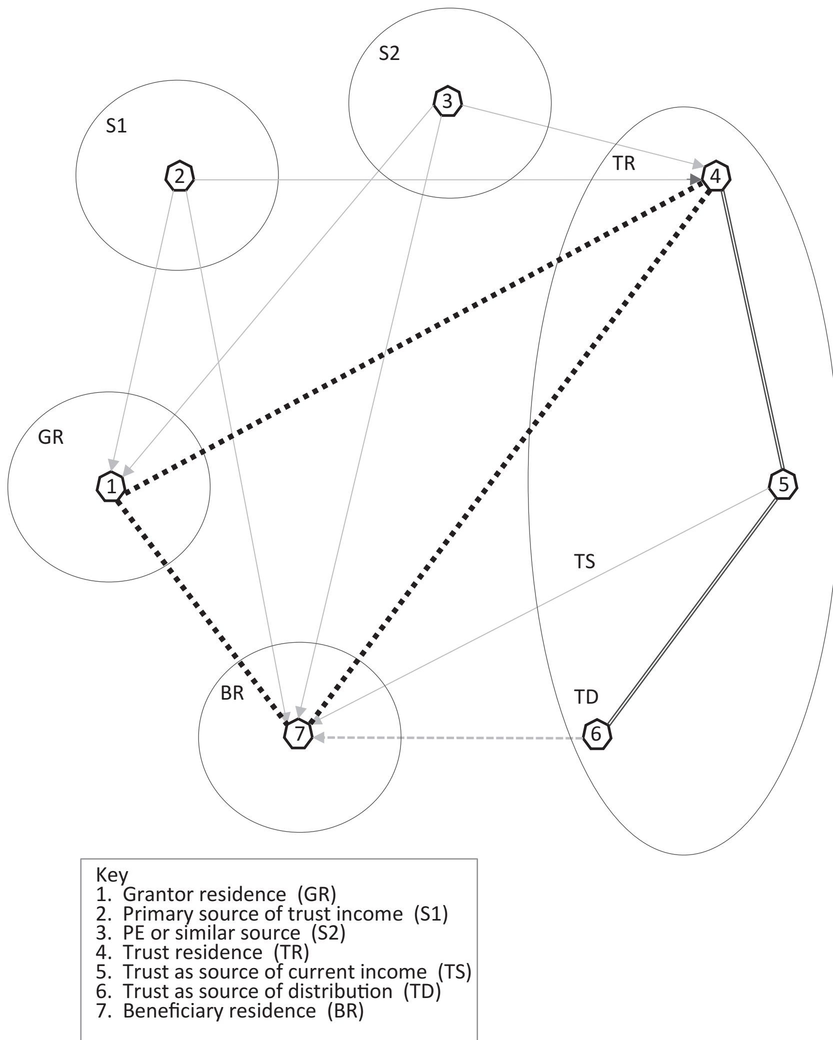

Figure 8.2 Residence–Residence Treaties

Model in 2017.[480] The present OECD approach owes much to the development of US treaty policy in the later part of the twentieth century. For some decades, US treaties applied a partial residence theory to partnerships, trusts and estates. That was replaced in 1996 by a

[480] Brabazon, *Treaties & Transparent Entities,* n 474, §1.2.

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transparent entity clause which made the recognition of any item of entity-level income as income of a treaty resident – and thus its ability to attract treaty benefits – dependent on its treatment as income of a resident of a treaty country by the tax law of that country.[481] By this subtle and elegant device, treaty benefits were tied to the fiscal attribution of particular income in a residence country.

A general principle of the 1999 OECD Partnership Report was to similar effect – that a source country should recognize income attribution in a treaty country to a resident of that country as necessary and, subject to other treaty conditions, sufficient for the purpose of according treaty benefits, but without modifying its own attribution and qualification of income.[482] The operation of the general principle is summarized in Table 8.2.[483]

The exercise is repeated in Table 8.3 with reference to whether each country attributes the relevant entity-level income to the entity ("e"), treating the entity as nontransparent with respect to that income or to a participant ("p").[484] At least where there is only one class of participants to be considered, these are simply different ways of viewing the same analysis.

By contemplating treaty relief where a source and residence country attribute income to and impose tax on different taxpayers, this basic principle of the Partnership Report contemplated relief beyond the

[481] 1996 US Model Art 4(1)(d); 2006 US Model Art 1(6). The 1996 location of the clause in the residence article reflects its historical development from the earlier partial residence concept. Its relocation in 2006 without change of wording indicates a (correct) perception that the clause was really concerned with a broader question of treaty application. The wording of the OECD transparent entity clause differs little from that of the 1996 US clause.

[482] Partnership Report [52], [53], [56], [57]; OECD Comm Art 1 [6.3]–[6.6], Art 4 [8.8].

[483] Abbreviations in the table are as follows: S is the source country. E is the country where the partnership entity is resident or established. (If the partnership is seen as inherently transparent and hence not taxable, it may be impossible to say that it has residence.) R is the residence country of the partner. T indicates that the relevant country sees the entity as transparent in respect of the relevant income and attributes that income to the partner. N indicates that the relevant country sees the entity as nontransparent in respect of the income and attributes it to the partnership entity. The 'Treaty' column indicates which treaty applies to income that is attributed under particular settings of transparency or nontransparency in the countries concerned. 'Lower of S–R, S–E' indicates that S complies with both treaties by compliance with whichever is more restrictive.

[484] See Kees Van Raad, 'Recognition of Foreign Enterprises as Taxable Entities: General Report' (1988) 73a *Cahiers de droit fiscal international* 19; Richard L Doernberg and Kees van Raad, 'Hybrid Entities and the US Model Income Tax Treaty' (1999) *Tax Notes International* 745.

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Table 8.2 *Partnership Report, General Principle*

Case	S	E	R	Treaty
1	T	T	T	S–R
2	N	T	T	S–R
3	T	N	N	S–E
4	N	N	N	S–E
5	T	N	T	Lower of S–R, S–E
6	N	N	T	Lower of S–R, S–E
7	T	T	N	None
8	N	T	N	None

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Table 8.3 *Partnership Report, General Principle (Attribution)*

Case	S	E	R	Treaty
1	T/p	T/p	T/p	S–R
2	N/e	T/p	T/p	S–R
3	T/p	N/e	N/e	S–E
4	N/e	N/e	N/e	S–E
5	T/p	N/e	T/p	Lower of S–R, S–E
6	N/e	N/e	T/p	Lower of S–R, S–E
7	T/p	T/p	N/e	None
8	N/e	T/p	N/e	None

Modified from M L Brabazon, 'The Application of Tax Treaties to Fiscally Transparent Entities' in Richard Vann (ed), *Global Tax Treaty Commentaries IBFD* (IBFD online, 2018).

confines of purely juridical double taxation of the same taxpayer on the same income.

A second principle, which qualified the first, was that the treaty does not constrain a country in the taxation of its own residents, leaving aside provisions clearly directed to a residence country such as the exemption/

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credit double tax relief article.[485] This was similar to the saving clause which had long been a fixture of US treaty policy: regardless of whether its resident was the entity or a partner, the source+residence country was not obliged to give treaty relief based on the other country's attribution of income to its resident.

The logic of the US transparent entity clause and saving clause was reflected in the principles of the Partnership Report, for which they and related US draft regulations[486] served as inspiration,[487] albeit without reference in the Report or resulting OECD Commentary.

With one limited exception,[488] the Partnership Report did not recommend changes to the OECD Model, but only to the Commentaries. The principles of the Report were not unanimously shared by the countries and delegates that participated in its production, and the text of the Report records a number of significant minority positions and reservations. While the Report's principles have been widely implemented, significant reservations also persisted, and not all countries accepted them as a correct interpretation of the model treaty prior to the 2017 Update. A strong academic argument was separately made that the connecting terms in the distributive rules of the OECD Model should be given an autonomous and contextual interpretation that would support the general principle but not the qualification.[489]

In 2015, the BEPS Action 2 Report revisited the principles of the Partnership Report and recommended the addition of a transparent entity clause to the OECD Model,[490] while Action 6 proposed the addition of a saving clause and a conceptually related amendment of

[485] Partnership Report [127]; OECD Comm Art 1 [6.1] (2000).

[486] 62 Fed Reg 35673 (26 June 1997); 26 CFR s 1.894-1T. For a clear account of the history, policy and operation of the temporary and proposed regulations and their interaction with the statute and US treaties, see Carol Doran Klein and Diane L Renfroe, 'Section 894: Payments to Flow-Through Entities' (1997) 26 *Tax Management International Journal* 547.

[487] Danon, *Qualification of Entities*, n 12, 194; Jacques Sasseville, 'OECD Releases Report on Application of Model Treaty to Partnerships' (1999) *Tax Notes International* 623 (16 August 1999), acknowledging that the principles of the Partnership Report were close to the conclusions of the US draft regulations of June 1997.

[488] The addition of OECD Model Art 23A(4), also implemented in 2000.

[489] See Danon, *Qualification of Entities*, n 12; Danon, *Swiss International Trust Taxation*, n 10, 296–362; Danon, *Conflicts of Attribution*, n 11.

[490] BEPS Action 2 Report recommendation 14, now OECD Model Art 1(2) (2017 Update).

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the double tax relief article.[491] These measures have counterparts in the MLI[492] and are reflected in the 2017 update of the UN Model.[493]

The transparent entity clause differed from most other BEPS measures: while it was undoubtedly concerned with combating unintended double non-taxation, it was also concerned with avoiding double taxation. It was driven by two objectives: to complete the work of the Partnership Report by promoting its principles from contestable opinion in the Commentaries to positive law in the Model treaty, and to extend those principles expressly to entities other than partnerships – including trusts.[494]

As has been mentioned, the Partnership Report contemplated that its principles might also apply to other non-corporate entities and foreshadowed further work on the application of the OECD Model to such entities.[495] That work did not eventuate, except in relation to collective investment vehicles[496] and pension funds.[497] This may perhaps be explained by a level of suspicion that a number of civil law countries direct toward trusts and trust-based tax planning in common-law countries. The fact that trusts continue to be used, with and without tax

[491] BEPS Action 6 Report [63], [64], now OECD Model Art 1(3) and substituted Arts 23A (1), (2), 23B(1) (2017 Update).

[492] MLI Art 3(1) – transparent entities; Art 11 (or Art 3(3)) – saving of residence taxation; Art 3(2) – method of residence double tax relief in the context of Art 3(1) (cf Art 5(6)).

[493] UN Model Arts 1(2), (3) and parenthetical amendments to Art 23 A and B.

[494] BEPS Action 2 Report [435]. The transparent entity clause in the OECD Model is recognized as confirming the corresponding conclusions of the Partnership Report: OECD Comm Art 1 [4], [5] (2017 Update), [26.5], [26.6] (BEPS Action 2 Report). This suggests that the Partnership Report itself may retain some utility in the interpretation of the OECD Model post-BEPS as well as ongoing relevance to treaties not adopting the new provision.

[495] Section 7.1.4, n 397.

[496] OECD, *CIVs Report*, n 398. Unlike the Partnership Report, the OECD approach to collective investment vehicles favours entity-level qualification for treaty benefits, safeguarded if necessary by integrity rules that take account of the residence or status of their participants. This reflects the impracticability of applying transparent methods directly to the income of a widely held entity in order to determine treaty benefits. The assumption is that entity-level treaty benefits will flow through to participants by transparent taxation or some other means under the domestic law of the relevant residence country.

[497] See OECD Comm Art 18 [69] and related provisions, added in 2005. Arising from BEPS Action 6, recognized pension funds (those which are regulated as such in a treaty country) are also to be treated as treaty residents: BEPS Action 6 Report [12], [13]; OECD, *Treaty Residence of Pension Funds: Public Discussion Draft* (2016); new OECD Model Arts 3(1)(i), 4(1) (2017 Update).

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motivation, suggests that this work is still needed. The addition of the transparent entity clause to the OECD Model means that the task can no longer be delayed.

8.2 Treaty Access

A preliminary issue in applying the operative provisions of a tax treaty is the identification of those persons who and those items of income which are capable of attracting treaty benefits.[498] The conventional primary criteria for access to treaty benefits are expressed in the concept that a treaty applies to persons who are residents of one or both of the contracting states.[499] The criteria of personhood and treaty residence require no particular consideration in relation to a beneficiary or grantor, but they do require examination in relation to a trust itself, including trustees in the capacity of a trust entity, in respect of trust-attributed income.

8.2.1 'Person' for Treaty Purposes

The OECD Model defines a 'person' non-exhaustively to include 'an individual, a company and any other body of persons'.[500] Trusts are not mentioned, but the US Model[501] and some non-US bilateral treaties[502] expressly include them. A country that is considering its own resident trust (including a trust entity in the form of trustees with collective tax responsibility for their trust) will have no difficulty in

498 See also Brabazon, *Treaties & Transparent Entities*, n 474, §3.

499 OECD Model Art 1(1) (2017 Update), previously Art 1: 'This Convention shall apply to persons who are residents of one or both of the Contracting States.' The question whether particular provisions should be regarded as having an irregular operation outside the scope of the general rule has relatively little bearing on trusts, and is left aside. For a contrary view arguing that the criteria for personal coverage should be found in the distributive and other substantive articles, see Dhruv Sanghavi, *Resolving Structural Issues in Income Tax Treaties* (PhD Thesis, Maastricht, 2018).

500 OECD Model Art 3(1)(a). The UN Model definition is similar.

501 2016 US Model Art 3(1)(a). Similar provisions have been included for many years (see, e.g., 1977 US Model Art 3(1)(a)), although they are absent from early US treaties. UK–US 1945 and Australia–US 1953, for example, had no persons covered article, no definition of 'person', and made no reference to trusts.

502 Other than the United States, Canada is a notable proponent of this approach. Australia and New Zealand have included a trust as a person in their treaty with each other (Australia–New Zealand 2009 Art 3(1)(j)) and in their treaties with the United States and Canada, although neither does so as a matter of general treaty practice.

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identifying a 'person' of some kind;[503] the same is true of a source country that attributes local income to a trust that may be non-resident. It is conceivable, however, that a country might perceive a particular trust as a nonperson,[504] in which case the domestic perspectives of two countries may differ about whether a particular trust is a person for tax purposes. It is also possible that two countries may differ in their conception of the relevant person as trust or trustees. Perhaps it may be inferred that any entity which either party to a treaty regards as a taxpayer is a person; if so, a trust is a person if either country regards it (or its trustees) as a taxable subject. Where trustees are taxable in respect of a trust separately from their own non-fiduciary tax affairs, the better view is that they should be regarded as separate persons in their capacity as the trust entity.[505] The contrary has nevertheless been argued.[506]

It would be preferable to recognize trusts more clearly as treaty persons if either party to a treaty regards a trust (including its trustees) as a taxable subject.

8.2.2 Treaty Residence

The OECD Model primarily defines a resident of a contracting state as any person who, under the laws of that country, 'is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature'.[507] A second sentence expressly excludes 'any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein'.

[503] See discussion by Avery Jones et al., *Treatment of Trusts II,* n 9, 65–66; the relevant term appears to be the undefined concept of a 'person' rather than the inclusion 'body of persons': see Avery Jones et al., *Origins,* n 381, 699–700. US case law supports the view that a trust is a person for treaty purposes, even without special definition, at least when the United States is the country applying the treaty: *Maximov* v *United States*, 373 US 49 (1963), 53. Ana Paula Dourado et al., 'Article 3' in Ekkehart Reimer and Alexander Rust (eds), *Klaus Vogel on Double Taxation Conventions* (Wolters Kluwer, 4th edn, 2015) m. no. 33, conclude that a trust (other than a corporate-taxed trust) will be a body of persons; this analysis would not be readily accepted in a common law jurisdiction.

[504] The country might disregard the particular trust and perceive only its grantor or beneficiaries. Alternatively, it might conceivably disregard the trust relationship altogether and perceive only the trustees in their own right.

[505] See Beckham and Elliffe, n 374, §5.1; TR 2005/14.

[506] See Prebble, *Trusts and DTAs*, n 373, 194–195.

[507] OECD Model Art 4(1). Government entities and (from the 2017 Update) recognized pension funds of the relevant country are also included.

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The general part of the definition has two limbs: the person must be liable to tax under the laws of the country in question, and that liability must arise by reason of a connection of the specified kind.

Liability to tax: An entity that is always treated as transparent in a particular jurisdiction is not potentially taxable there. It is therefore not liable to tax and does not qualify as a treaty resident.[508] This includes an entity that is recognized for tax accounting purposes and is obliged to pay tax on behalf of and by reference to the characteristics of its participants.[509]

A differentially transparent trust is liable to tax if it is fully taxable on trust-attributed income (income attributed to it other than by reference to a particular beneficiary). The existence or non-existence of such income in a particular year does not matter: liability to tax is a characteristic of the entity, not its income. A differentially transparent trust is resident where it would be fully taxable on trust-attributed income on a basis mentioned in the residence article. Considered purely as an entity, such a trust is simultaneously transparent and opaque because it has the capacity to be treated in either manner in respect of particular income.

Subject to establishing a jurisdictional connection equivalent to residence, trusts that fall within the general trust rules of each of the surveyed jurisdictions are liable to tax in the relevant treaty sense.

In certain circumstances, New Zealand goes further than other countries in its trust rules and provides that an election made by a trustee, grantor or beneficiary to pay tax on trust-attributed income has the effect

[508] Roland Ismer and Katharina Riemer, 'Article 4' in Ekkehart Reimer and Alexander Rust (eds), *Klaus Vogel on Double Taxation Conventions* (Wolters Kluwer, 4th edn, 2015) m. no. 35; Danon, *Swiss International Trust Taxation*, n 10, 284–286; OECD Comm Art 4 [8.13] (2017 Update), previously [8.8]. For contrary views, see Michael Lang, 'Taxation of Income in the Hands of Different Taxpayers from the Viewpoint of Tax Treaty Law' (2001) 55 *Bulletin for International Fiscal Documentation* 597, 598; Klaus Vogel, *Klaus Vogel on Double Taxation Conventions: A Commentary to the OECD-, UN-, and US Model Conventions for the Avoidance of Double Taxation on Income and Capital, with Particular Reference to German Treaty Practice* (Kluwer, 3rd edn, 1997) 95 n 25. There may be difficulties in distinguishing between an entity that is initially within the sphere of liability to tax but is exempted or relieved of actual tax obligation and an entity that is never within that space, but that is what the concept of liability to tax requires – otherwise its meaning in Art 4 becomes evanescent to the point of redundancy. The difficulty of applying Art 4(1) to a territorial tax system is also real, but peculiar to that context.

[509] Partnership Report [40].

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of qualifying trust income for worldwide taxation.[510] The election also affects the tax treatment of distributions and (in some cases) whether the elector can recoup such tax from the trust.[511] In broad terms, the election enables a trust to avoid distribution taxation of beneficiaries of a kind that would otherwise be engaged when a foreign grantor immigrates or a resident grantor emigrates.[512] This presents several conceptual challenges, one of which is whether the trust is liable to tax. At least where a grantor is liable as deemed agent for the trustees with right of indemnity, and even if the trustees are not directly assessable, the better view is that the trust is indeed liable to tax via that deemed agency.[513]

Residential connection: The second limb requiring liability to tax 'by reason of' the trust's 'domicile, residence, place of management or any other criterion of a similar nature' is satisfied if such a connection with the taxing country is the legal feature that exposes it to actual or potential comprehensive taxation.[514] In a country that founds its claim to tax on a residence/source paradigm, comprehensive taxation implies worldwide taxation of trust-attributed income. The relevant connections are therefore those which expose a trust to potential tax liability on worldwide trust-attributed income. Typically, they correspond to a domestic law label that connotes trust residence: in Australia, residence of the trust estate;[515] in the United States, US person status of a 'domestic trust';[516] in the United Kingdom, residence of the trustees

[510] ITA NZ ss HC 33; cf s HC 29(5). In relation to grantor election, see Brabazon, *Trust Residence,* n 152, 353, 366–372; Section 2.5.3.

[511] A grantor-elector who has immigrated to New Zealand post-settlement is treated as an agent of the trustees, even if he or she is not directly taxable, and has a right of recoupment: ITA NZ s HC 29(2), (5); cf ss HD 5(2), HD 12(2); ibid, 353, 366–368; Section 2.5.3. Whether a trustee-elector can resort to trust assets is left to the general law, including the terms of the trust. Beneficiary-electors, it seems, are left to their own devices.

[512] Prebble, *NZ 1988 International,* n 158, 71; Prebble, *NZ 1999 International,* n 158, 402, 403.

[513] This is a corollary of the conclusion that, in such a case, New Zealand is not applying grantor taxation but is taxing the trust. See Brabazon, *Trust Residence,* n 152, 366–372.

[514] *Crown Forest Industries Ltd* v *Canada* [1995] 2 SCR 802; David A Ward et al., 'A Resident of a Contracting State for Tax Treaty Purposes: A Case Comment on *Crown Forest Industries*' (1996) 44 *Canadian Tax Journal* 409.

[515] ITAA 1936 s 95(2); or in a capital gains context, the status of a 'resident trust for CGT purposes' (ITAA 1997 s 995-1).

[516] IRC s 7701(a)(30)(E); cf s 7701(a)(31) ('foreign trust'); 26 CFR US § 301.7701-7(a)(2) ('domestic trust').

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as a notional single person.[517] These concepts feed in to the ordinary rules of residence taxation or (in Australia) equivalent trust-specific rules.[518] New Zealand does not have a specific label for trust residence but taxes the trustees as notional single person[519] by reference to criteria that are functionally equivalent to trust residence.[520]

The treaty residence analysis depends on legal connecting factors rather than the label that a national tax law attaches to them, although a residence label gives a clear indication that the country in question sees its chosen criteria as similar to residence. Those factors in the surveyed countries involve various combinations of the fiscal residence of trustees (any or all), a professional trustee's PE, fiscal residence of persons with significant control or veto rights, central management and control of the trust, grantor residence (historical or current) and primary judicial supervision.

A trust may factually possess a place of management in the same way as an individual, but whether a trust (or a fiscal entity conceived as the trustees collectively) has domicile or residence is inevitably a question of tax law. It is, in any event, not difficult to conclude that such factors as those mentioned earlier correspond to place of management or are of similar nature to domicile, residence or place of management.

Other approaches to residence: Some countries depart from the general definition of treaty residence in the Model. Australian treaties frequently adopt tax-law residence of the countries concerned as the test of treaty residence: a person is a treaty resident of X 'if the person is a resident of [X] for the purposes of [X] tax'.[521] This method works well enough for trusts, provided that the countries concerned use the label of residence, whether of the trust or the trust entity, to describe the set of connections that attract worldwide tax liability.

[517] ITA UK s 474; TCGA s 69.

[518] ITAA 1936 ss 99, 99A; ITAA 1997 s 855-10.

[519] ITA NZ ss HC 2, HC 24.

[520] ITA NZ ss HC 25, HC 26; Brabazon, *Trust Residence,* n 152.

[521] Australia–UK 2003 Art 4(1). To similar general effect, see, e.g., Australia–US 1982 Art 4 (1); New Zealand–UK 1983 Art 4(1). Australia–New Zealand 2009 Art 4(1) is similar ('any person who, under the laws of that State, is liable to tax as a resident of that State'), but adds a second sentence as in the OECD Model excluding persons who are liable to tax only on a source basis. TR 2005/14 relies on that sentence to deny New Zealand treaty residence to a trust that has New Zealand trustees but is only liable to New Zealand tax on a source basis because the grantor is non-resident. The design of the residence criteria varies from treaty to treaty.

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New Zealand frequently uses domestic law to define residence in its treaties,[522] notwithstanding that its domestic law eschews a concept of trust residence and can treat a trust as functionally non-resident when all its trustees are resident, or vice versa. If regard is had to the personal fiscal residence of the trustees, which appears to be the accepted view in New Zealand,[523] a trust may be treated as resident for treaty purposes when it is not fully liable to tax, or as non-resident when it is fully liable to tax.[524] Alternatively, the view might be taken that there is no New Zealand concept of residence of the trust or trust entity, and that a trust is consequently incapable of trust residence. Each of these results is anomalous. The right result from a policy viewpoint would be to treat the criterion for tax liability on worldwide trust-attributed income, incorporating reference to the residence of the grantor, as the criterion for treaty residence of the trust. It seems doubtful that this sensible result can be shoehorned into a treaty reference to a person (trust or trust entity) being a resident of New Zealand for New Zealand tax purposes.

New Zealand treaties that define residence by reference to domestic tax concepts are consequently open to treaty shopping unless that effect can be defeated by other provisions or principles. The issue is most likely to arise in the other treaty country in relation to its source taxation. The anomalies identified earlier could be avoided, however, if New Zealand in its domestic law applied the terminology of trust residence, or residence of the trustees as a notional single person, to its criteria for worldwide tax liability in relation to trustee income.

[522] Beckham and Elliffe, n 374, §3 identify four main types of residence clause in New Zealand tax treaties: (1) those which follow OECD Model Art 4(1); (2) those which follow that model but omit the second sentence; (3) those which, like NZ–UK 1983, refer only to the domestic law concept of residence; and (4) those which refer to domestic law but add the OECD Model second sentence.

[523] Ibid §3: 'It is a point of little contention that New Zealand trustees are at least treated resident as such under domestic legislation and, therefore, for the purposes of New Zealand tax would meet the definition' of resident in New Zealand UK 1983. On this basis, a trust entity comprised of New Zealand trustees that accumulates UK-sourced income free of New Zealand tax due to the non-residence of the grantor is recognized as a New Zealand resident under that treaty.

[524] Anomalous treaty residence, but not anomalous non-residence, may arguably be avoided if the treaty also contains the OECD Model second sentence. This is the view in TR 2005/14, referring to an earlier treaty which (like Australia–New Zealand 2009) contained that sentence. The issue must be approached with caution, however, in light of the function of the second sentence and the difficulty of applying it in a country that taxes on a territorial basis: see Beckham and Elliffe, n 374, §4.2.

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Some older US treaties and a small number of treaties of other countries still contain partial residence clauses.[525] Within the scope of their operation, these often produce similar results to a transparent entity clause, but each treaty and clause requires separate consideration. Further analysis of these clauses will not be pursued.

The general conclusion of this section is that a country's criteria for treaty residence of trusts should be aligned with its criteria for full tax liability – liability as extensive as that of other taxpayers of a similar kind (apart from their residence) – in relation to trust-attributed income. In a country that generally taxes on a residence/source basis, full tax liability ordinarily implies tax liability for worldwide trust-attributed income.[526]

8.2.3 Dual Residence

Dual residence of trusts can arise due to differences in domestic rules relating to trust residence (Sections 4.2 and 6.1.4). Until the 2017 Update, the OECD Model resolved dual residence of non-individual persons by a tiebreaker rule based on place of effective management, but that approach has now been rejected: the competent authorities are instead directed to endeavour to resolve the issue by mutual agreement, failing which a non-individual is only entitled to treaty benefits to the extent of any agreement between the competent authorities.[527] Actual treaty practice has been diverse, with some countries favouring one approach or the other and some further distinguishing between companies and other non-individual persons, and the OECD Commentary accepts that some countries may prefer to adhere to their traditional practice.[528] A trust within the trust rules of a particular tax system is not ordinarily regarded as an individual or a company. Trustees who serve as a trust entity do not, in that capacity, have their own personal character for the purpose of

[525] See, e.g., Australia–US 1982 Art 4(1); Canada–US 1980 Art IV(1). There are differences of wording and design in these provisions, the 1977 US Model, and the example cited in the Partnership Report [43]–[46]. The Partnership Report concluded that the approach was not promising enough to justify further work.

[526] It is difficult to determine how comprehensively OECD Model Art 4 should apply to countries that tax on a territorial basis. Similar difficulties arise where a treaty country has no income tax at all, where some or all residents are taxed on a remittance basis, or where temporary residents are taxed on a modified territorial basis. These issues are not considered in the present analysis.

[527] OECD Model Art 4(3). The present rule implements the recommendations of BEPS Action 6 Report [43]–[48], a passage which only discusses corporate dual residence.

[528] OECD Comm Art 4 [24.5] (2017 Update).

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the dual residence rules: they, like a trust, are properly regarded as a non-individual, non-corporate person.[529] Where a trust is a dual resident, its entitlement to treaty benefits in respect of trust-attributed income will therefore depend on mutual agreement of the competent authorities if the relevant treaty follows the present OECD Model.

8.2.4 Anti-Abuse Limitations

Following the BEPS Action 6 Report, the 2017 Update strengthened the terms of the OECD Model and Commentaries against treaty abuse by adding a limitation on benefits rule[530] and a principal purpose test,[531] to the intent that an actual treaty should include either or both of these.[532] The MLI takes a similar approach, requiring either or both as a minimum standard.[533] At the time of writing, it is understood that most countries propose to use only the principal purpose test. These measures will affect trusts in common with other entities.

The area of greatest specific significance for trusts is the limitation on benefits rule. Such a rule has long been part of US treaty practice, and the OECD version has obvious similarities to the US rule.[534] Leaving aside publicly listed trusts and specialized cases such as pension funds and not-for-profits, if the OECD limitation on benefits rule applies, a trust will generally be denied treaty benefits for trust-attributed income unless it passes an ownership/base erosion test,[535] a derivative benefits

[529] Beckham and Elliffe, n 374, §5.1; TR 2005/14; contrà, Prebble, *Trusts and DTAs*, n 373, 194–195.

[530] OECD Model Art 29(1)–(7)) (2017 Update).

[531] OECD Model Art 29(9) (2017 Update). The principal purpose test denies a treaty benefit 'if it is reasonable to conclude . . . that obtaining that benefit was one of the principal purposes of any arrangement or transaction' that produced it, unless it is shown that granting the benefit 'would be in accordance with the object and purpose' of the relevant treaty provisions.

[532] BEPS Action 6 Report [19], [22]. For critique, see Luc de Broe and Joris Luts, 'BEPS Action 6: Tax Treaty Abuse' (2015) 43 *Intertax* 122, 128–134.

[533] MLI Art 7.

[534] For consideration of the latest version, see Rita Julien, Petra Koch and Rita Szudoczky, 'What Has Changed in the Limitation on Benefits Clause of the 2016 US Model?: Technical Modifications, Policy Considerations and Comparisons with Base Erosion and Profit Shifting Action 6' (2017) 45 *Intertax* 12. See also Alexander Rust, 'Article 1' in Ekkehart Reimer and Alexander Rust (eds), *Klaus Vogel on Double Taxation Conventions* (Wolters Kluwer, 4th edn, 2015) m.no. 63–92.

[535] OECD Comm Art 29(2)(e/f) [43]–[54] (2017 Update). The drafting of the limitation on benefits rule in Art 29(1)–(7) is pushed down to the Commentary: see footnote to new

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test[536] or an active business test,[537] or secures a favourable discretionary determination from the competent authority of the country concerned.[538] A discretionary trust faces particular difficulty in qualifying for treaty benefits in respect of trust-attributed income unless it can show that the entire class of its potential beneficiaries is limited to qualified persons[539] and/or equivalent beneficiaries or, alternatively, unless it can attract a favourable exercise of discretion by the relevant revenue authority.

8.3 Trust Income

The largest issue in applying treaties to trust situations concerns the qualification of current trust income for treaty benefits in a source or residence country. This will be considered in the context of the transparent entity clause of the OECD Model[540] and the equivalent MLI provision.[541]

Section 8.3.1 identifies the ways in which double taxation of trust income may arise and frames the rest of the section as an investigation of attribution conflict cases. Section 8.3.2 briefly summarizes the function and effect of the transparent entity clause. Section 8.3.3 considers the meaning of fiscal transparency and the potential significance of OECD Commentary and US regulations, particularly the US 'whether or not distributed' criterion. Section 8.3.4 describes the general operation of the clause on trust income and identifies the circumstances in which it engages one or more of the treaties of a source country with the residence country of the trust, a beneficiary or a grantor. Section 8.3.5 describes the effect of the saving clause on income subject to the transparent entity clause.

OECD Model Art 29. Compare 2016 US Model Art 22(2)(e); 2006 US Model Art 22(2)(f); MLI Art 7(9)(e).

536 OECD Comm Art 29(4) [82]–[91] (2017 Update). Compare 2016 US Model Art 22(4); MLI Art 7(11).

537 OECD Comm Art 29(3) [68]–[81] (2017 Update). Compare 2006, 2016 US Model Art 22(3); MLI Art 7(10).

538 OECD Comm Art 29(5/6) [101]–[112] (2017 Update). Compare 2016 US Model Art 22(6); 2006 US Model Art 22(4); MLI Art 7(12).

539 See OECD Comm Art 29 [48] (2017 Update).

540 OECD Model Art 1(2) (see Table 8.1, n 475).

541 MLI Art 3(1). The text is materially equivalent to OECD Model Art 1(2).

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Section 8.3.6 describes the recognition of differential transparency of trusts by the transparent entity clause. Section 8.3.7 considers the interaction between grantor attribution and the transparent entity clause and whether grantor attribution can support a claim for treaty benefits in a source country under distributive articles or in the grantor's country under a double tax relief article. Limited answers are found. It is concluded that, if either party to a proposed treaty operates a grantor attribution regime, both should actively consider whether they want attribution under that regime to be taken into account in allocating taxing rights and should address the subject in their negotiations. Section 8.3.8 considers whether attribution to a beneficiary or grantor under various rules in the surveyed countries can qualify a trust as fiscally transparent and attract the operation of the transparent entity clause with respect to the beneficiary- or grantor-attributed income. The consideration of actual tax laws and treaties in this section relates back to the discussion of differential transparency and the role of the grantor in preceding sections. Section 8.3.9 considers the significance of reference to another country's national tax law in the conferral of treaty benefits, including the issue of derivative treaty rights in hybrid cases where the treaty countries see different persons as the relevant taxpayer.

The next three sections consider how distributive treaty articles apply to trust income that satisfies the criteria of the transparent entity clause for recognition as income of a resident of one of the contracting states. Section 8.3.10 considers whether and how an appropriate correlation between attribution of trust income and attribution of a trust-level enterprise, business or PE can be achieved. Section 8.3.11 considers the interaction between provisions that depend on the concept of beneficial ownership and the transparent entity clause in cases where trust income is attributed to the trust, a beneficiary or a grantor and proposes a treaty rule to regularize that interaction. Section 8.3.12 considers the operation of treaty criteria for reduced or zero taxation of intercorporate dividends where the dividend is derived through a trust with a corporate trustee or beneficiary. Section 8.3.13 considers how a double tax relief article applies to trust income that satisfies the criteria of the transparent entity clause, the present limitation of relief to source-residence double taxation and strategies that have been adopted bilaterally for the relief of residence–residence double taxation, and proposes a possible treaty rule for that purpose.

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8.3.1 Double Taxation

Double taxation of trust income may arise under the national laws of two contracting states where both attribute the same income to the same taxpayer. One country may tax on a source basis, regarding the income as having a primary source in its territory or belonging to a taxable presence there,[542] and the other because it regards the taxpayer as resident. Alternatively, both may regard the taxpayer as resident, or both may tax on a source basis. In each of these permutations, the taxpayer may be the trust, a beneficiary or a grantor. If double taxation arises in these cases, it is juridical double taxation because the income and the taxpayer are the same in the eyes of both tax systems, both taxing on a current basis.[543]

Dual residence of trusts is resolved (as has been mentioned earlier) by tiebreaker or the mutual agreement process. Dual source is possible, particularly if a trust country recharacterizes source.[544] Double source taxation as such is unrelieved, but a measure of relief may be provided under tax treaties between the beneficiary's residence country and each of the source-taxing countries. Whether this results in full relief depends on the post-treaty rates and basis of taxation in the two source-taxing countries compared with the pre-treaty tax burden in the residence country.[545] Source–source conflicts of this kind appear to be relatively

[542] Some national tax laws treat local source (in terms of their domestic source rules) and nexus with a local taxable presence as separate bases for the taxation of non-residents, while others include the latter in their domestic source rules. For purposes of comparative and treaty analysis, both constitute a source nexus with the taxing country.

[543] OECD Comm Intro [1], Art 23 [1], [3].

[544] As Canada does: see n 167. Thus, a non-resident beneficiary to whom Canada and an original source country both attribute particular trust income may face source taxation by both. Relief may be available under tax treaties between the beneficiary's country and those two source countries or unilaterally under the tax law of the beneficiary's country. Whether that eliminates double taxation depends on the terms and method of relief and the applicable tax rates. Canada recharacterizes not only the source, but also the income itself, and taxes it as income of a non-resident beneficiary on a gross basis by final withholding. Canadian treaty practice addresses this in the other income article, which generally follows the OECD Model but permits source taxation of trust income attributed to a non-resident beneficiary limited to 15% instead of the usual 25% tax rate (see, e.g., Australia–Canada 1980 Art 21(3), applicable to Canadian resident trusts; *Income Tax Act 1985* (Can) s 212(1)(c), (11)).

[545] The aggregated burden of source taxation in the original source country and the trust country may exceed residence taxation in the beneficiary's country. Even if that country gives unilateral or treaty relief for tax in both of the other countries, it will not do so beyond the amount of its own taxation.

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uncommon. The commoner class of same-taxpayer double taxation cases, where one country taxes on a source basis and the other on a residence basis, may also arise in a trust context, but such cases do not present trust-specific difficulties.

Double taxation of trust income may also arise where the countries concerned attribute the same income to different taxpayers: differences in their national tax laws produce an attribution conflict. Several combinations of taxing perspectives are possible. One country may tax purely on a source basis and the other purely on a residence basis; both may be purely residence countries; or one or both may have a composite source +residence perspective.[546] There are also several possible pairings of attributable taxpayers as identified by those countries, most obviously: trust–beneficiary; trust–grantor; grantor–beneficiary; and beneficiary$_{(1)}$–beneficiary$_{(2)}$. If double taxation arises in any of these cases, it is economic double taxation because, although the income and tax timing match, the taxpayers are different.[547] These cases all involve attribution conflicts and are the main focus of Section 8.3.

8.3.2 The Transparent Entity Clause

The OECD Model transparent entity clause addresses most but not all of the attribution conflict issues identified earlier. It represents the present culmination of a long process by which tax treaties have come to recognize trusts and other non-corporate entities and to integrate them into the existing treaty framework (Section 8.1).

The chosen method is to recognize residence-country attribution of entity income for the purpose of allocating taxing rights under the treaty while leaving untouched the qualification and attribution of income under each country's national tax laws. If a source country is also a residence country, its residence taxing rights are preserved by the accompanying saving clause. Thus, in order to engage the protection of a treaty with a source country with respect to particular current income of an entity to which the clause applies, it is necessary that the other treaty

[546] It is theoretically possible that both countries might tax on a source basis by attribution to different taxpayers, but that seems too remote to warrant analysis. The taxing claim of a source+residence country is normally equivalent to a residence taxing claim, but the presence of a potential source taxing claim becomes important in a treaty context, particularly in light of the 2017 amendments to OECD Model Art 23 and MLI Art 3 (2), Art 5(6) (Option C). See Section 8.3.13.

[547] OECD Comm Art 23 [2].

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country attribute that income to its resident, and it is not necessary that the source country attribute that income to a resident of the other country.[548] This removes a potential cause of unintended non-taxation. If a source country took the view that its own attribution of such income to a resident of the other country attracted treaty protection, even though the other country did not attribute that income to a resident, source-country treaty benefits could be claimed although the other country did not tax or even regard the income as potentially taxable. Conversely, the transparent entity clause removes an impediment to double tax relief that would arise if access to treaty benefits in the source country required attribution under that country's own tax law to a resident of the other treaty country.

Fiscal transparency is established if either treaty country attributes the income of an entity to a participant in that entity on a current basis for tax purposes, subject to the qualification that some attribution regimes may need to be disregarded as lying outside the contemplation of the treaty and hence the transparent entity clause or because the attribution for which they provide is notional and attributed income is therefore not identified with the income of the entity.[549] This interpretation of the concept in the OECD Model differs in some respects from the corresponding concept in US treaties as elaborated in US Treasury regulations. The preferred interpretation is explained in Section 8.3.3 with particular reference to trusts. The corresponding general operation of the clause is outlined in Section 8.3.4. An underlying theme is that the recognition of current attribution of trust income by reference to the law of a residence country should be recognized without unnecessary doctrinal complexity.

8.3.3 Fiscal Transparency

The transparent entity clause only applies to income of an entity that is 'treated as wholly or partly fiscally transparent' in either contracting state. That concept is not defined in the text of the OECD or US Model, but its

[548] See Table 8.2, Table 8.3.

[549] Brabazon, *Treaties & Transparent Entities,* n 474, §2.1. See also Angelo Nikolakakis et al., 'Some Reflections on the Proposed Revisions to the OECD Model and Commentaries, and on the Multilateral Instrument, with Respect to Fiscally Transparent Entities' [2017] *British Tax Review* 295 and (2017) 71 *Bulletin for International Taxation* 475–504, 553–567.

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meaning is considered in OECD Commentary and US regulations. Those sources agree on some points but differ on others.

The OECD Commentary says that an entity or arrangement is fiscally transparent where, under the tax law of a contracting state,

> the income (or part thereof) of the entity or arrangement is not taxed at the level of the entity of the arrangement but at the level of the persons who have an interest in that entity or arrangement.[550]

This general proposition accords with the structure and function of the transparent entity clause. Even without taking account of the status of the Commentary, it would represent a rational general interpretation of the concept of fiscal transparency for the purposes of the OECD Model. The Commentary goes on to illustrate the general proposition by saying that it will 'normally' be satisfied where the amount of tax is determined by reference to the personal characteristics and circumstances of the participant – also the concept used by the Partnership Report to determine whether a partnership or its partners are liable to tax.[551] It then goes on to say that

> 'the *character* and *source*, as well as the *timing* of the realisation, of the income for tax purposes will not be affected by the fact that it has been earned through the entity or arrangement'.[552]

The US regulations define an entity as fiscally transparent under the laws of its jurisdiction or an interest holder's jurisdiction with respect to an item of income to the extent that the laws of the relevant jurisdiction require the interest holder

> to separately take into account *on a current basis* the interest holder's respective share of the item of income paid to the entity, *whether or not distributed* to the interest holder, and the *character* and *source* of the item in the hands of the interest holder are determined as if such item were realized directly from the source from which realized by the entity.[553]

[550] OECD Comm Art 1 [9] (2017 Update), [26.10] (BEPS Action 2 Report).
[551] Partnership Report [40].
[552] OECD Comm Art 1 [9] (2017 Update) (emphasis added).
[553] 26 CFR s 1.894-1(d)(3)(ii)(A), (iii)(A) (emphasis added). Items that are non-separately recognized attract the same result under those provisions, provided that the difference between separate and non-separate recognition makes no difference to the interest holder's tax liability and provided that the 'whether or not distributed' condition is still met.

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The OECD Commentary does not include a whether-or-not-distributed criterion.

There is a preliminary question about the use that may be made of US regulations in the interpretation of the OECD Model and bilateral treaties outside the United States. While the Commentaries are widely recognized as capable of assisting the interpretation of treaties based on the OECD Model,[554] the regulations are a legal direction by the US Treasury Secretary which is binding on US courts.[555] This is an important qualitative difference, and it is not immediately obvious that the regulations would qualify for consideration as extrinsic interpretive evidence elsewhere.[556] The courts of countries outside the United States may resist the proposition that such an instrument, not adopted by their country, should carry weight in the interpretation of its treaties. Another consideration is historical. While US treaty practice played an important part in the formulation of the principles expressed in the Partnership Report, and while those principles inform the transparent entity clause and the saving clause now included in the OECD Model, the present version of the US regulations differs from the draft regulations that existed when the Partnership Report was published.[557] The OECD has drawn upon

[554] See John F Avery Jones, 'Treaty Interpretation' in Richard Vann (ed), *Global Tax Treaty Commentaries IBFD* (IBFD, last updated 2018) §3.10–§3.12; Vogel and Rust, n 393, m. no. 98–106; Hugh J Ault, 'The Role of the OECD Commentaries in the Interpretation of Tax Treaties' (1994) 22 *Intertax* 144; Klaus Vogel, 'The Influence of the OECD Commentaries on Treaty Interpretation' (2000) 54 *Bulletin for International Fiscal Documentation* 612; Monica Erasmus-Koen and Sjoerd Douma, 'Legal Status of the OECD Commentaries – In Search of the Holy Grail of International Tax Law' (2007) 61 *Bulletin for International Taxation* 339; *Thiel* v *FCT* (1990) 171 CLR 338.

[555] *CIR* v *South Texas Lumber Co*, 333 US 496 (1948), 501: Treasury regulations 'must be sustained unless unreasonable and plainly inconsistent with the revenue statutes.'

[556] See *Vienna Convention on the Law of Treaties*, opened for signature 23 May 1969, 1155 UNTS 331 (entered into force 27 January 1980) Arts 31, 32; Avery Jones, n 554, §2.2.7, §3.4.5, §3.5, §5.2.2. The US regulations do not fall within any of the permissible categories for reference under Art 31, such as agreements in connection with conclusion of the relevant treaty, instruments made by one country and accepted by the other as relevant to the treaty, subsequent agreements between the countries. A unilateral instrument of one party might theoretically be admissible if the conditions for applying Art 32 are otherwise satisfied, but it is unlikely to carry weight. As Avery Jones has observed (n 554, §3.5.1.4), '[u]nilateral material may be used as supplementary means of interpretation, but with care, as there is no certainty that the other state agrees with it. If the other state does not agree, it has no value as an aid to interpretation.'

[557] See 62 Fed Reg 35673 (26 June 1997); 26 CFR s 1.894-1T; Klein and Renfroe, n 486. The present regulations differ from the 1997 draft regulations in a number of respects, including the references to trusts now found in 26 CFR s 1.894-1(d)(5) Examples

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treaty drafting in the US Model, but without any indication of an intention or agreement also to follow the interpretation in the US regulations.[558]

Another preliminary point concerns the OECD Commentary's reference to 'persons who have an interest in' the entity. The concept does not correspond to any particular element of the transparent entity clause itself, and the better view is that the reference to an 'interest in' an entity is satisfied by whatever the tax law of the relevant country regards as sufficient to treat an item of entity-level income as income of its resident. It therefore should not matter, for example, that a mere discretionary object as beneficiary of a trust has no proprietary interest in the trust property either generally or specifically[559] if that person's country attributes particular trust-level income to him or her. The US regulations do not suggest a contrary approach, and accept that a grantor may qualify on the basis of tax-law attribution.[560]

8.3.3.1 Character, Source and Timing

The character and source requirements in the US regulations are mandatory, while in the OECD Commentary they are arguably illustrative; they are not mentioned in the treaty text. There is no obvious policy reason to distinguish between full current taxation of a resident participant on attributed income and full current taxation of the same person on the same income with retention of the same source and character as in the hands of the entity.[561] Retention of character and source are frequent but (as the Canadian example shows)[562] not inevitable elements of transparent trust taxation. They tend to confirm transparency and may assist in determining whether beneficiary-attributed income has the requisite identity with entity income, but they should not be treated as preconditions. The preferable approach is to treat references to these concepts in the Commentary as illustrative of features that commonly

4 and 5 (see Peter Blessing, 'Final Section 894(c)(2) Regulations' (2000) 29 *Tax Management International Journal* 499).

[558] The high-water mark seems to be an oblique reference to the 1997 US draft regulations in a press release when the Partnership Report was published (Sasseville, n 487).

[559] *Gartside* v *IRC* [1968] AC 553. Whether such a beneficiary may be said to have an interest 'in' rather than under the trust itself is a separate question which tends to the metaphysical. See n 14.

[560] 26 CFR s 1.894-1(d)(5) Example 4.

[561] Nikolakakis et al., n 549, BTR 321–322.

[562] See n 167, 544.

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confirm identity of income. Failing that, they should be applied flexibly.[563]

The other aspect mentioned specifically in the Commentary is identity of tax timing. What is meant by this is not explained; the language may have been left somewhat loose to allow flexibility of interpretation. There should be no objection where timing differences arise from the use of different tax accounting methods or tax periods in different countries. There may be technical issues – one country may have to decide whether to grant relief in anticipation of taxation by the other, or to tax now and adjust later – but the tax periods should generally be close enough to allow practical solutions to be found.[564] A timing mismatch may arise if a beneficiary's country taxes on a remittance basis, but that issue is not limited to trust income and therefore must be addressed more generally.

8.3.3.2 'Whether or Not Distributed'

The most problematic aspect of the US regulations is the whether-or-not-distributed requirement. The significance of that test in addition to current tax recognition is not explained. It dates from the final regulations promulgated in 2000 and was not present in earlier draft regulations.[565] It features in a number of examples in the current regulations, including two relating to trusts. The meaning and utility of the test will be examined by reference to those examples, and it will be concluded that the test should not be recognized as an element of the transparent entity clause in the OECD Model.

The first posits a grantor trust (as perceived by US tax law) organized in a non-treaty country, the grantor of which is a resident of a country with which the United States has a treaty.[566] The grantor's country has a grantor attribution rule that treats the trust's income as that of the

[563] Nikolakakis et al., n 549, BTR 321–322.

[564] It has been suggested that a larger relaxation of timing identity may be desirable: ibid, BTR 320–321, the view of some of the authors. This contemplates that the clause might be extended to a case where a distribution *from* a trust or other entity is sufficiently associated with underlying entity-level income to permit the two to be identified, in order to overcome double taxation that is not otherwise avoided. If so, a tracing principle and an adjustment rule would be required, which cannot be inferred from the transparent entity clause. Should such a thing be desired by the countries concerned, they could instead provide relief in the context of distribution taxation by reference to source-country taxation of underlying trust income (Section 8.4).

[565] 65 Fed Reg 40993 (3 July 2000); contrast 62 Fed Reg 35673 (26 June 1997). See Blessing, n 557; Klein and Renfroe, n 486.

[566] 26 CFR s 1.894-1(d)(5) Example 4.

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grantor with the same source, character and tax timing, 'whether or not distributed to [the grantor]'. The United States recognizes the trust as fiscally transparent under its treaty with the grantor's country. The point of the example is that grantor attribution is recognized as a basis of entity transparency. The 'whether or not distributed' element is not particularly significant here – it is difficult to imagine a grantor attribution regime being designed in a way that would depend on distribution.

The second example is headed 'Treatment of complex trust'.[567] In US terminology, a simple trust is a non-grantor trust which, in the subject year, is required by its terms to distribute all income currently other than by deductible charitable donations, and which in that year distributes no other amounts (e.g., capital).[568] The obligation currently to distribute income is sufficient: it does not matter whether the recipients may be chosen from a class of beneficiaries by an exercise of discretion, or whether the distribution actually occurs. Tax-law income of a simple trust is generally attributed to beneficiaries.[569] A complex trust is any other non-grantor trust.[570] After accounting for income required to be currently distributed, its income is attributed by reference to 'other amounts properly paid or credited or required to be distributed'.[571] It will be seen that the statute does not refer to distribution as a criterion for attribution, although it is common in US tax parlance to refer to distributions and distribution deductions.

The second trust example repeats the facts of the first with two modifications: (1) although the United States recognizes grantor attribution of trust income, the grantor's country does not; (2) the grantor (who presumably is also a beneficiary) receives a discretionary distribution of current trust income which, under the law of the residence country, is attributed to the grantor-beneficiary with its original character and source, but, it is said, there is no requirement under that law that the grantor-beneficiary 'take into account [the trust's] income on a current basis whether or not distributed to him in that year.' The example simply recites itself into the result – a denial of fiscal transparency – by repeating the words of the regulation. No attempt is made to explain what the

[567] 26 CFR s 1.894-1(d)(5) Example 5.
[568] IRC s 651(a).
[569] Up to the amount required to be distributed or the distributable net income, whichever is lower: IRC ss 651(a), 652(a).
[570] IRC s 661(a). The terms 'simple trust' and 'complex trust' are not used in the Code, but they are universally understood and widely used in the regulations.
[571] IRC s 661(a); cf s 662.

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concept of income not being taken into account by a beneficiary 'on a current basis whether or not distributed' might actually mean, particularly where source and character are retained.

An explanation for the reference to a complex trust and for the whether-or-not-distributed rule may perhaps be found in the terms of the US withholding regulations, which govern the obligations of a payer as withholding agent and refer to the distinction between a simple and a complex trust. Broadly speaking, the Code requires withholding by any person 'having the control, receipt, custody, disposal, or payment' of fixed or determinable income from US sources, not being effectively connected income, of a non-US person including a foreign trust.[572] The first step is for the payer to identify the payee. Secondly, the payer must determine whether the payee is a US person, such as a domestic trust or estate. If so, no withholding is required. Thirdly, if the payee is not a US person, the payer must attempt to determine whether the beneficial owner of the income (also a payee, but not necessarily the proximate payee identified at the first step) is a US person or, alternatively, whether the income is paid directly or indirectly to a qualified intermediary that has entered into a withholding agreement with the IRS. If not, the payer must withhold. The process is driven by a series of presumptions and documentary requirements. A payer can initially assume that a proximate payee is a US person in the absence of indicia of foreignness but, once those indicia are present, foreignness is rebuttably presumed. A foreign complex trust is treated as the beneficial owner of its income for the purpose of the withholding obligation, and withholding is required. A foreign simple trust, however, is treated as transparent, and another layer of documentation is required in order to demonstrate beneficial ownership.[573] If a point is reached where beneficial ownership cannot be demonstrated, foreignness is presumed.

At the end of the withholding process, there may have been over- or under-withholding relative to the substantive tax liabilities of beneficiaries or other taxpayers. A tax shortfall may be claimed by assessment of a beneficiary;[574] a credit or refund may be claimed in the event of

[572] See IRC ss 1441(a), 1442(a), 26 CFR s 1.1441-5. The description in the principal text of the withholding regulations and their operation in relation to foreign trusts largely follows Lilo A Hester, Michael G Pfeifer and Joseph S Henderson, 'US Withholding and Foreign Trusts' (2002) 43(8) *Tax Management Memorandum* 139.

[573] If the trust has assumed withholding obligations under an agreement with the IRS, that process may be undertaken by the trust rather than the payer to the trust.

[574] *Central de Gas de Chihuahua SA* v *CIR*, 102 TC 515 (1994).

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over-withholding relative to substantive tax liabilities.[575] At that point, the rights and liabilities of the relevant taxpayer rather than the obligations of the withholding agent are determinative. This fact alone makes it inapposite to base substantive rights under a treaty on a distinction in the withholding regulations, if that is indeed what has happened.

The inappropriateness of relying on such a distinction between simple and complex trusts may also be illustrated by modified versions of the second trust example referred to earlier. Suppose that the grantor is dead, the trust is discretionary and it distributes its income to an Australian beneficiary such that, in Australia, the trust's US income is attributed to the beneficiary. Under Australian tax law, character and source of income are retained. What of the whether-or-not-distributed test? Attribution in Australia depends on present entitlement to trust-law income of the trust, scaled up or down to tax-law income.[576] The statute provides that a beneficiary in whose favour a trustee exercises a discretion is deemed presently entitled to the amount 'paid to the beneficiary or applied for the beneficiary's benefit'.[577] It is sufficient that the trustees have resolved to appoint or (as it is often expressed) to distribute an amount or proportion or class of trust income to a particular beneficiary absolutely and that the appointment becomes irrevocable no later than the end of the income year: present entitlement is established regardless of the fact or timing of distribution.[578] A separate statutory provision that taxes distributions as such is not engaged because taxation on the basis of current attribution excludes it.[579] On these facts, the US condition for transparency should be satisfied.

[575] See 26 CFR s 1.1441-1(b)(8); IRC ss 6401, 6402. In some permutations, a refund or credit may go to the withholding agent (IRC s 1464; 26 CFR s 1.1464-1).

[576] ITAA 1936 s 97(1)(a).

[577] ITAA 1936 s 101. This ensures that discretionary appointments are on the same footing as non-discretionary entitlements. It also ensures that consequent distributions do not fall out of the present entitlement regime on the basis that an entitlement is no longer present if it has been satisfied by payment. See also s 95A(1), which was enacted in 1979 and resolved a previous ambiguity by confirming that paid entitlements are taxable on the same basis as unpaid ones by deeming a beneficiary's present entitlement (under s 101 or otherwise) to continue after the payment or beneficial application of trust income.

[578] See *Re Vestey's Settlement* [1951] Ch 209; *IRC (NZ)* v *Ward* (1969) 1 ATR 287; *Chianti Pty Ltd* v *Leume Pty Ltd* (2007) 35 WAR 488; *Fischer* v *Nemeske Pty Ltd* (2016) 257 CLR 615.

[579] ITAA 1936 s 99B(2)(c).

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Consider next a factual variation in which the beneficiary is resident in New Zealand. The New Zealand result is the same: the trust's US income is attributed to the beneficiary with character and source intact. Beneficiary attribution is generally based on particular trust income vesting absolutely in interest in the beneficiary in the income year, or being paid to the beneficiary within the year or the following six months, and results in the income being treated as the beneficiary's income in the year of trust-level derivation.[580] If the relevant trust income is irrevocably appointed within the income year, the vesting limb is probably engaged independently of the payment limb. Regardless of which limb of the current attribution provision is engaged, New Zealand's separate provision taxing distributions is not engaged. A distribution is undoubtedly recognized,[581] but not a taxable distribution.[582] Distribution taxation is excluded by current attribution.

Finally, suppose that Australia or New Zealand tightens its rules to require actual current distribution as a condition of attribution of appointed income.[583] There is no plausible policy basis on which it could be said that income so attributed to a beneficiary is any less deserving of recognition as such than under the present rules of those countries, yet that would be the result of rejecting attribution if it is based on distribution.

The only sensible basis for distinction between transparency and opacity of a trust or other entity is the presence or absence of current attribution of entity-level income in the country of the participant, not whether distribution plays a role in the criteria for current attribution. The United States itself recognizes beneficiary attribution by reference to discretionary appointments and constructive or actual distributions of current trust income.[584] The whether-or-not-distributed criterion should not be recognized as an element of the transparent entity

[580] ITA NZ s HC 6(1), (1B), (3).

[581] ITA NZ s HC 14.

[582] ITA NZ s HC 15(2)(a), (4)(a).

[583] Consider, e.g., ITAA 1936 s 100AA, an integrity measure which negates attribution to a beneficiary that is a tax-exempt entity by treating it as not presently entitled to trust income if the trustees have not given that entity notice in writing of that entitlement by two months after the end of the relevant income year, and which contains a direction to 'treat the trustee as giving the exempt entity notice in writing of the present entitlement at a time to the extent that the trustee pays the exempt entity the amount of the present entitlement at that time'.

[584] *CIR* v *Stearns*, 65 F 2d 371 (1933), 373; *Lynchburg Trust & Savings Bank* v *CIR*, 68 F 2d 356 (4th Cir, 1934), 359.

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clause in the OECD Model. Alternatively, if it is insisted upon, it should be read down to reflect no more than the distinction between taxation based on current attribution and taxation independent of current attribution.[585]

8.3.3.3 An Implied Limitation?

There is finally a question whether the scope of the transparent entity clause is implicitly limited, perhaps as an aspect of the concept of fiscal transparency, so as not to apply to an undefined set of attribution regimes on the basis that they are simply outside the scope of its contemplation. It is obvious that the transparent entity clause was drafted with a view to the income of partnerships, trusts (at least under ordinary trust rules) and check-the-box entities, but what of entities whose income is subject to other attribution regimes, which may have a specifically outbound or anti-avoidance character? The most obvious candidates for possible exclusion on the basis that they are simply outside the contemplation of the transparent entity clause are CFC rules, having regard to OECD Commentary stating that CFC legislation 'is not contrary to the provisions of the Convention'.[586] Similar questions may arise with respect to other offshore investment regimes, including some grantor attribution rules. The issue is considered in greater detail in Sections 8.3.7 and 8.3.8.2.[587]

8.3.3.4 Conclusion

To summarize the conclusions drawn in Section 8.3.3, the transparent entity clause and the concept of fiscal transparency should be interpreted in a way that is free from inessential qualifications, subject to resolving – preferably in clear terms – the intended scope of the clause with respect to special attribution and offshore investment regimes.

[585] Similar conclusions are reached by Nikolakakis et al., n 549, BTR 317, 320.

[586] OECD Comm Art 1 [81] (2017 Update), previously [23]. The quoted proposition dates from 2008. The 2017 version includes reliance on the saving clause which, not previously having been in the Model, was not previously mentioned in this paragraph of Commentary. There is no reference to the transparent entity clause. Particularly if it is regarded as a consequence of the saving clause, the quoted proposition does not address the question of source-country treaty benefits or of the potential application of a double tax relief article.

[587] See also Brabazon, *Treaties & Transparent Entities,* n 474, §2.1.3, §2.2.4.

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8.3.4 *Application of the Transparent Entity Clause to Trust Income*

In its general operation, the transparent entity clause mandates a three-step process. First, the country applying the treaty identifies income derived by or through an entity. To do so, it applies its domestic law. Secondly, it ascertains whether either country treats the entity as fiscally transparent. To do so, it consults its own law and, separately, the law of the other country. If so, it thirdly ascertains the extent (if any) to which either country treats the income as that of a resident. It consults its own tax law and that of the other country, regardless of which law produced an affirmative answer at the previous step, but the only law that can produce a positive result at the third step is that of the residence country of the entity or of a participant in the entity.[588]

Applying these principles to a trust situation, and assuming that the applicable attribution rule qualifies the trust as fiscally transparent, the following cases are found within the criteria of the transparent entity clause:

- ***Opaque/transparent***: The source country (S) attributes some or all of the income of a trust to the trust itself, but the residence country of a beneficiary (B) or that of a grantor (G) treats the entity as fiscally transparent (step 2) and attributes some or all of its income to its own resident (step 3). Under the S–B treaty, beneficiary-attributed trust income is treated as belonging to a resident of B. This would be relevant if, for example, S applies a limited doctrine of beneficiary attribution that only recognizes vested interests, but B applies a wide doctrine that recognizes discretionary appointments of income as supporting beneficiary attribution. Under the S–G treaty, grantor-attributed trust income is treated as belonging to a resident of G.

  The result is that, depending on the nature of the income and other conditions in the distributive articles of an applicable treaty,[589] the source country may be required to exempt or limit its taxation of the trust on income attributed (as the case may be) to the beneficiary or grantor in that person's residence country, and the beneficiary's or grantor's country (or both, if both have treaties with the source country) may be obliged to grant credit or exemption in accordance with the double tax relief article.[590]

[588] Ibid, §2.2.1.
[589] Such as are considered in Sections 8.3.10, 8.3.11 and 8.3.12.
[590] See Section 8.3.13.

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S may have to comply with multiple treaties in respect of the same income if B attributes to its resident beneficiary and G to its resident grantor and S has treaties with both; in that case, S taxation of particular income is effectively limited by whichever applicable treaty is more restrictive,[591] although each residence country only applies its own treaty or treaties.[592] Likewise, if the trust's residence country (T) attributes the same income to the trust as B or G attributes to its resident beneficiary or grantor, S must also comply with the S–T treaty although, as neither S nor T treats the trust as transparent with respect to the income in question, the transparent entity clause plays no part in engaging that treaty.

- ***Transparent/opaque***: Although S treats the trust as fiscally transparent and attributes some or all of its income to a non-resident grantor[593] or beneficiary (step 2), T attributes that same income to the trust (step 3). Under the S–T treaty, such income is treated as belonging to a resident of T. Thus, accumulating income that is taxable to the trust in T is recognized as income of a resident of T, even if S would have attributed it to a non-resident grantor. Likewise, if S applies a wide view of beneficiary attribution and treats particular income as that of a non-resident beneficiary to whom it is appointed but T applies a narrow view and attributes the same income to the trust, the income is treated as belonging to a resident of T.

The result in each of these cases is that S may be required to exempt or limit its taxation and T to give double tax relief under the S–T treaty, notwithstanding that S taxes a beneficiary or grantor. If S also has a

[591] Each treaty must be fully complied with. Compare Table 8.2 and Table 8.3, cases 5 and 6.

[592] Unexpected results may arise in triangular situations if the distributive articles of the various treaties are incongruent. Thus, if S is permitted to tax under a treaty with an entity's residence country (because it recognizes a services PE in S) but forbidden under a second treaty with a participants' residence country (which does not recognize services PEs), S cannot tax; whether either of the other countries can tax depends on its own treaty with S and any separate treaty between the two residence countries: see Dhruv Sanghavi, 'BEPS Hybrid Entities Proposal: A Slippery Slope, Especially for Developing Countries' (2017) 85 *Tax Notes International* 357. Sanghavi is particularly concerned with cases where the law of a residence country allows an entity to be transparent by election and the impact of this on the tax base of an ultimate source country. His scenario does not depend on the nature of the entity, other than its transparency in a participant's residence country.

[593] Source-country grantor attribution occurs, for example, where US income is attributed to a non-US grantor of a revocable trust within IRC s 672(f)(2), or where UK income is attributed under the settlements legislation to a non-resident grantor (see ITTOIA ss 577 and 648; n 103).

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treaty with B or G and that country attributes to its own resident, S must comply with each of the applicable treaties; but as discussed earlier, each residence country only applies its own treaty.

- ***Transparent/differently transparent***: S treats the trust as fiscally transparent and attributes some or all of its income to a non-resident grantor or beneficiary (step 2); B attributes such income to its resident beneficiary, and it is treated as income of a resident of B under the S–B treaty; or G attributes such income to its resident grantor, and it is treated as income of a resident of G under the S–G treaty. There is, of course, no difficulty where S agrees with the other country on attribution to its own resident. The outcomes are more complex if both countries treat the trust as transparent in respect of the same income, but disagree about attribution.

  If S attributes income to a non-resident beneficiary and G attributes the same item to its resident grantor, the clause in the S–G treaty is engaged. Similarly, if S attributes to a non-resident grantor[594] and B to its resident beneficiary, the clause in the S–B treaty is engaged. A scenario could also be conceived with conflicting attributions to different beneficiaries in different countries. These scenarios may also lead to a doubling-up of treaty obligations if more than one treaty applies.

8.3.5 The Saving Clause

The transparent entity clause does not confer treaty benefits as such but, rather, governs and constrains the operation of the distributive articles and, through them, the double tax relief article of a treaty. The operation of the distributive articles, and hence of the transparent entity clause, is further constrained by the saving clause.[595] Its design is based on the US saving clause.[596] The general effect is that a source country is not restricted

[594] See n 593.

[595] OECD Model Art 1(3) (see Table 8.1). MLI Art 11(1) is to similar effect. If the transparent entity clause in Art 3(1) is operative but a treaty country has reserved against Art 11, Art 3(3) supplies a contextual saving clause: 'In no case shall the provisions of this paragraph [i.e. the transparent entity clause] be construed to affect a Contracting Jurisdiction's right to tax the residents of that Contracting Jurisdiction.'

[596] Art 1(4), (5) in the 2006 and 2016 US Models; Art 1(3) and (4) in earlier Models. The US clause is wider, extending to citizenship taxation and persisting for a period after expatriation.

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in the taxation of its own residents except by rules that specifically focus on residence taxation.[597]

There are three trust cases in which this saves taxation by a source country (S) under a combination of the transparent entity clause with the distributive articles:[598]

- The trust is resident in the source country and opaque there in respect of the subject income. Notwithstanding that the beneficiary's country (B) or the grantor's country (G) may attribute the same income to its own resident, the saving clause of the S–B or S–G treaty (as the case may be) applies.
- The source country attributes income to its own resident beneficiary or grantor. Notwithstanding that the trust residence country (T) may attribute the same income to the trust, the saving clause of the S–T treaty applies.
- The source country attributes the subject income to its own resident beneficiary or grantor.[599] Notwithstanding that the residence country of another person as beneficiary or grantor may attribute the same income to its resident, the saving clause of the S treaty with that country applies.

The consequence is that a residence–residence attribution conflict as between the trust and a participant or among the participants cannot attract source-country relief if the source country is also one of the residence countries.

[597] The listed exceptions are provisions under which it is envisaged in the treaty that a residence country may be required to provide benefits to its own resident, such as by adjustment or double tax relief. Cf OECD Comm Art 1 [19] (2017 Update). Similar exclusions are stipulated in MLI Art 11(1). The exclusions are not mentioned in MLI Art 3(3) (n 595). Such exclusions are necessary to preserve the efficacy of residence-country targeted measures, and a similar qualification should presumably be implied in Art 3(3). Alternatively, the context of Art 3(3) may preclude its application to residence-country targeted measures.

[598] For similar analysis in non-trust cases, see Brabazon, *Treaties & Transparent Entities,* n 474, §2.2.2.

[599] See the example given by Danon, *Swiss International Trust Taxation*, n 10, 305–307; Danon, *Qualification of Entities*, n 12, 197–198. A trust derives royalty income sourced in the residence country of its grantor; a life tenant beneficiary lives elsewhere. Both countries treat the trust as transparent, but SG (Canada or the United States) attributes the income to the grantor and B (Switzerland) attributes it to the beneficiary. No source-country treaty relief applies, and there is full double taxation, subject to possible residence country relief for source tax.

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The principle of the saving clause has been criticized as unprincipled, at least in the form that it took in the Partnership Report, on the basis that it reverts without justification to the attribution rules of the source country.[600] Against this critique, it may be observed that the OECD view applies the internal attribution rules of a residence country, which happens also to be the source country. The distributive articles are designed to balance the rights of source and residence countries. The saving principle prevents one residence country's rules from displacing those of another residence country. The problem of residence–residence attribution conflicts and methods for resolving them, including cases where the conflict is between a residence country and a source+residence country, are a different subject, more appropriately dealt with in the context of residence-country double tax relief (Section 8.3.13).

8.3.6 Differential Transparency

Two issues stand out in relation to the application of the transparent entity clause to trusts: differential transparency, considered in this section,[601] and the role of the grantor, considered in Section 8.3.7. Section 8.3.8 then revisits these issues by examining the capacity of the beneficiary- and grantor-attribution rules of the surveyed countries to generate fiscal transparency and engage the transparent entity clause.

The reference to partial transparency in the OECD transparent entity clause directly accommodates the differential transparency of trusts. It reflects the item-by-item approach of the corresponding US clause and its historical evolution from a provision for partial residence of partnerships, trusts and estates. Access to treaty benefits with respect to the taxation of particular income in a source country under the treaty's distributive articles depends on a particular primary connection between a treaty resident of the other country and that income. Although those connections in different articles are expressed in different ways, the transparent entity clause treats them alike:[602] if the entity is fiscally

[600] Danon, *Qualification of Entities*, n 12, 198: 'Indeed, the only reason why the OECD arrives at this result' – that source+residence country taxation is unrestricted in the example outlined in n 599 – 'is precisely because, without any sound argument, it suddenly implicitly applies the internal attribution rules of the source state, thereby causing the income to be allocated to one of its residents.'

[601] See also Brabazon, *Treaties & Transparent Entities,* n 474, §2.1.4.

[602] OECD Comm Art 1 [8], [12] (2017 Update), [26.9], [26.13] (BEPS Action 2 Report); ibid, §4.2.

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transparent in the view of either country, the connection is established and the entity's income is treated as that of a resident of the treaty country for the purposes of the treaty if and only to the extent that the tax law of such country attributes it to a resident.

Differential transparency is relatively straightforward at a conceptual level. Its role in the transparent entity clause is to focus the application of a tax treaty and the potential attraction of treaty benefits primarily on income as the object of taxation rather than a taxpayer as the subject of taxation, subject to the requirement of a residence-country attribution nexus between that income and a qualified treaty resident.[603] In practice, the greatest difficulty associated with it relates to establishing identity between entity-level income and that which a beneficiary's or grantor's country attributes to its resident.

8.3.7 Role of the Grantor

This section considers the fiscal role of the grantor.[604] A country may regard the grantor as the appropriate person to be treated as owner of trust income for tax purposes for a range of reasons, including (if such be the case) the possibility of reversion or factual economic benefit and/or retention of influence or control, or simply the fact that the trust carries out the grantor's personal purpose and mandate until the trust property is sufficiently vested in particular beneficiaries, perfecting (as it were) the gift inherent in the trust. A country may also be concerned at potential erosion of its tax base by evasion, avoidance or deferral if assets contributed by a resident grantor can generate income in an offshore trust without current attribution to a resident taxpayer. In such a case, there is a risk that the income or other assets into which it has been converted may be brought back or applied for the benefit of residents surreptitiously, in non-taxable form, or with the benefit of tax deferral.

Particular grantor rules may apply as part of a country's general tax law or may be specifically outbound in their operation. Even among the

[603] Compare the proposition that distributive treaty articles address the treatment of specific items of income or capital but do not link them to specific taxpayers (Hugh J Ault, 'Issues Relating to the Identification and Characteristics of a Taxpayer' (2002) 56 *Bulletin for International Fiscal Documentation* 263, 267; Danon, *Conflicts of Attribution*, n 11, 211).

[604] See also Brabazon, *Treaties & Transparent Entities,* n 474, §1.1.2.2 (tax design and policy choices), §2.1.3 (offshore investment regimes and fiscal transparency), §2.2.4 (recognition of transparent attribution).

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surveyed countries, there is considerable diversity in the design and policy of general and outbound grantor rules. In a treaty context, and specifically in the context of the transparent entity clause, it is necessary to consider the intended interaction between such rules and the provisions of the treaty. It is clear from the saving clause that the distributive rules of the OECD Model are not intended to limit the primary operation of grantor attribution and taxation in the grantor's country, but other questions remain:

- whether grantor attribution in the grantor's country is intended to affect the operation of the distributive rules of the treaty in the source country; and
- whether treaty allocation to the source country of taxing rights over particular trust income, which the grantor's country attributes to its resident, is intended to affect the operation of the double tax relief article in the grantor's country.[605]

These questions may be framed by reference to the interaction between grantor rules and the treaty generally in the context of the transparent entity clause, or by reference to the question whether the grantor's country treats the trust as fiscally transparent. It is not clear that the latter approach adds anything to the former.

There is no single or clear answer to these questions. The history and background of the transparent entity clause demonstrate that some forms of grantor attribution – notably US grantor attribution – are intended to be recognized as capable of qualifying an entity as fiscally transparent and as supplying the residence-country attribution of entity income that engages the operation of the clause. On the other hand, some countries regard their grantor attribution rules, particularly those which only operate in an outbound context, as anti-avoidance rules, and may be reluctant to allow taxation under such measures to be affected by double tax relief under a treaty; some may regard their outbound grantor regimes as analogous to CFC rules[606] and, therefore, as fundamentally unrelated to the transparent entity clause.[607] There is much to be said,

[605] Bearing in mind that the saving clause is expressed not to affect double tax relief under OECD Model Art 23.

[606] See discussion of Australia's transferor trust and CFC rules in Section 8.3.8.2 (esp n 635 and corresponding text).

[607] See OECD Comm Art 1 [81] (2017 Update) referring to CFC rules – although it must be conceded that that paragraph does not mention the transparent entity clause.

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however, for the view that the OECD Model and its Commentaries do not preserve domestic special anti-avoidance rules from being overridden by a tax treaty, even after the 2017 Update.[608] If countries wish to preserve such rules, the better course[609] is to address the subject expressly in tax treaties and treaty negotiations.[610]

Separately from these considerations, it is necessary to consider the technical question whether a particular rule attributes the income of the trust to the grantor. If the view is taken that a grantor rule attributes notional income that is not the same income as that of the trust, although it may be calculated by reference to trust income and may even be identical in amount, the criteria for fiscal transparency of the entity and for engagement of the transparent entity clause in respect of the grantor-attributed income are not satisfied. This gives the grantor's country a simple and effective veto which it may exercise unilaterally in its domestic law.[611] The veto excludes not only treaty-based double tax relief at home,[612] but also the possibility of source-country relief by reference to grantor attribution. This strategy is less likely to prove attractive in a general rule than an expressly outbound one.

One clear conclusion can be drawn, however: if either party to a proposed tax treaty operates a grantor attribution regime, both countries should actively consider whether they want attribution under that regime to be taken into account in allocating taxing rights under the treaty and should address the subject in their negotiations.

8.3.8 *Transparent Attribution Analyses*

The question in this section is whether attribution to a beneficiary or grantor in each of the surveyed countries can qualify a trust as fiscally transparent and produce the result that, in terms of the transparent

[608] See OECD Comm Art 1 [68]–[75] (2017 Update); de Broe and Luts, n 532.

[609] Contemplated by OECD Comm Art 1 [72] (2017 Update).

[610] As is done in a number of Australian treaties discussed later (n 641 and corresponding text; Australia–UK 2003 Exchange of Notes (1)(d), (e); Australia–Germany 2015 Art 23 (3), Protocol (7)(1)(c)).

[611] It appears that the United Kingdom has structured some of its rules on this basis: see Baker, *Finance Act Notes*, n 37, referring to amendments to the transfer of assets abroad rules. In a CFC context, see *Bricom Holdings Ltd* v *IRC* [1997] STC 1179.

[612] But see n 722 and corresponding text regarding UK treaty practice, which has the effect of reinstating access to benefits under a double tax relief article.

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entity clause, trust income is 'treated, for the purposes of taxation by [a treaty country], as the income of a resident' of that country. Beneficiary attribution and grantor attribution are considered separately. The only firm conclusion is that each attribution rule requires its own analysis. Subject to this, it is found that beneficiary attribution usually but not inevitably supports fiscal transparency. The results for grantor attribution are more variable. It appears that a general grantor rule is more likely to support fiscal transparency, while a specifically outbound rule with clear anti-avoidance characteristics is less likely to do so.

8.3.8.1 Beneficiary Attribution

The question will be tested for beneficiaries by examining beneficiary attribution in the surveyed countries (Section 3.1). It is not proposed to consider beneficiary attribution as an aspect of CFC or FIF taxation. Outside a CFC or FIF context, offshore attribution regimes do not generally focus on trust beneficiaries.[613] For reasons already given (Section 8.3.4), the focus is on beneficiary attribution under the law of the residence country, without otherwise distinguishing between income vested in a beneficiary a priori and income that is currently attributed as a result of discretionary appointment (and, perhaps, consequent distribution).

United Kingdom: UK beneficiary attribution of income follows directly from trust law. An interest-in-possession beneficiary is treated for tax purposes as the owner of an attributed item of trust income.

New Zealand: New Zealand beneficiary attribution is clear in the statute: 'An amount of income derived . . . by a trustee of a trust is either . . . beneficiary income . . . or . . . trustee income'.[614] The attribution rules are predominantly based on trust concepts, although they include some statutory modifications.

Australia: The Australian position is less obvious, but supports the same conclusion. Subject to source and residence criteria, a beneficiary's assessable income (or the income assessable to trustees on behalf of a particular beneficiary) includes 'that share of the [tax-law] net income of the trust estate' which corresponds proportionately to the 'share of the [trust-law] income of the trust estate' to which the beneficiary is 'presently entitled'.[615] Trust income attributed to beneficiaries has the same

[613] An historical exception was the Australian deemed present entitlement rules in ITAA 1936 ss 96B, 96C. See n 193, 466.
[614] ITA NZ s HC 5(1).
[615] ITAA 1936 s 97(1)(a); cf s 98. Cf n 849, but see also n 850.

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character as in the hands of the trust.[616] Where beneficiary attribution operates, tax law treats the trust as a conduit.[617] Specialized attribution regimes – the streaming rules for capital gains[618] and franked dividends[619] – do not detract from this proposition.

United States: An affirmative answer is also found in the United States. The identification of trust-level income with income attributed to beneficiaries passes through the complex process of DNI accounting. The statute requires various 'amounts' to be calculated by reference to a combination of trust-law facts and tax-law rules, and includes them in a beneficiary's gross income.[620] The trust has corresponding distribution deductions,[621] and character retention applies at both levels.[622] What might not be obvious on reading the statute becomes clear from the history and design of these provisions: that they apply a conduit theory of the trust.[623]

United Kingdom – outbound taxation of capital gains: Greater difficulty attends the UK outbound beneficiary attribution rule for capital gains.[624] Chargeable gains are treated as accruing to a resident beneficiary in a non-resident trust who receives or has previously received capital payments to the extent that they can be matched with hitherto unmatched gains in the trust. Trust gains in one year may be matched with a payment in a later year, or vice versa. The prescribed accounting process aggregates gains and payments into annual batches and acquits them on a last-in, first-out basis.[625] Although an association could be made between trust gains and deemed gains of a beneficiary by making some accounting assumptions about proportional allocation, the statutory language does not require it, and the connection seems too tenuous to conclude that a particular trust gain is treated to an identifiable extent as a gain of a particular beneficiary. This is not least so because there could be many years between the two events. Although a factual connection might be made in a particular case involving a single gain and a single distribution in the same year, there is no

[616] *Charles* v *FCT* (1954) 90 CLR 598.
[617] *FCT* v *Bamford* (2010) 240 CLR 481, 502 [21].
[618] ITAA 1997 Sub-div 115-C.
[619] ITAA 1997 Sub-div 207-B.
[620] IRC ss 652(a), 662(a).
[621] IRC ss 651, 661.
[622] IRC ss 652(b), 661(b), 662(b). The issue does not arise under s 651.
[623] See n 831, 832.
[624] TCGA ss 87, 88; see Section 3.3.2, n 205 and corresponding text. The Australian and US outbound capital gains tax settings do not raise similar issues.
[625] TCGA s 87A.

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necessary identity of tax timing between UK attribution to the beneficiary and recognition of an underlying gain to the trust in its residence country. The better view seems to be that gains attributed to a beneficiary would not be equated with particular trust-level gains.[626]

In each of the surveyed countries, the process of tracing particular trust income to a beneficiary may require consideration of outgoings incurred by the trust in deriving the income. A beneficiary's trust-law entitlements are generally determined net of such outgoings. The corresponding process of tax-law attribution also generally operates on a net basis. Precise national mechanisms differ but generally allow tracing of particular items of trust-level income to particular beneficiaries, whether in whole or to a quantifiable extent.[627]

Beneficiary attribution in each of the surveyed countries thus supports the conclusion that particular trust income is treated as income of beneficiaries to whom it is attributed to the extent of such attribution, with the exception of outbound beneficiary attribution of capital gains in the United Kingdom. Extrapolating from these findings, it is anticipated that beneficiary attribution under other countries' trust tax regimes will support the application of the new transparent entity clause in most cases, but not all.

8.3.8.2 Grantor Attribution

The same question will be tested for grantors by examining general and outbound grantor attribution in the United States, Australia and the United Kingdom.

United States: The US rule is clear and affirmative. A grantor who satisfies the criteria for general or specifically outbound attribution is treated as owning the trust or the relevant part of the trust.[628] The trust is pro tanto disregarded or radically transparent. Income and outgoings are attributed to the grantor on a gross basis.

Australia: Where Australia's outbound transferor trust rules apply, they include in the assessable income of a resident grantor the 'notional attributable income of the trust estate'[629] which is generally equal to the

[626] See also n 651 and corresponding text.

[627] See Sections 3.1, 3.2 and 3.2.4.4. The Privy Council in *Syme* v *Commissioner of Taxation (Vic)* (1914) 18 CLR 519, 525 described the correlation of income from a particular trust-level source with income attributed to a beneficiary net of offsetting trust-level losses from other sources as 'mere bookkeeping'.

[628] IRC ss 673, 674, 675, 676, 677, 679 (Sections 2.3.1 and 2.5.1).

[629] ITAA 1936 s 102AAZD (Section 2.5.1). This is scaled back proportionately if the grantor is resident for only part of the year.

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'attributable income of the trust estate'.[630] That 'attributable income' is defined for a non-resident trust as the 'net income of the trust estate' – the same concept of tax-law trust income that is ordinarily subject to attribution between the trust and its beneficiaries – or a defined subset of that net income,[631] subject in either case to reduction first by subtracting items that have been included in specified ways in the tax base of the trust or someone else in Australia or elsewhere,[632] and then by subtracting the amount of Australian or foreign tax paid by the trust or a beneficiary on items not taken out at the previous step.[633] That last step is equivalent to double tax relief by deduction. It has the effect that items of trust-level income which have not been entirely excluded are recognized on an after-tax basis. Despite the complexity of the legislation, it is possible to track an item of trust-level income directly from trust to grantor.[634] The statutory language and policy are also consistent with attribution. These factors permit an analysis that leads to an affirmative answer, that the transferor trust rules treat items of non-resident trust income as income of a resident grantor to the extent that they are so attributed.

On the other hand, the transferor trust rules are closely linked to Australia's CFC rules. Both originated in the same package of anti-deferral legislation,[635] and the transferor trust rules borrow several concepts and distinctions from the CFC rules. The CFC rules themselves contain provisions for tracing CFC income through a foreign trust with an Australian grantor[636] – as it were, a mini-transferor trust regime designed to reach company income that would not be recognized simply by the attribution of trust income. This suggests that, at

[630] The second concept accommodates the possibility that the grantor may use a non-standard income year, in which case proportionate calculations are performed to match year to year. 'Notional' attributable income relates to the grantor's income year.

[631] ITAA 1936 s 102AAU(1)(a), (b); cf s 102AAB ('net income'). The subset is used if the trust is a 'listed country trust estate': a notional exemption is applied to all income other than 'eligible designated concession income'. Regarding attributable income generally, see Burns and Krever, n 112, 44–48.

[632] ITAA 1936 s 102AAU(1)(c).

[633] ITAA 1936 s 102AAU(1)(d).

[634] If apportionment is required under s 102AAZD due to part-year residence or a mismatch of accounting periods, the total amount attributed to a grantor is reduced proportionately. This suggests that each item comprising attributable income may be taken to undergo a corresponding reduction.

[635] *Taxation Laws Amendment (Foreign Income) Act 1990* (Cth) ss 18, 49. For further consideration of the relationship between the transferor trust rules and CFC rules, see Burns and Krever, n 112, chapter 3.

[636] The key provisions are ITAA 1936 ss 347 and 348.

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least in the view of the ATO, these two offshore investment regimes are likely to be seen as having a similar relationship to tax treaties. It is probable that the ATO will regard both as having the character of anti-avoidance rules and, therefore, as being outside the scope of the ordinary rules of tax treaties,[637] with the consequence that the application of the transferor trust rules would not qualify a trust as fiscally transparent in respect of grantor-attributed income. It is possible that this view would be accepted by an Australian court,[638] although special

[637] See the Commissioner's argument in *Russell* v *FCT* (2009) 74 ATR 466, 492–494. Although the case did not concern the CFC or transferor trust rules, the argument was broad enough to include them.

[638] *Russell* v *FCT* (2011) 190 FCR 449; 13 ITLR 538 concerned Australia's personal service income rules, under which company income from personal services of an individual (resident or otherwise) may be attributed to the individual and correspondingly dis-attributed to the company. The subject income arose from services provided by the individual taxpayer in Australia, where he also happened to be resident, but was paid to an associated company resident in New Zealand with no Australian PE. The taxpayer claimed that the income was exempt under the business profits article of Australia–New Zealand 1995. Logan J held that the treaty did not preclude attribution of the income to the taxpayer, relying inter alia on *Re A Oyj Abp* (2002) 4 ITLR 1009 and the proposition that tax treaties are only concerned with juridical double taxation (*Russell* v *FCT* (2009) 74 ATR 466). The taxpayer's appeal failed on this issue, but for somewhat different reasons: *Russell* v *FCT* (2011) 190 FCR 449; 13 ITLR 538. Dowsett J (with whom the other members of the Full Court agreed) reasoned at [37] that, as the Australian legislation excluded personal services income from the company's assessable income, that income was no part of its profits, with the consequence that taxation of that income was not taxation of the profits of the enterprise of the New Zealand company. This (as noted in ITLR commentary by Richard Vann) is comparable with the reasoning in *Bricom Holdings Ltd* v *IRC* [1997] STC 1179 concerning the UK CFC rules. His Honour then also referred to the anti-avoidance purpose of the personal service income rules as providing confirmation of that conclusion:

> There is nothing surprising about such an outcome. [The personal services income attribution regime in ITAA 1997] Part 2–42 is plainly an anti-avoidance measure. [The company] Ancath's so-called profits were effectively attributable to Mr Russell's exertions. There is no reason to believe that Parliament intended, in enacting the [*International*] *Tax Agreements Act*, that an Australian resident, earning personal services income in Australia, should be able to avoid the operation of Pt 2–42 simply by using a New Zealand company . . . In those circumstances, it is not necessary to consider the OECD material, overseas cases and academic commentary.

The Court's reliance on *Australian* attribution of the subject income would be difficult to reconcile with the transparent entity clause unless the anti-avoidance character of the rule is treated as a basis to deny the fiscal transparency of the entity. The treaty in *Russell* contained no such clause. There is also, with respect, much to be said for the view that the Full Court too lightly dismissed the relevance of the OECD and international

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anti-avoidance rules are not ordinarily regarded as exempt from abrogation by treaty.[639]

A number of Australian treaties avoid this difficulty by dealing expressly with the status of anti-avoidance rules and, in most cases, nominating the CFC and transferor trust rules as having that character. Two main approaches have been taken. The first is to stipulate that the non-discrimination article of the treaty does not apply with respect to provisions of national law 'designed to prevent the avoidance or evasion of taxes'.[640] Being confined to the non-discrimination article, it does not

material and unjustifiably watered down the orthodox approach to tax treaty interpretation in *Thiel* v *FCT* (1990) 171 CLR 338. The decision in *Russell* seems correct, but some of the reasoning may be questioned.

It may also be observed that a general saving clause or an equivalent principle of treaty interpretation would also have preserved Australian taxation of Mr Russell, leaving aside the question (which was not argued) whether he should have received credit for New Zealand tax paid by his company.

The factual situation in *Russell* has some similarities with a French case involving the singer, Charles Aznavour: Conseil d'État, 28 March 2008, No 271366 Rec Lebon (*Aznavour*); Tax Treaty Case Law IBFD; see also Wheeler, *Missing Keystone*, n 39, §5.2.1. M Aznavour, a resident of Switzerland, gave a concert in France in 1989. The fee for his appearance was paid to a related UK promoter company. French domestic law attributed a performer's fee in such circumstances to the individual performer. Such taxation of M Aznavour was permitted by the treaty between France and Switzerland. He argued unsuccessfully that the treaty between France and the United Kingdom precluded French taxation because the UK company did not have a PE in France; the argument was that the income fell within the business profits article of that treaty. The Conseil d'État considered it sufficient that French domestic law determined the taxable event and the taxable person.

Personal services attribution rules such as were considered in *Russell* and *Aznavour* have a distinct anti-avoidance flavour. Unlike *Russell*, the *Aznavour* case only concerned a claim of source taxation. If similar facts occurred under a treaty following the OECD Model (2017) between the source country and the residence country of the promoter company, a series of questions would arise, including whether the French attribution rule is within the scope of the transparent entity clause, and whether the autonomy of the French qualification of the income (which is not affected by the transparent entity clause) precludes identity between the personal services income of the individual and the business income of the company.

[639] See OECD Comm Art 1 [68]–[75] (2017 Update); de Broe and Luts, n 532..

[640] Australia–Norway 2006 Art 24(6)(a), (7)(b); Australia–Finland 2006 Art 23(5)(a), (6)(b); Australia–South Africa 1999 (as amended by Protocol 2008) Art 23A(5)(a), (6)(b); Australia–New Zealand 2009 Art 24(5)(a), (6)(b); Australia–Turkey 2010 Art 24(6)(a), (7)(b). Australia–US 1982 Art 23(2)(c) is differently worded. It excludes anti-avoidance rules from the non-discrimination article. The transferor trust rules were not enacted until 1991. The Australia–US Protocol 2001 substituted Arts 11 (interest) and 16 (limitation on benefits) in terms which saved anti-avoidance rules from the operation of those Articles. Anti-avoidance rules are not listed or defined. See also Australia–India

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affect the ordinary operation of a transparent entity clause in conjunction with the distributive articles.

The second approach – presently found in treaties with the United Kingdom and Germany – is broader. It provides that nothing in the treaty shall restrict (UK) or prevent (Germany) the application of such provisions.[641] It is useful here to compare Canadian treaty practice, which takes the approach of the special saving clause one step further. Canada has long pursued a policy of negotiating saving clauses for its CFC rules, but in a substantial number of treaties, the saving clause extends to taxation of its residents with respect to a partnership or trust without limiting the clause to anti-deferral or anti-avoidance provisions.[642]

Unlike the general saving clause, these special saving clauses are not subject to carve-out of the double tax relief article and other rules directed to a residence country as such. This raises the question whether relief in the grantor's country under a double tax relief article would be precluded on the basis that it would restrict or prevent the application of a specially saved taxing rule.[643] There is also a question whether source-country treaty benefits are implicitly precluded if the attribution regime in question supports fiscal transparency in terms of the transparent entity clause, but also attracts a special saving clause that removes any treaty obligations on the part of the residence country.[644]

1991 (as amended by Protocol 2011) Art 24A(6), Australia–Chile 2010 Art 24(6)(a), referring to anti-avoidance provisions without nominating particular rules.

[641] Australia–UK 2003 Exchange of Notes (1)(d), (e); Australia–Germany 2015 Art 23(3), Protocol (7)(1)(c). The practical effect of these provisions on the transferor trust rules is limited by Australia's unilateral subtraction from the tax base under ITAA 1936 s 102AAU(1)(c) of amounts currently paid to a resident of a listed country and subject to tax in that country. The UK treaty also contains non-discrimination limitations (Australia–UK 2003 Art 25(6)(a); cf Australia–Japan 2008 Art 23(7), Protocol (21)).

[642] See, e.g., Australia–Canada 1980 (as amended by Protocol 2002) Art 26A: 'Nothing in this Convention shall be construed as preventing Canada from imposing a tax on amounts included in the income of a resident of Canada with respect to a partnership, trust, or controlled foreign affiliate, in which that resident has an interest.' In a trust context, the Canadian saving clause preserves domestic taxation of beneficiaries as well as grantors. For an example of the more limited special saving clause referring only to Canada's CFC rules, see Barbados–Canada 1980 Art XXX (2).

[643] In a CFC context, *Canada-Israel Development Ltd* v *Minister of National Revenue* [1985] 2 CTC 2460 suggests an affirmative answer.

[644] Source-country benefits are most likely to be a significant issue where DIR or business income is derived from a country where neither grantor nor trust is resident and where the trust has no relevant PE. The question would arise under a treaty between the grantor's country and the source country.

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These questions are not reached, of course, if a more fundamental view is taken that the treaty or its transparent entity clause does not have regard to anti-avoidance rules and, therefore, does not recognize attribution under such a rule as capable of supporting fiscal transparency. An interpretive argument could be made that express but limited references to anti-avoidance rules actually support the proposition that such rules are in other respects capable of giving rise to treaty benefits, although this is probably the opposite of what Australia's treaty negotiators had in mind.

Australia's treaties with New Zealand and Germany already contain transparent entity clauses, and it is clear that those clauses apply to trusts. There is however no indication that the possibility of interaction between the transparent entity clause and the transferor trust rules has been contemplated under the New Zealand treaty.[645] By contrast, as mentioned earlier, the treaty with Germany preserves the transferor trust rules as an anti-avoidance measure. Each treaty ultimately requires separate consideration.[646] Some existing treaties will acquire transparent entity clauses under the MLI, depending on elections made under that instrument.[647] If so, it will be necessary to consider whether and how the transferor trust rules interact with those treaties.

Whether by judicial decision, by legislation, or by the terms of future treaties, Australia needs to work out whether anti-avoidance rules as such and/or the transferor trust rules are capable of qualifying a trust as fiscally transparent and attracting treaty benefits by reference to

[645] See Explanatory Memorandum, International Tax Agreements Amendment Bill (No 2) 2009 (Cth), esp commentary on Arts 1(2), 23(3), 24(5), (6); cf n 640.

[646] Australia–US 1982 (as amended by Protocol 2001) raises more difficult issues of interpretation. It includes a partial residence provision for partnerships, trusts and estates in Art 4(1) and provisions saving the operation of domestic anti-avoidance rules from abrogation by specified articles: see Arts 11(4)(b) (the interest article), 16(7) (the limitation on benefits article), 23(2)(c) (the non-discrimination article).

[647] See www.oecd.org/tax/treaties/mli-database-matrix-options-and-reservations.htm. Australia has not foreshadowed reservations against MLI Art 3(1), other than to preserve a small number of existing specific clauses via Art 3(5)(d), including Australia–Japan 2008 Art 4(5) (Australia, Status of List of Reservations and Notifications at the Time of Signature (7 June 2017, OECD, www.oecd.org/tax/treaties/beps-mli-position-australia.pdf). Subject to reservations by other countries, Australia will acquire a suite of transparent entity clauses in existing treaties covered by the MLI. As the United Kingdom has not reserved against MLI Art 3, Australia–UK 2003 is one of the treaties that will acquire a new transparent entity clause under Art 3(1). Australia–Germany 2015 is effectively post-BEPS and already contains a transparent entity clause (Art 1(2)). It is not nominated by either party as a covered tax agreement under the MLI.

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Australian grantor attribution. Whether the income that is attributed to the grantor is the same as the income derived by the trust is one aspect of this question.

United Kingdom: In the United Kingdom, the first rule of the settlements legislation concerning possible reversions and retained interests and the second rule concerning income that would otherwise be attributed to the grantor's infant children or is applied for their benefit stipulate that settlement income to which they apply shall be treated for tax purposes as 'the income of the settlor and . . . the settlor alone'.[648] Where the grantor (settlor) is UK resident, these considerations point to an affirmative conclusion in terms of the new transparent entity clause, that the relevant trust income is 'treated, for the purposes of taxation by [the United Kingdom], as the income of' its resident grantor.

The third and fourth rules of the settlements legislation concern capital payments such as loans from the trust or a related body corporate.[649] These are treated as income of the grantor if, when and so far as the amount of the payment 'falls within the amount of income' of the settlement that would be available under principles set out in the legislation in the same year or any of the following 10 years. The relationship between entity income and attributed income has an accounting character. While tracing might be possible, it is not provided for. The entity income is not said to belong to the grantor alone. These considerations suggest a negative answer in relation to income attributed under those rules.

The UK–US Treaty 2001 includes an exchange of notes proposed by the United Kingdom and accepted by the United States which, with respect to the transparent entity clause,[650] stipulates inter alia that

> in applying the paragraph, the United Kingdom shall, exceptionally, regard an item of income, profit or gain arising to a person as falling within the paragraph where another person is charged to United Kingdom tax in respect of that item of income, profit or gain
>
> a) under section 660A or 739, *Income and Corporation Taxes Act 1988*; or
> b) under section 77 or 86, *Taxation of Chargeable Gains Act 1992*.[651]

[648] ITTOIA ss 624(1), 629(1). See Section 2.3.2.
[649] ITTOIA ss 633, 641.
[650] UK–US 2001 Art 1(8), the terms of which substantially followed the 1996 US Model Art 4(1)(d).
[651] UK–US 2001 Exchange of Notes re Art 1(8).

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The cited provisions represented respectively the first rule of the settlements legislation,[652] the transfer of assets abroad rules,[653] a grantor attribution rule applicable to capital gains of resident trusts (subsequently repealed), and the outbound grantor attribution rule for capital gains of non-resident trusts. The word 'exceptionally' appears to imply a view that, but for this additional point of agreement, the United Kingdom would not have regarded the income or gain attributed to its resident grantor under these provisions as falling within the transparent entity clause, although another explanation may be that UK tax law changed the character of the income. It was, in any event, obviously desirable that both countries' grantor rules were covered.

The four cited provisions contained quite different wording. The first was substantially similar to its present counterpart. It provided for exclusive attribution to the grantor. The second referred to income 'of' a person abroad that had the requisite connection with the grantor and deemed 'that income' to be income of the grantor. The third and fourth provided that 'an amount equal to' an amount calculated in relation to the entity should be attributed to the grantor.[654] The transfer of assets abroad rules were rewritten into ITA UK in 2007. The provisions that corresponded to the repealed section 739 were differently worded,[655] but the new wording made no stronger identification between entity income and attributed income. Nevertheless, there seems to have been a concern that the charge to tax might be overridden by a tax treaty, and the wording was changed to its present form, discussed in the following paragraphs, in 2013. Consideration of the legislative history and the exchange of notes emphasizes the interpretive complexity that may be involved in applying a transparent entity clause to grantor attribution provisions.

The transfer of assets abroad rules (Section 2.5.2.1) use a different form of words which, in its present form, deliberately differentiates the notional income attributed to a resident from the corresponding income of a person abroad in order to prevent tax treaties from

[652] See now ITTOIA s 624. The second and third rules of the settlements legislation existed in 2001, but were not cited.
[653] See now ITA UK ss 720, 722.
[654] TCGA s 77 (since repealed) also stipulated that the corresponding trust amount should not be attributed to the trust. Section 86 contains a carve-out for gains that are taxed to the trust itself (see Section 2.5.2.2).
[655] ITA UK ss 721, 729 (as enacted).

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applying, as they might if the resident were taken to derive the foreign income.[656] This raises a subtler question. The United Kingdom recognizes an item of entity-level income, uses that fact to attribute an equal amount to its resident, and says that they are not the same item. Suppose that the item is sourced in a country that attributes it to the entity and that the entity is not resident in either country. What legal rules determine whether the item recognized as entity-level income is the same as the item attributed to the UK resident? The answer seems to be that UK law, as the law of the residence country, determines both attribution (step 3 under the transparent entity clause, described in Section 8.3.4) and whether the item so attributed is the same as the one derived 'by or through' the entity (step 1).[657] This implies that a participant's country can unilaterally prevent the transparent entity clause from applying in either country to income under a particular attribution regime by expressly denying identity between entity-level income and income attributed to its resident. It follows that a UK grantor cannot claim treaty relief abroad or in the United Kingdom under a transparent entity clause by reference to attribution under the transfer of assets abroad rules unless the treaty itself overrides the domestic rule and recognizes identity of income for treaty purposes.

Where the criteria for attribution are satisfied under both the settlements legislation and the transfer of assets abroad rules, the latter rules

[656] See Baker, *Finance Act Notes*, n 37, 409, referring to amendments of the transfer of assets abroad rules by FA 2013: 'It is also made clear that the charge to tax is on a notional attribution of income, rather than the actual income of the non-resident person; the aim of this change being to put beyond doubt, so it would seem, any argument that the charge to tax is overridden by a double taxation convention.'

[657] Two possibilities may be considered. The first is that identity is determined by the law of the country applying the treaty, which is also the law applied at step 1. If a participant's residence country is applying the treaty, these are the same. If the source country is applying the treaty and attributes the income to its own resident, the question does not arise because the saving clause precludes treaty benefits. If the source country does not attribute to its own resident, it will have to consider the question of identity and, in doing so, will need to determine what the participant's country attributes to its resident. To do that, it will consult the other country's law and find that it denies identity.

The other possibility is that an autonomous treaty meaning applies to determine identity. This seems unlikely to be accepted by a participant's country, however, if it has already taken a definite view on the question of identity in its domestic law. If an autonomous meaning would not be applied by a participant's country, neither should it be considered by a source country.

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are excluded.[658] This implies that treaty benefits arising by reference to the settlements legislation are not lost by such an overlap.

The UK outbound grantor attribution rule for capital gains (Section 2.5.2.2) attributes 'an amount equal' to the net trust-level capital gains from which the gain attributed to a resident grantor is derived.[659] This form of words has a similar effect to that in the transfer of assets abroad rules.[660]

This survey of grantor attribution rules suggests that a more variable set of outcomes will be found than in relation to beneficiary attribution. Whether a particular grantor attribution rule is capable of generating transparent entity status and/or treaty consequences in either country must be considered. Whether the income that a particular rule attributes to a resident grantor is the same as the income of the entity, which is not necessarily the same question, can only be determined by analysis of the rule in question and its application. That said, it would be reasonable to expect that general grantor attribution rules which apply in domestic as well as international situations are more likely to support the application of the new transparent entity clause than dedicated outbound rules which focus on resident grantors of non-resident trusts. Specifically outbound grantor regimes have more in common with CFC rules and are more likely to be characterized as having an international anti-avoidance character. An explicitly outbound rule is more likely to be designed in such a way as to exclude identity with trust income and the application of a treaty than a general one.

8.3.9 *Consequences of Recognizing Fiscal Transparency of Hybrids*

One consequence of treaty recognition of fiscal transparency is that a source country must learn something of its treaty partner's tax system. This is already the case where Partnership Report principles are applied to partnership income.

Another consequence is that a person whose residence and taxability support access to treaty benefits may not be the same person as the taxpayer whose source-country taxation the treaty alleviates: the source

[658] ITA UK ss 721(3C), 728(2A) (n 135). It is a moot point if UK–US 2001 applies, at least so far as the transparent entity clause is concerned, because of the Exchange of Notes re Art 1(8).

[659] TCGA s 86(4).

[660] See n 141, 147; cf CG 38345 (at 27 December 2017).

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country must therefore be prepared to investigate and act upon a claim by or on behalf of a person who, in its eyes, is not the taxpayer. This lack of personal identity follows inevitably from the structure of the transparent entity clause and, therefore, should not impede the assertion of derivative treaty rights.[661] To avoid inconvenience, countries should establish procedures for asserting such rights, but the absence of a dedicated procedure should not preclude their legally effective assertion. The right or fact of source country taxation in accordance with the treaty then also supports a right of double tax relief in the residence country. These propositions should preferably be addressed in the OECD Commentaries.

8.3.10 Attribution of Business Structures

Income attribution is not the only condition that must be satisfied in order to qualify trust income for particular treaty benefits or to attract the operation of treaty provisions in the same way as they would apply to direct investment. Having established that an item or share of trust income is recognized under the transparent entity clause as income of a resident of a treaty country, the next step is to consider how the distributive articles of the treaty apply to that income. Each distributive article sets out its own substantive criteria and consequences. The method adopted here is to focus on issues of particular significance in relation to trust income. This section considers the attribution of trust-level business structures to a beneficiary or grantor.[662] Section 8.3.11 considers issues relating to beneficial ownership, and Section 8.3.12 considers the treatment of corporate participation dividends.

Several distributive provisions of the OECD Model determine the allocation of taxing rights over income by reference to its connection with a business conducted in a contracting state through a PE in that country. Broadly speaking, if the relevant connection is established, the source/host country may tax the income or profits in question under the business profits article[663] and the residence country is obliged to give

[661] A treaty is to be interpreted *ut res magis valeat quam pereat* – to be effective, not to fail. See Brabazon, *Treaties & Transparent Entities*, 474, §2.2.3. The issue is not peculiar to trusts.

[662] See further ibid, §4.3.

[663] OECD Model Arts 7(1) (business profits), 10(4) (dividends), 11(4))(interest), 12(3) (royalties), 13(2) (capital gains from movable property), 21(2) (other income, other than from third-country immovables).

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corresponding relief from double taxation by exemption or credit, reflecting the general setting of the double tax relief article, but if the connection is not established, source-country taxing rights may be denied[664] or limited[665] by the treaty.

The requisite connection between the business and PE and the relevant treaty resident is differently expressed in different provisions. The business profits article itself refers to the profits of an enterprise of the residence country and to that enterprise carrying on business in the source/host country through a local PE;[666] other provisions refer to the treaty-resident beneficial owner[667] or recipient[668] of income carrying on business in the source/host country through a local PE. It seems relatively clear from a policy perspective that recognition under the transparent entity clause of income attribution to a beneficiary or grantor should carry with it the attribution of a relevant business and PE so that a consistent result is obtained. The interposition of a trust or other transparent entity should not exclude or limit source taxing rights.

It may be that this result can be obtained by purposive interpretation of the OECD Model as it stands after the 2017 Update, but as neither the text of the Model nor the Commentary is entirely clear, the better course is to address the issue directly. This invites consideration of how the right result can best be achieved. Two methods are considered, based on the trust PE clause as found in Australian and New Zealand treaty practice and on modification of the definition of 'enterprise of a Contracting State'. The latter approach is found to be preferable.

[664] OECD Model Arts 7(1) (business income), 12(1) (royalties), 13(5) (capital gains not otherwise taxable on a source/situs basis) 21(1) (other income). The UN Model (Arts 12(1), (2), 21(3)) and numerous bilateral treaties allow limited source taxation of non-PE royalties and general source taxation of non-PE other income; Canadian treaty practice allows limited taxation of Canadian trust income (n 544, 744). The beneficial ownership condition for denying or limiting source taxation of DIR income is separately considered below.

[665] OECD Model Arts 10(1), 11(1); cf n 664.

[666] OECD Model Art 7(1); cf Art 13(5).

[667] OECD Model Arts 10(4), 11(4), 12(3). Where income that qualifies as business profits is also dealt with by another distributive article, the business profits article is initially turned off by Art 7(4), but if DIR income has the requisite source and PE connection with the host country, the provisions of Art 7 are re-engaged under the applicable throwback rule in Art 10(4), 11(4) or 12(3).

[668] OECD Model Art 21(2).

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8.3.10.1 Trust PE Clauses

Twelve years before the 1996 US Model adopted the transparent entity clause, Australia became concerned that the business profits article of a treaty with a beneficiary's residence country might prevent it from taxing beneficiary-attributed business income referable to a trust-level Australian PE. The argument was that, while the character of trust income passes through to the beneficiary, a trust is not as such an undertaking of or an agency for a beneficiary, and a beneficiary does not ordinarily carry on business through a trust PE.[669]

While denying that the argument was valid,[670] Australia responded by enacting an override for existing treaties, the wording of which appears to have been inspired by the US statutory rule attributing a local trust business to a foreign beneficiary.[671] A beneficiary who

> is presently entitled, either directly or through one or more interposed trust estates, to a share of the income of the trust estate derived from the carrying on by the trustee in Australia of a business through a permanent establishment in Australia

would be deemed to carry on that business in Australia through a PE in Australia, and the beneficiary's share of the income would be deemed attributable to that PE.[672]

[669] See J R Sharp, 'Tindal, and All That . . .' (1984) 18 *Taxation in Australia* 1038. The author developed the argument by reference to Australia–US 1982 Art 7 with reference to a US unit-holder that has its own business which qualifies as an enterprise of the United States, but has no Australian PE. A later decision of the Administrative Appeals Tribunal relating to Australia–US 1953 accepted that a trust business in Australia was not part of the separate US business of a US beneficiary to whom its income was appointed: *AAT Case 6103* (1990) 21 ATR 3594 [10]. That point was common ground between the parties, and seems to have been accepted as meaning that an Australian PE, which the trust must have had, was not a PE of the beneficiary. The Tribunal ultimately rejected a claim for exemption on a different and, with respect, somewhat questionable ground, that the business profits article did not address passively derived 'industrial or commercial profits' and that an underlying treaty rule of source taxation should be inferred, absent any clear provision to the contrary.

[670] Explanatory Memorandum, Income Tax (International Agreements) Amendment Bill 1984 (Cth), note on cl 3; Commonwealth, Parliamentary Debates, House of Representatives, 13 September 1984, 1286 (John Dawkins, Minister for Finance). Both refer to 'distributions' to beneficiaries, but it is clear from the context that present entitlement and consequent current attribution was intended; these alone were capable of producing the effect of fiscal attribution which was the point under discussion, regardless of whether distribution had occurred.

[671] IRC s 875(2), adverted to by Sharp, n 669, as a solution.

[672] IntTAA s 3(11), inserted by *Income Tax (International Agreements) Amendment Act 1984* (Cth) s 3, commenced 19 October 1984.

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Subsequent Australian treaties have consistently included a trust PE clause, usually in the business profits article. The Australia–UK clause illustrates the usual wording:

> [W]here:
>
> (i) a resident of a Contracting State is beneficially entitled, whether directly or through one or more interposed trust estates, to a share of the business profits of an enterprise carried on in the other Contracting State by the trustee of a trust estate other than a trust estate which is treated as a company for tax purposes; and
>
> (ii) in relation to that enterprise, that trustee would, in accordance with the principles of Article 5, have a permanent establishment in that other State, the enterprise carried on by the trustee shall be deemed to be a business carried on in the other State by that resident through a permanent establishment situated in that other State and that share of business profits shall be attributed to that permanent establishment.[673]

The wording has remained fairly stable over time, and most other countries seem to have no objection to accommodating the Australian policy.

Trading trusts are significant in New Zealand as well as Australia. Beginning with its 1995 treaty with Australia, New Zealand embraced the trust PE clause in its treaty policy,[674] initially adopting the Australian wording. This changed in 2002, and most subsequent New Zealand PE clauses depend on whether a beneficiary 'beneficially owns' a share of trust PE income, not whether he or she is 'beneficially entitled' to it,[675] but it should not be assumed that a different meaning was intended.[676] A number of recent New Zealand treaties also replace the reference to 'a

[673] Australia–UK 2003 Exchange of Notes (3)(b) re Art 7. Australia–US 1982 (as amended by Protocol 2001) Art 7(9) refers to fiscally transparent entities, including trusts. A few treaties have unidirectional clauses that only apply where the beneficiary is a resident of the other country and the trust PE is in Australia (e.g. Australia–Germany 2015 Art 7(7)).

[674] See Graham Hunt, 'New Zealand's Evolving Approach to Tax Treaties' (2008) 14 *New Zealand Journal of Taxation Law and Policy* 131, 160–161.

[675] The earliest instance of the new drafting appears to have been New Zealand–South Africa 2002 Art 7(6). Fourteen subsequent New Zealand treaties follow the new wording.

[676] There are other differences in drafting, which seem to suggest a stylistic change or a desire to conform more closely to the language used elsewhere in the OECD Model. In a thorough review, Hunt, n 674, does not mention the change. Australia–New Zealand 2009 Art 7(7) uses the New Zealand wording, but subsequent Australian treaties refer to beneficial entitlement.

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share of the business profits of an enterprise' with the words 'a share of the profits of a business of an enterprise'.[677]

The trust PE clause, like the transparent entity clause, can apply to income of a trust that is not resident or established (except in the sense of a business PE) in either treaty country.

The clause operates by attributing the trust enterprise, and thus the trust business, to a beneficiary and attributing the beneficiary's share of 'business profits' or 'profits of [the] business' to the PE in order to engage the right of source taxation under the business profits article. There may perhaps be some doubt whether the reference to 'business profits' is wide enough to include DIR income that would, for a direct investor, attract source taxation because of its connection with the investor's PE[678] or to capital gains referable to the movable business property of the PE.[679] The question is whether 'business profits' refers to the character of the profits or simply their connection with the business. The wider interpretation would avoid irrational distinctions between classes of PE-related income. The alternate wording, 'profits of a business', is more readily interpreted in this way.

Another issue is the meaning of beneficial entitlement or beneficial ownership. Beneficial entitlement could be interpreted as referring only to trust-law entitlement existing a priori, or as including entitlements created by the exercise of discretionary powers of appointment.[680] A third possibility is that it refers to tax-law attribution, or the concept of beneficial ownership as used in the DIR articles. Historically, many Australian treaties have referred to beneficial entitlement where the OECD Model has referred to beneficial ownership.[681] A prominent view of beneficial ownership equates that concept with tax-law attribution, subject to the exclusion of agency, nominee and similar arrangements.[682]

[677] The newer wording is found in the New Zealand–US Protocol 2008 and seven subsequent treaties, including Australia–New Zealand 2009 Art 7(7).

[678] OECD Model Art 10(4), 11(4), 12(3); cf Art 7(4).

[679] OECD Model Art 13(2).

[680] The expression 'beneficial entitlement' is not a technical concept of equity or trust law. It may be interpreted as referring to an equitable proprietary interest in particular trust property or the produce from time to time of particular trust property or, more broadly, as including an entitlement in equity to particular income that has been appointed to a beneficiary. From a tax viewpoint, it cannot realistically matter whether the entitlement (of whichever character) has been satisfied and technically extinguished by payment out before the end of the tax year (cf ITAA 1936 s 101).

[681] See, e.g., Australia–Austria 1986 Arts 10(1), 11(1), 12(1); compare Art 7(9).

[682] See Section 8.3.11 and Brabazon, *Treaties & Transparent Entities*, n 474, §4.4.

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The trust PE clause was designed with an Australian tax-law perspective in mind. Beneficial entitlement as such was not an element of Australia's trust tax rules, but it is no great leap to infer that these words were intended to connote fiscal attribution to a beneficiary. It is unlikely that a pure trust-law concept was intended, as that would have required a separate attribution principle to be overlaid on existing tax-law principles. The better view is that tax-law attribution was intended.[683] The more recent New Zealand wording suggests that the concept of beneficial ownership in the DIR articles is intended, although the trust PE clause applies primarily to business income.

If a treaty includes a trust PE clause and a transparent entity clause, it will be necessary to determine whether beneficial entitlement or ownership in the PE clause is determined under the tax law of the source country or that of the beneficiary's residence country. This situation may arise under existing treaties if a transparent entity clause is added under the MLI.[684] If a trust PE clause operates by reference to source-country attribution, there is a further question whether it may confer treaty rights with respect to income that is not attributed to the beneficiary in the beneficiary's residence country and, therefore, does not attract the transparent entity clause.

In summary, while the trust PE clause works effectively in many situations, there are still some interpretive problems, its scope is limited to trusts and is in some respects uncertain, and it is not readily integrated with a transparent entity clause.

8.3.10.2 Enterprise Attribution

A better approach is expressly to correlate the operation of the transparent entity clause with the concept of an enterprise of a contracting state and the carrying on of its business.[685] This has been done in US treaty practice since the 1996 US Model, which extends the definition of an enterprise of a contracting state to include

[683] Avery Jones et al., *Origins*, n 381, 747 n 324, suggest that Australia uses 'beneficially entitled' in its treaties for that very purpose, so as to comprehend the attribution of trust income to discretionary beneficiaries.

[684] The OECD considers that that trust PE clauses belong to a class of integrity measures which will not be superseded by the MLI transparent entity clause, but may coexist with that clause (see OECD/G20 BEPS Project, *Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (2016) [45]).

[685] See further Brabazon, *Treaties & Transparent Entities*, n 474, §4.3.4.

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> an enterprise carried on by a resident of a Contracting State through an entity that is treated as fiscally transparent in that Contracting State.[686]

There is a good case for reading the words 'carried on by' as referring to nothing more than income being treated as that of a resident by a country of residence, at least in Australian and US treaty jurisprudence.[687] As that beneficial interpretation is somewhat subtle and may be overly dependent on the legislative history of a particular country, the better approach is to deal with the point expressly, such as by an addendum to the 'enterprise of' definition in the OECD Model:[688]

> and includes an enterprise to the extent that its income is recognised as income of a resident of that Contracting State under paragraph 2 of Article 1, in which case such resident shall be taken to carry on the business of the enterprise.

If a trust PE and business are not attributed for treaty purposes together with corresponding trust income, source taxing rights are determined on an anomalous basis. This results in a misallocation of taxing rights between source and residence countries. It may also result in greater or less source taxation than should be the case, depending on the rate of tax, the basis of double tax relief and the tax affairs of the beneficiary or grantor in the residence country.

8.3.11 Beneficial Ownership

This section considers the interaction between provisions that depend on the concept of beneficial ownership and the transparent entity clause in cases where trust income is attributed to the trust, a beneficiary or a

[686] 1996, 2006, 2016 US Models Art 3(1)(c); the US definition is otherwise equivalent to OECD Model Art 3(1)(d).

[687] *Thiel* v *FCT* (1990) 171 CLR 338 treated similar words as no more than a linking expression. This also seems to be what the US drafters had in mind: see IRS, General Counsel Memorandum 39361 (20 Jan 1982), (1985) 27 Tax Notes 1034, 1036 (cf IRS, Revenue Ruling 85–60, 1985–1 CB 187), discussed by Sanford H Goldberg and Saul M Shajnfeld, 'Attribution of a Trust's Permanent Establishment to its Beneficiaries' (1986) 34 *Canadian Tax Journal* 661, reflecting the logic of IRC s 875.

[688] OECD Model Art 3(1)(d). The wording, suggested in Brabazon, *Treaties & Transparent Entities,* n 474, §4.3.4, frankly engages the transparent entity clause. The last 17 words accommodate the traditional terms of PE clauses in the DIR articles, which refer to the beneficial owner of the income rather than the enterprise as carrying on business (contrast Art 7(1)).

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grantor.[689] Beneficial ownership of DIR income by a treaty resident of the other contracting state is a condition for source-country tax limitation or exemption.[690] The concept of beneficial ownership is generally undefined. Literature on the subject is vast, and there is no international consensus about its meaning.

Following Meindl-Ringler,[691] this book proceeds on the basis that the preferable view of beneficial ownership of particular income is equivalent to residence-country liability to tax with respect to that income, excluding agency and nomineeship arrangements and possibly also excluding forwarding company arrangements. If this view is accepted, it will be seen that factual conditions which support recognition of attribution to a resident of a treaty country under the transparent entity clause also establish the positive elements of beneficial ownership of income by a resident of that country. Both tests depend on fiscal attribution under the law of the residence country. There is substantial scholarly support for the view that treaty benefits should not fail where the transparent entity clause would recognize DIR income of a resident of the other treaty country, leaving aside agency, etc, situations and cases where the source country would attribute the income to its own resident.[692] The present US view of beneficial ownership concurs to the extent that it equates beneficial ownership with fiscal attribution, but would determine attribution by reference to tax-law principles of the source country.[693]

If the suggested interpretation of beneficial ownership is accepted, the conditions for applying the transparent entity clause to DIR income of a trust and for recognizing beneficial ownership of that income by a treaty resident both identify the same personal subject. The operation of the two rules can thus be stated in an integrated form such that source-country tax limitation (or exemption, as the case may be) depends on

(1) whether the trust, a beneficiary or eligible grantor is resident in the other country and
(2) the extent to which the subject income is attributed in that country to such resident(s) and is not excluded from beneficial ownership by agency, nomineeship or being a mere intermediary.

[689] See also Brabazon, *Treaties & Transparent Entities*, n 474, §4.4.
[690] OECD Model Arts 10(2), 11(2), 12(1).
[691] Angelika Meindl-Ringler, *Beneficial Ownership in International Tax Law* (Wolters Kluwer, 2016).
[692] Nikolakakis et al., n 549, BTR 334.
[693] *US Model: Technical Explanation* (2006) Art 10(2). (At the time of writing, no technical explanation has yet been published for the 2016 US Model.)

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If the suggested interpretation is not accepted, the two rules may identify different personal subjects and their operation cannot necessarily be integrated.

The application of the beneficial ownership rule to trusts, beneficiaries and grantors will be considered in turn. In each case, it is assumed that the operation of a transparent entity clause or Partnership Report principles identifies residence-country attribution of DIR income to subject trust, beneficiary or grantor[694] as attracting treaty benefits, and that the subject so identified is not relevantly acting as a mere agent or nominee. None of the situations described in the following paragraphs is emblematic of tax avoidance.

Trust: If an attributes-of-ownership of income approach is applied and particularly if the trustees are identified as the relevant trust entity, there is a risk that the obligation to use trust property for the purposes of the trust and not for the personal benefit of the trustees may be construed as negating beneficial ownership. The risk may be exacerbated by a simplistic understanding of the trust as involving inherent separation of equitable and legal title.[695]

New Zealand is one of the few countries to address the issue expressly. Its longstanding treaty policy has been to include a clause treating the beneficial ownership requirement as satisfied if the relevant income is subject to tax as income of the trustees in the non-source country.[696]

[694] Recognition of a grantor as a relevant resident under the transparent entity clause is subject to previous observations concerning the scope of fiscal transparency and identity between trust income and grantor-attributed income (Sections 8.3.3, 8.3.7 and 8.3.8.2). Similar considerations affect the recognition of a grantor as beneficial owner of entity income.

[695] Australian case law accepts that there may be such a separation but rejects the proposition that it is inherent. If no beneficiary has an equitable estate in particular trust property, the trustees have the full legal and equitable estate: *Glenn* v *Commissioner of Land Tax* (1915) 20 CLR 490; *CPT Custodian Pty Ltd* v *Commissioner of State Revenue* (2005) 224 CLR 98, 112.

OECD Comm Art 1 [28] supports the view that a widely held collective investment vehicle should be treated as the beneficial owner of its investment, notwithstanding that it may be structured as a trust, provided that the managers of the entity have discretionary power to manage its investment assets and that disqualifying circumstances are not present at the level of the entity. This sheds no light on the proper treatment of trusts generally.

[696] The earliest example dates from 1966: New Zealand–UK 1966 Art VI (3), (4) (dividends), Art VII (1), (2) (royalties); a new dividends article was substituted in 1980 without this provision (see New Zealand–UK Protocol 1980). Given this provenance, the New Zealand policy may be seen as a trust-specific descendant of the earlier UK practice of imposing a subject-to-tax requirement (see Richard J Vann, 'Beneficial Ownership:

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The precise terms vary between treaties.[697] Most of New Zealand's treaty partners have agreed to such clauses, but not the United States or the United Kingdom.[698] The clause is at odds with the US interpretive approach of using source-country attribution to determine beneficial ownership.[699]

Beneficiary: A beneficiary is at risk if the source country applies a more stringent view of beneficial ownership than the principles of fiscal attribution in the beneficiary's residence country. This is particularly an issue for discretionary beneficiaries. If the source country applies its own attribution rules as a measure of beneficiary attribution and those rules either require a priori entitlement or use allocative principles as between participants that differ from those of the residence country, beneficial ownership of particular income may be denied or cut down. A beneficiary is also at risk if the source country determines beneficial ownership by its own attribution rules and attributes the subject income to a grantor in another country.

Grantor: A source country that does not itself attribute the income in question to a foreign grantor may have difficulty in accepting the grantor as the beneficial owner at a technical as well as an intuitive level. This will be so if it applies an attributes-of-ownership approach or if it consults its own attribution rules. The justification for recognizing the grantor as

What Does History (and Maybe Policy) Tell Us?' in Michael Lang et al. (eds), *Beneficial Ownership: Recent Trends* (IBFD, 2013) 267; John F Avery Jones, 'The Beneficial Ownership Concept Was Never Necessary in the Model' in Michael Lang et al. (eds), *Beneficial Ownership: Recent Trends* (IBFD, 2013) 333). The rule moved to its usual modern place in the definitional article in Australia–New Zealand 1972 Art 3(2).

697 A typical modern version is Australia–New Zealand 2009 Art 3(4): 'For the purposes of Articles 10, 11 and 12, dividends, interest or royalties arising in a Contracting State and derived by or through a trust shall be deemed to be beneficially owned by a resident of the other Contracting State where such income is subject to tax in that other State in the hands of a trustee of that trust.' Some later treaties extend the rule to dividends that would be subject to tax but for exemption (e.g., Canada–New Zealand 2012 Protocol re Arts 10, 11, 12).

In some treaties the clause only applies to income subject to tax in New Zealand, reflecting that country's concern to ensure that functionally resident trusts are not deprived of treaty benefits if they invest abroad.

698 The clause is absent from New Zealand–UK 1983.

699 See Department of the Treasury, *Technical Explanation of the Protocol Between the United States of America and New Zealand Signed at Washington on December 1, 2008 Amending the Convention and Protocol Between the United States of America and New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Signed at Wellington on July 23, 1982* re Protocol Art VI, reflecting *US Model: Technical Explanation* (2006).

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beneficial owner is similar to the justification for recognizing grantor attribution under the transparent entity clause. The grantor has voluntarily capitalized the trust, and the grantor's residence country regards this as sufficient to attribute resulting trust income to the grantor for its own tax purposes. But a source country may be reluctant on grounds of reciprocity to consider grantor attribution if the residence country also insists that its grantor taxation rules are unaffected by the treaty.

Given the absence of a clear international meaning of beneficial ownership, it is preferable for countries to deal with the subject expressly in bilateral treaties if they can reach agreement between themselves. The New Zealand approach may usefully be extended beyond its presently limited context by adopting an interpretive provision that recognizes residence-country attribution under the transparent entity clause as beneficial ownership, subject if necessary to the exclusion of agency, etc, cases:

> For the purposes of Articles 10, 11 and 12, income that is considered to be income of a resident of a Contracting State under paragraph 2 of Article 1 shall be considered to be beneficially owned by a resident of that State to the extent that it is liable to taxation as such income in that State [and is not derived as agent or nominee for a non-resident].[700]

8.3.12 Corporate Participation Dividends

This section considers the capacity of dividends paid on shares held in trust to qualify for special intercorporate treatment where the trustee or a participant in the trust is a company.[701] In order to ameliorate the economic double taxation that would otherwise be caused by cascading of tax on intercorporate dividends in addition to taxes imposed on primary corporate income and on dividends paid to ultimate individual shareholders, tax treaties typically set a lower or zero rate for corporate participation dividends. The OECD Model provides a lower rate limit for source taxation 'if the beneficial owner [of the dividend] is a company which holds directly at least 25 per cent of the capital of the company

[700] Wording proposed in Brabazon, *Treaties & Transparent Entities,* n 474, §4.4.5. The term 'liable to tax' rather than 'subject to tax' preserves the interests of tax-exempt organizations. The last 11 words may be omitted if it is thought that the preceding words cover the same ground.

[701] See also ibid, §4.5.

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paying the dividends'.[702] Other formulations typically use some variation of an ownership or holding threshold, with or without a requirement of directness.

Where a trust with a corporate trustee is interposed as shareholder, it should be relatively clear that the corporate status of the trustee is irrelevant. Unless the trust is itself corporate-taxed in its residence country and, therefore, outside that country's trust tax rules, the remaining issues are whether ownership can be traced through the trust as a transparent entity to a corporate beneficiary or (somewhat less probably) a corporate grantor.

In contrast to the beneficial ownership condition which applies to the dividend, the ownership condition applies to the capital asset that produces the dividend. That issue is outside the scope of the transparent entity clause and will ordinarily be determined from the perspective of the source country as the country applying the treaty. On any view, the capital holding/ownership requirement cannot be satisfied by a beneficiary who has no interest in trust capital or whose interest is discretionary, contingent or defeasible.

The principal questions for a corporate beneficiary are whether an indefeasibly vested interest in trust capital can satisfy the ownership or holding requirement and, under the clause in the OECD Model, the directness requirement. There is some diversity of opinion, including contradictory official Australian positions stating variously that the 'holds directly' test requires nothing less than legal registration of the shareholding company as a shareholder,[703] that the 'holds directly' test can be satisfied through a nominee,[704] and that an ownership requirement in a zero-rate clause without those words can be traced through a trust.[705] At least one of these positions must be wrong or overstated. The official US view has generally facilitated tracing of ownership through a

[702] OECD Model Art 10(2)(a). The 2017 Update removed the qualification '(other than a partnership)' which had previously applied to 'a company'.

[703] ATO ID 2011/14 *Income Tax: Dividend withholding tax: dividend paid by an Australian resident company to a New Zealand Limited Partnership*, relying on *FCT* v *Linter Textiles Australia Ltd (in liq)* (2005) 220 CLR 592, 604 to equate holding with legal ownership. The decision concludes that, in order to 'hold directly' in terms of Australia–New Zealand 2009 Art 10(2)(a), a company 'must be the legal owner of the shares with no intervening agency or interposed entity between [itself] and the shares'.

[704] TD 2014/13, Income tax: the application of Article 10.2(a) of the United Kingdom Convention.

[705] ATO ID 2004/863 *Income tax: Assessability of Australian dividend income received by a UK resident company – beneficial ownership of shares – 80% test.*

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transparent entity, though the explanation has not always been compelling. Successive versions of the US Model variously required direct or indirect ownership (1977), ownership (1981) or direct ownership (1996, 2006, 2016) of the relevant capital.[706] The 2006 Technical Explanation downplayed the directness requirement and concluded that ownership could be traced through a transparent entity.[707]

The 2016 US Model addresses the interaction between that test and the transparent entity clause by stipulating that, for the purpose at hand,

> a company that is a resident of a Contracting State shall be considered to own directly the shares owned by an entity that:
>
> A) is considered fiscally transparent under the laws of that Contracting State; and
> B) is not a resident of the other Contracting State of which the company paying the dividends is a resident;
>
> in proportion to the company's ownership interest in that entity . . .[708]

The connecting concept of an 'ownership interest in [the interposed transparent] entity' is not defined, although concepts of ownership and interest also occur at a number of points in the limitation on benefits article.

A different solution is adopted in Australia's recent post-BEPS treaty with Germany, which addresses the interaction between the transparent entity clause and the dividends article in its final Protocol:

> With reference to paragraph 2 of Article 1 and Article 10
>
> It is understood that where dividends derived by or through a fiscally transparent entity or arrangement are treated, for the purposes of taxation

[706] 2016 US Model Art 10(2)(a). The 2016 Model refers to 10% ownership of 'vote and value of the shares' where previous versions referred to 'voting stock'.

[707] *US Model: Technical Explanation* (2006) Art 10(2) (pp 33–34). The Technical Explanation took the view in relation to source taxation that direct ownership, being undefined, was determined under the domestic law of the country applying the treaty – i.e., the source country. It was necessary that the person deriving the income (identified under the transparent entity clause by reference to residence-country law) and the beneficial owner of the dividend (identified under the beneficial ownership requirement which, in the US view, referred to source-country law) should both be resident in the residence country, although they need not be the same person. This was at odds with the terms of the treaty in both US and OECD forms, which required the qualifying company to *be* the beneficial owner. The discussion also slid over the possibility that ownership of capital might not match ownership of dividends by observing that the interposed entity could be made transparent under US check-the-box regulations.

[708] *US Model* (2016) Art 10(2)(a)(ii).

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> by a Contracting State, as the income, profits or gains of a resident of that State, Article 10 shall apply as if that resident had derived the dividends directly.[709]

The Australian understanding of this appears to be, in summary, that the interposition of a third-country transparent entity in corporate form does not entitle a non-corporate beneficial owner to a lower treaty rate by reference to the corporate status of the interposed entity[710] and that the interposition of the entity is disregarded for the purpose of the 'holds directly' requirement.[711] To disregard the entity implies that a corporate beneficiary, if entitled in equity to dividend-bearing shares through a fixed interest in a trust, qualifies as holding those shares directly for treaty purposes. To disregard the entity in this way precludes an objection based on the fact that the beneficiary is not registered as the shareholder[712] but does not imply that the recipient beneficiary 'holds' or owns the shares that generate the dividend:[713] as discussed earlier, the interest of a discretionary beneficiary still does not qualify.

As a matter of policy, it is difficult to see why an interest in shares by way of fixed capital entitlement through a transparent entity, including a trust, should not qualify as both a holding and a direct holding. The Protocol quoted earlier in the treaty between Australia and Germany appears to provide a workable solution to remaining problems.

Similar recognition of a corporate grantor is not impossible[714] but is limited by the fact that ownership and direct holding are determined from the perspective of the source country.

[709] Australia–Germany 2015 Protocol (3).

[710] The view that the corporate status of an intermediary that is transparent in its own country does not attract the lower rate is not limited to the treaty with Germany: see ATO, Private Binding Ruling 1012320848597. Contrast earlier German case law by which a US-transparent S corporation in receipt of German dividends succeeded in obtaining a lower treaty rate due to its corporate status despite all its shareholders being individuals (*Re US S Corporation's German Withholding Tax Status* I R 48/12; (2013) 16 ITLR 428) – but the treaty in that case did not include wording equivalent to the Protocol quoted earlier, particularly the reference to 'that resident'.

[711] See Explanatory Memorandum, International Tax Agreements Amendment Bill 2016 (Cth) [1.46]–[1.48], [1.211].

[712] As in ATO ID 2011/14 (n 703): there would be no point in recognizing directness of derivation, as the Protocol requires, if the interposition of the entity as legal shareholder prevented the recognition of a beneficial holding by the participant.

[713] See Explanatory Memorandum, International Tax Agreements Amendment Bill 2016 (Cth) [1.47], [1.211].

[714] US grantor attribution imputes ownership of the trust – i.e., the property of the trust – in whole or part to the grantor.

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8.3.13 *Treaty Relief in Residence Countries*

Previous sections of this chapter have considered the scope and operation of the transparent entity clause and its interaction with distributive treaty articles. This section proceeds to consider how trust income that falls within those other provisions is treated in a residence country under a double tax relief article.[715]

The impact of the OECD Model on residence-country taxation is limited by the saving clause, which precludes relief under most provisions of the distributive articles (Section 8.3.5),[716] and by the parenthetical qualification of the double tax relief article, which excludes relief based on taxation or taxing rights in the other contracting state that would accord with the treaty 'solely because the income is also derived by a resident of that State'.[717] Both measures were added by the 2017 Update, although it is arguable that similar principles already applied by implication.[718]

The double tax relief article requires identity of relevant income in both countries, but does not in terms require identity of taxpayer. Whatever may be the case in situations where a transparent entity clause does not apply,[719] it is clear that that clause contemplates the possibility

[715] The issues in this section are considered at greater length in Brabazon, *Treaties & Transparent Entities*, n 474, §4.6 regarding conflicts involving a residence country and a source or source+residence country and §4.7 regarding conflicts involving two residence countries.

[716] The few distributive provisions which are expressly excluded from the effect of OECD Model Art 1(3) are positively designed to apply to residence-country taxation.

[717] OECD Model Art 23A(1), (3), 23B(1) (2017 Update); cf Table 8.1 and n 475. MLI Art 3 (2) is to similar effect with respect to the effect of a transparent entity clause added by Art 3(1). Countries that accept Art 3(1) may reserve against Art 3(2), and a small number (including the United Kingdom) are expected to do so. Presumably those countries intend, in the interpretation of existing bilateral treaties that receive a transparent entity clause under the MLI, to rely on pre-2017 principles (see n 718) to refuse double tax relief in respect of residence taxation in the other country.

[718] For the previous position under the double tax relief article, at least as recognized in the United Kingdom, see *Bayfine UK Ltd* v *HMRC* [2011] STC 717; (2011) 13 ITLR 747. That case and relevant background to the 2017 Update are considered further in Brabazon, *Treaties & Transparent Entities*, n 474, §4.6.1.

[719] The New Zealand Court of Appeal in *Lin* v *CIR* (2018) 20 ITLR 602 reasoned in part that the OECD Model double tax relief article was only concerned with juridical double taxation, that this required double taxation of the same taxpayer, and that it therefore did not address the case of a New Zealand shareholder claiming credit by reference to Chinese tax imposed on or (by reference to a tax-sparing provision) spared to a Chinese CFC. Several aspects of the case have been criticized with some force: see the ITLR editorial note and Brian J Arnold, 'The Relationship between Controlled Foreign

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of different taxpayers. The OECD Commentary on the double tax relief article also now responds to that situation.[720] Where the transparent entity clause applies to particular trust income, the present position is that

- a trust country as residence country may be required to give relief where the source country taxes or (where the exemption method applies) may tax a beneficiary or grantor on that income;
- a beneficiary's country as residence country may be required to give relief where the source country taxes or may tax the trust or a grantor on that income; and
- a grantor's country as residence country may be required to give relief where the source country taxes or may tax the trust or a beneficiary on that income.

Some of these permutations are more or less probable than others.[721]

Particularly where residence taxation by the grantor's country is concerned, it is necessary to consider whether the applicable grantor regime is amenable to the treaty and to the transparent entity clause and whether identity of income is established. UK treaty practice finesses this point somewhat by allowing treaty-based foreign tax credit where tax in both countries is computed by reference to the same income.[722] Under this approach, even if national law indirectly attributes trust income to a grantor in terms that would deny the identity of grantor-attributed income with that trust income, the grantor has access to benefits under the double tax relief article. This is so, notwithstanding that the relevant

Corporation Rules and Tax Sparing Provisions in Tax Treaties: A New Zealand Case' (2018) 72 *Bulletin for International Taxation* 430. For present purposes, it is sufficient to recognize that the treaty in *Lin* did not contain a transparent entity clause and long predated OECD Commentary recognizing the application of the double tax relief article in two-taxpayer cases (see n 720). The case was also outside the scope of the Partnership Report.

[720] OECD Comm Art 23 [9] – [11.2] (most of which dates from the 2017 Update); see also Brabazon, *Treaties & Transparent Entities,* n 474, §4.6.2.

[721] Source-country grantor taxation may be relatively uncommon, but it can occur in the United Kingdom (ITTOIA s 648(2)) and the United States (IRC s 672(f)(2)). See Section 2.4.

[722] See e.g. Australia–UK 2003 Art 22(2)(a); New Zealand–UK 1983 Art 22(1), (2); UK–US 2001 Art 24(4)(a) (n 148). The 'computed by' formulation only applies to UK double tax relief in the treaties with Australia and the United States, but applies bilaterally in the treaty with New Zealand.

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trust income may be ineligible for relief under the distributive articles by reference to the grantor.

Subject to these qualifications, the double tax relief article generally avoids double taxation of trust income as between a source country and a residence country, notwithstanding a source-residence attribution conflict, no less effectively than if the residence country's taxpayer had invested and been taxable directly in the other country.

The preceding account of residence-country double tax relief is premised on one of the contracting states having treaty rights of source taxation. The OECD Model gives no relief from double taxation of different taxpayers each in their own residence country if neither has source-taxing rights. This is explicit in the 2017 parenthetical amendment to the double tax relief article. The policy of that article as clarified by the amendment is to deliver residence-country relief commensurate with the other country's treaty-based right of source taxation. Thus, a treaty between the residence countries of a trust and a beneficiary provides no relief where both countries attribute and tax the same income, sourced exclusively in a third country, to their own resident. The same holds true as between residence countries of trust and grantor, and of beneficiary and grantor.

If one of two residence-taxing countries also has source taxing rights under a treaty between them, double taxation is relieved by the other country only to an extent commensurate with those source taxing rights. Thus, in the case of non-PE interest income, the residence country is required to give credit for tax in the source+residence country up to the applicable treaty rate for interest; but in the case of income attributable to a PE in the source+residence country,[723] the residence country is required to give full credit or exemption.[724] The OECD Model relieves against double taxation only in respect of the source-residence part of a compound attribution conflict involving a source+residence country and a residence country.

Residence–residence attribution conflicts are unfinished business for tax treaties.[725] They are not confined to trusts, but trusts are particularly

[723] Assuming that the treaty permits source taxation by reference to the PE; see Section 8.3.10.

[724] The application of these principles in more complex situations where each residence country also has source taxing rights is considered in OECD Comm Art 23 [9]–[11.2] and Brabazon, *Treaties & Transparent Entities,* n 474, §4.6.2.

[725] Danon, *Qualification of Entities*, n 12, 198–199.

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susceptible to them because of the multiplicity of participants and the diversity of tax regimes that apply to their income. A small number of treaties seek to address such conflicts.[726] Some of these engage directly with a transparent entity clause, while others address a particular class of entity or income with which they are concerned.

- The UK–US Treaty 2001 includes a modified double tax relief article which applies in conjunction with a transparent entity clause and the saving clause where each country claims to tax its own resident.[727] It prioritizes such taxing claims in order: first, the claim of a source (situs) country to tax its resident on real property income or corresponding capital gains; secondly, the claim of the entity's residence country; and, thirdly, where the residents are a grantor and a beneficiary in a trust, the claim of the beneficiary's country. Priority is effected by requiring the other country to allow foreign tax credit to its resident.
- The Australia–New Zealand Treaty 2009 includes a special double tax relief clause that applies in conjunction with a transparent entity clause: where one country taxes a resident entity and the other taxes a resident participant on the same income, the participant's country gives credit for residence taxation of the entity, regardless of the source of the income.[728]
- The Australia–Germany Treaty 2015 requires the competent authorities to consult 'to find an appropriate solution' if parallel residence taxation of an entity and a participant in accordance with the transparent entity clause results in double taxation.[729] This indicates that such double taxation is not intended and positively directs the competent authorities to try to achieve a solution. Being mandatory, it goes further than the standard mutual agreement article.[730]

[726] See also Wheeler, *Missing Keystone*, n 39, §2.4.4.
[727] UK–US 2001 Exchange of Notes re Art 24.
[728] Australia–New Zealand 2009 Art 23(3); cf Explanatory Memorandum, International Tax Agreements Amendment Bill (No 2) 2009 (Cth) [2.318]–[2.322]. The treaty does not include a saving clause, but the negotiators recorded their agreed understanding that a saving clause principle applies to the transparent entity clause (Art 1(2)): Explanatory Memorandum at [2.25].
[729] Australia–Germany 2015 Protocol (2); cf Nikolakakis et al., n 549, BTR 350.
[730] Art 25(3) of both the OECD Model and Australia–Germany 2015 provides that the competent authorities 'shall' endeavour to resolve difficulties or doubts concerning the interpretation or application of the treaty and 'may' consult for the elimination of double taxation in cases not provided for by the treaty. The Protocol does not, however, go so far as to allow a taxpayer to initiate the mutual agreement process under Art 25(1).

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- Certain UK treaties elevate the priority of beneficiary taxation by modifying the usual other income article so as to treat trust or estate income 'paid to' a beneficiary resident in the other country as if it were derived by the beneficiary.[731]
- The Nordic Convention resolves priority between residence taxation of a deceased estate and of a beneficiary by giving priority to entity taxation.[732]
- Some treaties contain what has been described as a 'reverse saving clause', the broad effect of which is to limit a hybrid company's residence-country taxation to that which could have been levied on a source basis under the treaty, to give its participants credit for that tax in their home country and to exempt corresponding distributions from separate taxation.[733] This prioritizes the taxing claim of the participants' country over the non-source taxing claim of the entity's country.

A small number of other cases may also be found in which residence–residence double taxation is resolved by ranking of double tax relief.[734]

Most of the treaties mentioned above address attribution conflicts between residence taxation of a transparent entity and residence taxation of a participant in the entity (such as between residence taxation of a

[731] Hong Kong–UK 2010 Art 20(2); Norway–UK 2013 Art 20(2). Attribution of the distributed trust/estate income includes the attribution of taxes paid by the entity. UK treaties traditionally excluded income paid out of trusts and estates from the other income article, which would otherwise have precluded source taxation of such distributions (e.g., UK–US 2001 Exchange of Notes re Art 22(1)). Longstanding UK administrative practice had been to apply transparency in accordance with the concession set out in ESC B18; the cited provisions appear to be a replacement of the administrative practice (with thanks to John Avery Jones for this explanation).

[732] Nordic Convention 1996 Art 24. The beneficiary cannot be taxed on income that has been taxed to the estate.

[733] See Nikolakakis et al., n 549, BTR 347, 353–354; Belgium–Netherlands 2001 Protocol (2), (4)(b). In the example cited, the clause operates in proportion to the entitlement of relevant participants (being liable to tax in their own country, which sees the company as transparent) to the capital of the company.

[734] Because the United States taxes citizens as well as residents on worldwide income, double tax relief is given in a form that, broadly speaking, ranks residence taxation ahead of citizenship taxation: see, e.g., Australia–US 1982 Art 22(1)(a), (2), (4). The OECD report on employee stock options suggests that ranking of tax claims as if under a double tax relief article may be an appropriate way to relieve double taxation under the mutual agreement procedure where the same income is treated as arising to the same employee at different times by different countries, one before and the other after a change of residence.

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trust and of a beneficiary); one, the UK–US Treaty 2001, also addresses residence–residence conflicts as between grantor and beneficiary.

The double tax relief article provides the most promising location for a provision dealing with residence–residence double taxation, particularly if one is concerned with hybrid or transparent entities as such. In that context, it is appropriate to begin by framing a solution by reference to the entity and its participants rather than a trust and its beneficiaries or grantors. In relation to entity-participant double taxation, two general strategies warrant consideration: exemption in the entity country (which implies priority for the taxing claim of the participant's country) and credit in the participant's country (which implies priority for the taxing claim of the entity's country).[735] The choice of strategy will reflect an evaluation of competing concerns of fiscal policy and practicability. If grantor attribution by either country is taken into account as fiscal transparency, a second point of double tax relief should be considered as between participants of different kinds – beneficiary and grantor. At both levels, the transparent entity clause provides an expedient frame of reference for residence–residence double tax relief.[736]

Two possible clauses have been suggested[737] and are reproduced following this paragraph. Each is drafted on the assumption that it will be inserted into a double tax relief article based on the OECD Model. The first version is based on participant-country credit, reflecting the general logic of the UK–US and Australia–New Zealand clauses. The second is based on entity-country exemption, reflecting the general logic of a reverse saving clause.[738] The second subclause in each version is only relevant if one of the countries applies a form of grantor taxation that is intended to interact with the fiscal transparency clause.[739] No attempt is

[735] Exemption in the participant's country and credit in the entity's country are theoretical possibilities, but they would be unacceptable on policy or practical grounds.

[736] This is the approach in Australia–New Zealand 2009 Art 23(3) and UK–US 2001 Exchange of Notes re Art 24.

[737] Brabazon, *Treaties & Transparent Entities*, n 474, §4.7.

[738] An exemption of matching distributions has been included in the second version to reflect the approach in the Belgium–Netherlands provisions mentioned earlier (n 733) and would require some form of tracing. There may be a risk of exploitation of an exemption-based clause if the fiscal relationship between the participant and his or her residence country is tenuous or contrived. A limitation on benefits rule and/or a principal purpose test would probably provide sufficient protection. Otherwise, if countries are concerned about abuse, a subject to tax requirement could be added.

[739] References to the [grantor] would be replaced by terminology appropriate to the countries concerned. The reference to [grantor/beneficiary] would be resolved according

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made to resolve attribution conflicts as between residents of the same character, such as where each country attributes the same trust income to its own resident beneficiary.

Residence–Residence Double Tax Relief Clause – First Version	Residence–Residence Double Tax Relief Clause – Second Version
To the extent that paragraph 2 of Article 1 applies to an item of income and to the extent that each Contracting State may tax the same income in accordance with the provisions of this Convention solely because it is derived by a resident of such State, (a) where one Contracting State so taxes the entity or arrangement referred to in that paragraph as its resident, the other such State shall allow as a deduction from the tax on the income of its resident an amount equal to the income tax paid in the first-mentioned State, and (b) where those residents are a [grantor] taxable as such and a beneficiary of a trust, the Contracting State where the [grantor/beneficiary] is resident shall allow to its resident a deduction from the tax on such income in an amount equal to the tax paid in the other Contracting State. Such deduction shall not in either case, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such income.	To the extent that paragraph 2 of Article 1 applies to an item of income and to the extent that each Contracting State may tax the same income in accordance with the provisions of this Convention solely because it is derived by a resident of such State, (a) a Contracting State of which the entity or arrangement referred to in that paragraph is not a resident shall exempt such income [and distributions thereof] from tax, and (b) where those residents are a [grantor] taxable as such and a beneficiary of a trust, the Contracting State where the [grantor/beneficiary] is resident shall allow to its resident a deduction from the tax on such income in an amount equal to the tax paid in the other Contracting State, but not exceeding that part of the tax, as computed before the deduction is given, which is attributable to such income.

to the choice of taxing priority. Priority for beneficiary taxation (as under the UK–US clause, n 727) implies tax relief in the grantor's country; priority for grantor taxation implies relief in the beneficiary's country.

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8.4 Distributions

This section considers how treaties affect the taxation of trust distributions as distinct from currently attributed trust income.[740] The only relevant treaty is between the trust residence country, which in this context becomes a source country,[741] and a beneficiary residence country. Trust distributions attract a range of tax treatments under domestic tax laws of trust- and beneficiary-residence countries (Chapter 5). If the trust falls within a tax system's general trust rules, a particular distribution may be seen as income or non-income (such as a distribution of capital, a gift, or a mere delivery of attributed entity-level income), or as a mixture of both.

Section 8.4.1 considers the issue from the perspective of the trust residence country, Section 8.4.2 from the perspective of the beneficiary's country, and Section 8.4.3 with reference to the combined effect of treaty relief. Section 8.4.4 addresses the effect on tax treaties of post-treaty relief in a trust country on the occasion of a distribution.

8.4.1 Source Taxation

Which distributive rule governs source taxation of a trust distribution depends on how the source country classifies the distribution as income of the beneficiary.

If the source country recognizes the entity as a trust for tax purposes and is applying the trust rules of its tax system, the distribution is likely not to fall into any of the specific treaty classifications. The character of underlying trust income should not be material to taxation of income *from* the trust. Dividend characterization requires corporate tax treatment of the entity. It is conceivable that a trust distribution may have business income character in some rather specific cases. The most likely outcome, however, is that source taxation of the distribution will be governed by the other income article of an applicable treaty.

Under the OECD Model, application of the other income article results in source-country exemption unless the income is effectively connected with a PE of the recipient in the source country,[742] although

[740] See Brabazon, *Treaties & Transparent Entities*, n 474, §5.

[741] The theoretical possibility that a country may claim source taxing rights without claiming the trust as its residence is discounted.

[742] OECD Model Art 21. (It is assumed that a trust distribution will not qualify as income from immovable property.)

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the UN Model[743] and many actual treaties preserve the right to source taxation of other income. An alternative approach favoured by Canada allows source taxation but limits the rate in the case of income from a trust resident in the taxing country.[744]

Business income attracts source-country exemption unless it is effectively connected with a source-country PE of the recipient. The possibility that a beneficiary may have a relevant PE in the source country may be discounted in the case of a donative trust,[745] and it would require quite specialized circumstances in the case of any other trust.

Countries that prefer a single-layer approach to trust taxation generally do not tax distributions, except as an integrity measure for distributions to residents from non-resident or formerly non-resident trusts. Of the surveyed countries, only the United Kingdom makes a serious claim to tax trust distributions to non-residents.[746] In certain circumstances mainly affecting DIR and foreign-sourced trust income, it also gives up that claim by an extra-statutory concession, the broad effect of which is to switch to a transparent paradigm.[747]

Some treaties, particularly of the United Kingdom, recharacterize distributions from a trust or deceased estate for tax purposes to reflect the character of underlying entity-level income.[748] The broad effect is

[743] UN Model Art 21(3).

[744] See, e.g., Australia–Canada 1980 Art 21(3), applicable to Canadian resident trusts. Canada taxes distributions from resident trusts to non-resident beneficiaries at a flat rate of 25% (*Income Tax Act 1985* (Can) s 212(1)(c), (11)). The treaty reduces the rate to 15%.

[745] Whether a beneficiary has a PE in the trust country to which income *from* the trust is attributable has nothing to do with whether a trust PE in that or any other country is attributed to a beneficiary for the purpose of allocating taxing rights over income derived *through* the trust.

[746] Canada also taxes distributions to non-resident beneficiaries (n 744). New Zealand nominally claims to tax distributions from non-complying trusts to non-residents by failing to apply its usual jurisdictional restrictions to the distribution-taxing provisions. Taxable distributions from a non-complying trust attract special taxation under ITA NZ s BF 1(b) and are treated as excluded income under ss HC 19 and CX 59; foreign-sourced non-residents' income is excluded from assessable income under s BD 1(5), but this is irrelevant because, as excluded income, they are already excluded from assessable income and are taxed without reference to that concept. Distributions from a foreign trust raise a different set of problems if they are traceable to New Zealand-sourced trust income. There is however no evident policy or appetite to collect tax on trust distributions of either kind to non-resident beneficiaries.

[747] See Section 5.3.2 and 5.3.4.

[748] See, e.g., the treaties with Hong Kong and Norway mentioned in n 731 and UK–US 2001, Exchange of Notes re Art 22(1).

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that, for treaty purposes, a transparent paradigm is applied and the distribution is recognized as representing underlying entity-level income. The issue of delay between entity-level derivation of the income and distribution is not addressed; it seems to be assumed that any such delay will be short and that tax deferral will be insignificant.

8.4.2 *Residence Taxation*

The survey of tax systems in this book suggests that a beneficiary's country may perceive and tax a distribution from a trust resident in another country on two main bases:

- Whether the particular distribution is intrinsically income. This is the UK position with respect to annuities and a wide range of discretionary distributions by reference to their character in the hands of the beneficiary.
- Whether the particular distribution is not shown to represent trust capital (excluding capital appreciation) or income otherwise sufficiently taxed in that country. Broadly speaking, this is the position in Australia, the United States and New Zealand.

The position in countries other than those surveyed is likely to be quite varied.[749]

If the beneficiary's country taxes a distribution, a conventional double tax relief article requires credit for any trust-country taxation under the other income article (if permitted by the treaty) or under the dividend article (if the source country regards the particular trust as a corporate-taxed entity). The only other treaty taxing rights of the trust country require the beneficiary to have a relevant PE there, in which case relief follows the general exemption/credit setting in the double tax relief article. There is no treaty relief for tax on underlying trust income.

8.4.3 *Effect of Treaty Relief*

The combined effect of treaty relief is summarized in the following paragraphs.

A beneficiary is only likely to have a separate PE in the trust country as part of an integrated international business structure in which the trust

[749] See Avery Jones et al., *Treatment of Trusts I*, n 8, 93–96.

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serves as an investment, business or holding entity – a rather specialized situation. The previous analysis does not suggest that the treaty provisions affecting distribution taxation will promote double taxation or non-taxation.

In the more usual case, the question relating to double taxation or double non-taxation resolves to (1) treaty-permitted or treaty-limited trust distribution taxation, if such tax is imposed in the trust country and permitted on a general or limited basis by the other income article of the treaty, (2) treaty-limited dividend taxation (possible if the trust is corporate-taxed in the trust country), and (3) distribution taxation in the beneficiary's country, if imposed, subject to double tax relief, limited to distribution taxation. The transparent entity clause will not apply because the income is not derived by or through the entity. It would be otherwise, of course, if the beneficiary were itself a transparent entity. The whole process would have to be repeated with respect to income from the trust in its capacity as income derived by or through the beneficiary entity. The relevant treaties would involve the trust country as source country and the residence countries of the beneficiary entity and its participants.

At least in a trust situation, it will be seen that any distribution exemption of the kind contemplated by the reverse saving clause discussed earlier[750] is limited to the removal of withholding tax. A separate normative question is whether tax treaties should require residence-country relief for underlying trust-level taxation. There is great diversity between the surveyed countries in their unilateral approaches to that question. A mechanism for relief would also require agreement on a tracing rule to match previously taxed trust income with distributions.[751] In some countries, distribution taxing rules have a distinct anti-avoidance flavour. And ensuring double tax relief for non-current cross-border trust distributions is unlikely to become a subject of high international priority. These factors suggest that it would be pointless to contemplate international agreement on the issue, except perhaps on a bilateral basis between countries with close economic relations where at least one of those countries has a sophisticated system of trust taxation.

[750] Section 8.3.13, n 733, cf n 738.

[751] Some countries have such mechanisms in their domestic rules for measuring the taxability of a distribution.

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8.4.4 Post-Treaty Relief

Distribution from a trust may serve not only as a taxing point in the trust country, but also as a point at which that country gives tax relief under its national law. If a distribution is associated with trust-attributed income that previously attracted treaty benefits in a source country because it was treated as the income of a resident of the trust country, and if the effect of subsequent non-treaty relief is to pass that benefit on to a beneficiary who would not have qualified for similar relief – most obviously, a beneficiary resident in a country that has no tax treaty or a less favourable treaty with the original source country – source taxation is pro tanto avoided, compared to a case of direct investment by the beneficiary. A degree of global non-taxation may result if the beneficiary is untaxed or only lightly taxed in his, her or its residence country.

It may be thought that the situation just described is improbable, but it is illustrated by two examples from the surveyed countries. In Australia, as a counterpart to taxation of resident beneficiaries on (non-resident) trust distributions, tax paid by a trust on trust-attributed income that is subsequently traced into a distribution to a beneficiary who was non-resident when the income was derived is refundable to the beneficiary.[752] In the United Kingdom, one aspect of the extra-statutory concession relating to trust distributions is that, where a payment to a non-resident beneficiary is recognized as being made out of trust income that would not have been chargeable to the beneficiary because of the latter's residence status, the beneficiary may claim a refund of tax that is treated as deducted from the payment – i.e., tax paid by the trust at the UK trust rate.[753] Each of these measures has the effect of converting what appears to be final entity or proxy taxation of trust income retroactively into non-final withholding for the subsequently-identified beneficiary who, being non-resident, attracts conduit treatment and a refund of tax. Meanwhile, if the trust was able to claim exemption or tax limitation in the original source country under a treaty with its residence country, that benefit remains intact.

The risk of arbitrage was evidently perceived during the negotiation of the Australia–New Zealand Treaty 2009. The Treaty contained a provision deeming DIR income to be beneficially owned by a trust if it is

[752] ITAA 1936 s 99D (see n 312).
[753] ESC B18 (see Sections 5.3.2 and 5.3.4).

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subject to tax in the contracting state where the trust is resident.[754] In the course of negotiations, the two delegations noted a shared understanding that 'a trustee is not regarded as being subject to tax to the extent that the trustee pays tax that is subsequently refunded to a non-resident beneficiary'.[755] That understanding was not, however, formalized in the text of the treaty or an exchange of notes, nor does it affect income of other kinds, such as that which may have benefited from exemption under the business profits article of an Australian treaty with an ultimate source country.

Global non-taxation is averted if the beneficiary is subject to sufficient residence taxation on the distribution to eliminate the value of source-country treaty benefits. The greatest risk of arbitrage consequently arises where an individual or entity as beneficiary is subject to little or no effective residence taxation.

The issue of unintended non-taxation may be addressed in the terms of tax treaties (necessarily, the treaties between the trust residence country and countries that might be the ultimate source of trust-attributed income) or the design of unilateral relief rules in the trust country. The trust country is best placed to respond. It may do so by qualifying its relief to exclude any amount of tax foregone by a source country pursuant to a treaty with that country. Alternatively, the terms of tax treaties may be modified to deny treaty benefits. This has the virtue of securing the tax base of the source country. The preferable method is to deny recognition of the subject income as that of a resident of a contracting state if tax on that income is subsequently refunded. Income of a treaty resident is a more useful concept than beneficial ownership because it is fundamental to all treaty benefits.

Both solutions present real challenges in relation to information and reporting, whether in the trust country or the source country. The treaty-based solution has the added difficulty that it relies on retroactive recharacterization – the tax accounts and assessment of the trust may have been finalized before the distribution and related relief.

8.5 Summary

This chapter has reviewed how tax treaties modify the international taxation of income derived by, through or from trusts. Its main findings

[754] Australia–New Zealand 2009 Art 3(4) (n 697).

[755] Explanatory Memorandum, International Tax Agreements Amendment Bill (No 2) 2009 (Cth) [2.69]; cf [2.70] referring to ITAA 1936 s 99D.

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are identified in the paragraphs that follow, focusing particularly on consequences of double- or non-taxation.

Section 8.2 identified the possibility that anomalous treaty residence may be used as a basis to claim unwarranted treaty benefits. It proposed that potentially taxable entities including trusts should be recognized as persons for treaty purposes and that concepts of treaty residence should be aligned with tax liability for worldwide trust-attributed income in residence/source taxing countries.

Section 8.3 considered the current taxation of trust income. It identified the possibility of treaty benefits being inappropriately granted or denied unless the primary connection between relevant income and a treaty resident is determined by reference to the tax law of the residence country. This anomaly is avoided by adopting the transparent entity clause. The transparent entity clause is a concise and elegant solution, but some unresolved issues remain in the application of the clause and its interaction with the distributive and double tax relief articles of the OECD Model.

Sections 8.3.3 and 8.3.4 proposed a general interpretation of fiscal transparency and the operation of the transparent entity clause in a trust context. Sections 8.3.3.3, 8.3.7 and 8.3.8 identified conceptual and technical issues affecting the scope of the clause which can make it difficult to say with certainty whether a particular grantor attribution rule, particularly an explicitly outbound rule, is capable of supporting transparent entity classification and the application of the transparent entity clause to trust income on the basis of grantor attribution. For these reasons, where either party to a proposed treaty has a grantor regime, both countries should consider and address the issue in treaty negotiations. If a particular grantor rule is not amenable to the operation of a tax treaty via the transparent entity clause, any double tax relief will generally depend on unilateral rules in the countries concerned.

Section 8.3.10 identified the need to ensure consistency, for the purpose of allocating and quantifying treaty taxing rights, between the attribution of income and the attribution of a related trust PE and business structure. Failure to ensure consistency may result in over- or under-taxation relative to a comparable non-trust investment. A possible solution was proposed in the form of an amendment to the treaty definition of 'enterprise of a Contracting State'. Section 8.3.11 contended that the concept of beneficial ownership should be based primarily on residence-country fiscal attribution, consistently with the approach of the transparent entity clause, and proposed that the issue should be

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addressed in the text of treaties between contracting states if they are able to agree. Failing this, the capacity of a tax treaty to relieve against double taxation of DIR income may be impaired in a trust context. Section 8.3.12 contended that treaty provisions granting access to more favourable source-country treatment for corporate participation dividends should be interpreted in such a way as to recognize indefeasibly vested interests of corporate beneficiaries in shares held by a fiscally transparent trust, viewed from the perspective of the tax law of the source country. A similar approach may in some cases apply to a corporate grantor.

Section 8.3.13 considered the application in a residence country of the OECD Model double tax relief article in a trust context. The article operates as would be expected to relieve against double taxation due to a source–residence attribution conflict, but it does not relieve against residence–residence attribution conflicts. Solutions were then identified by which the double tax relief article could be modified to address entity-participant attribution conflicts and grantor-beneficiary attribution conflicts.

Finally, Section 8.4 considered juridical and economic double taxation arising respectively from double taxation of distributions and successive taxation of trust income and distributions by different countries. The former is generally relieved by treaty; the latter is not and depends on such relief as may be granted unilaterally. A risk of treaty shopping and international non-taxation was identified in circumstances where a trust country gives unilateral relief in respect of distributions to non-resident beneficiaries after the trust has obtained source-country treaty benefits in respect of earlier taxation of trust income, and solutions were proposed by reference to the national law of the trust country and/or the terms of its treaties.

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9

Conclusions and Proposals

Taxing the Shadow

This chapter collates the main findings of previous chapters by reference to the three principal aims outlined in Section 1.1. Section 9.1 addresses the first of those aims by summarizing the principles by which countries tax income derived by, through or from a trust in an international context where more than one country has a potential taxing claim, having regard to inferences drawn from functional comparison of the trust rules of the surveyed countries. Section 9.2 summarizes the main situations of double taxation or non-taxation that can arise from the interaction of national tax systems in treaty and non-treaty situations. It reflects consideration of the national laws and tax treaties of the surveyed countries together with broader analysis based on international tax scholarship, consideration of the OECD Model and the BEPS project. Section 9.3 postulates principles of tax and treaty design to avoid inappropriate double taxation or non-taxation. Section 9.4 concludes with an overview.

As was mentioned at the outset, the present work is conceived as foundational: it provides a basis for similar analysis to be extended and applied to jurisdictions not directly considered in this book, including those which do not recognize the trust in their general law.

9.1 Principles

The principles by which the surveyed countries tax income derived by, through or from a trust in an international context are grouped around four connecting factors: the source of trust income, the grantor, the beneficiary and the trust itself. It may reasonably be inferred that any country wishing to tax trust-related income will do so by reference to some or all of these factors. The surveyed countries' general, inbound and outbound settings for taxing trust income and distributions and their trust residence settings were previously summarized in Section 6.1. This section examines the connecting factors as taxing principles, drawing on the analysis in Part I.

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9.1.1 Source

The source principle reflects primary source taxing concepts which vary from country to country and among classes of income, including capital gains. It includes taxation by reference to a taxable presence in a host country, through which income may be derived in that country, or from another country of primary source. Operation of the source principle in relation to trust income is not specific to the trust form, although a country may recharacterize income as having local source if it is derived through a trust (as Canada does). The concept of source operates separately in relation to distributions as a species of income from a trust.

Instances have been found in the surveyed countries where the source principle fails to operate coherently in conjunction with beneficiary attribution. These include cases where a trust-level taxable presence is not given the same effect in relation to income attributed to a non-resident beneficiary as it would have in relation to a direct non-resident investor[756] and the anomalous Australian treatment of beneficiary-attributed capital gains.[757] Such instances are primarily an issue for the country concerned and the internal coherence of its international tax settings. They emphasize the technical importance of coordinating different areas of tax design: trust rules and general source or inbound rules.

9.1.2 Grantor

The grantor principle is distinctive of trust taxation. In an international context, it fundamentally entails a claim to tax trust income by reference to the fiscal residence of the grantor. It may also entail taxation at the grantor's marginal rate, although this is not essential.[758] The claim may be exerted by attributing trust income to the grantor, considered in Chapter 2, or by strategies involving a worldwide claim to tax the trust on trust-attributed income by reference to the grantor, considered in Chapters 2 and 4.[759] The surveyed countries apply the grantor principle to the taxation of current-year trust income. There is little practicable scope for the principle to apply otherwise, although a catch-up

[756] See Sections 3.2.4 and 3.2.6.

[757] See Section 3.2.5.

[758] New Zealand taxation of trust-attributed income by reference to the residence of the grantor applies that country's trust rate.

[759] *Australia*: ITAA 1936 s 102 (Section 2.3.3). *New Zealand*: Taxation of trust-attributed income under the settlor regime (Section 4.2.4).

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approach might be taken where a grantor returns after a period of non-residence.[760] With that qualification, it may be inferred that the grantor principle can only realistically apply to the taxation of current trust income.

9.1.2.1 Priority of Taxing Principles

A taxing claim by reference to a resident grantor necessarily supplants any different claim or immunity that would otherwise be associated with the attribution of income to the trust itself.[761]

Grantor attribution or other taxation by reference to the grantor may take priority before or after beneficiary attribution. In Australia, the United States and the United Kingdom, a grantor-related taxing claim that is part of the country's general domestic tax settings consistently ranks first and displaces beneficiary attribution. The priority accorded to specifically outbound rules is more diverse. In some regimes, the grantor rule prevails generally;[762] in others, beneficiary attribution precludes grantor-based taxation.[763]

9.1.2.2 Taxable Subject

Some grantor-based taxing claims take the approach of attributing and taxing trust income to the grantor and making no further adjustment.[764] Others tax the trust with reference to the grantor but impose no liability on the grantor.[765] Still others take an intermediate position, taxing the grantor with provision for indemnity and adjustment so that the legal burden of tax at the grantor's rate is ultimately visited on the trust or on a

[760] Compare ITA NZ s HC 23, applicable to a returning beneficiary.

[761] The mechanism varies. With simple grantor attribution, it is straightforward. Under ITAA 1936 s 102, the grantor's rate and residence are used in lieu of the trust's rate and residence. The New Zealand settlor regime goes a step further by taking the grantor's residence as its principal test of functional trust residence.

[762] For example, the US outbound rule in IRC s 679 takes the same priority as the general rules in ss 673–677.

[763] The New Zealand settlor regime, which is essentially outbound in its operation, only affects income that is not attributed to a beneficiary. The Australian transferor trust rules exclude income taxable on a net basis by Australia by attribution to a resident or non-resident beneficiary or trust (ITAA 1936 s 102AAU(1)(c)(i)) and, in some circumstances, income that has been taxed by another country to its resident beneficiary (s 102AAU(1)(c)(ii)).

[764] This is the approach of all the US grantor tax rules and of the Australian transferor trust rules (ITAA 1936 s 102AAZD).

[765] *Australia*: ITAA 1936 s 102. *New Zealand*: This is the general position if there are resident trustees throughout the year: ITA NZ s HC 29(3).

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beneficiary in receipt of grantor-attributed income[766] or making the grantor liable as deemed agent for the trust with a consequent right of indemnity against the trust.[767]

To visit ultimate legal liability on the trust estate or on trust income traced into the hands of a beneficiary who has received it is consistent with the policy and theoretical justification for taxing the grantor or by reference to the grantor: until the trust estate is delivered into the effective ownership of particular beneficiaries, the trust is carrying out a private purpose of the grantor. This justifies the grantor's country in taking the view that the income sufficiently belongs to its resident to support a claim for worldwide taxation. It also justifies a taxing claim upon that person and/or the income itself and the capital assets that generate it. If it is legitimate to consider that a grantor by capitalizing a particular donative trust has insufficiently parted with the trust property to break the taxing claim of his or her residence country, it is equally legitimate to visit that claim on the trust capital or income. That the trust estate or a particular benefaction suffers deduction of grantor-related tax is in no way anomalous. It is analogous to treating the income as entrusted by the grantor after tax. In principle, this is the right result. Indeed, there may be anomalies in taxing the grantor without indemnity or adjustment. If the grantor's country imposes transfer taxes and fails to recognize the effective indemnity of the trust procured by grantor taxation as a net transfer, those taxes may be avoided.[768] Or, if the grantor fails financially, there may be real income but no means of collecting tax.

9.1.2.3 Inbound and Outbound Perspectives

Inbound grantor attribution (where local income is attributed to a non-resident grantor and taxed on a source basis as income of a non-resident) is permitted by some regimes and precluded by others.[769]

In most circumstances, the grantor principle is not allowed to give rise to conduit treatment – i.e., the non-taxation of foreign-sourced trust income by reason of the grantor's non-residence. Two important exceptions have been identified in the surveyed countries, both of which are significant in international tax planning/avoidance/evasion. The first is a

[766] This is the general position under the UK settlements legislation: ITTOIA s 646.
[767] *New Zealand*: ITA NZ s HC 29.
[768] See n 81 regarding the use of grantor trusts to avoid or reduce US transfer tax.
[769] It is permitted by the UK settlements legislation, generally precluded in the United States by IRC s 672(f), but permitted under the exceptions in s 672(f)(2).

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US exception to the general rule precluding attribution to a non-US grantor.[770] This permits revocable trusts of non-US grantors to accumulate or currently appoint and distribute foreign income to US beneficiaries free of US income tax. The second is an inherent structural element of the New Zealand settlor regime: if the settlor nexus is not satisfied, there is no claim to tax trust-attributed foreign-sourced income – the trust is functionally non-resident. This, together with historically light reporting requirements, has been the foundation of the New Zealand foreign trust industry. It now seems likely that the tax-avoidance elements of that industry are in the process of being dismantled.[771]

Outbound application of the grantor principle is a significant feature in each of the surveyed countries, whether by general and/or specifically outbound grantor attribution rules or, in the case of New Zealand, by functional trust residence.

9.1.3 Beneficiary

The beneficiary principle involves taxation of income derived through or from a trust as income of a beneficiary by reference to the beneficiary's residence and other fiscally relevant characteristics. It is represented by two main models in the surveyed countries.

One model combines an inclusive beneficiary attribution rule for trust income, comprehending income appointed by discretion as well as vested income, with a supplementary rule of distribution taxation limited, in ordinary circumstances, to distributions from trusts that might have accumulated untaxed or lightly taxed income offshore. This is the general approach of Australia, the United States and New Zealand (Sections 3.1, 5.2, A.1.2, A.1.3 and A.1.4).

There are significant structural similarities, and inevitably some differences, between the Australian, US and New Zealand rules of beneficiary attribution and of distribution taxation. Inbound taxing differences should be understood in the context of the source principle, discussed earlier. More broadly in relation to current trust income, each country has its own view about the manner and circumstances in which it is willing to permit trust-law allocations of income to determine tax-law attribution. The issue arises because of the inclusive basis on which beneficiary attribution operates. Given that discretionary appointments

[770] IRC s 672(f)(2).
[771] See n 282–284, 443 and corresponding text.

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of trust income give rise to beneficiary attribution, the question is whether and how they may determine the attribution of particular items among beneficiaries and the trust, including the attribution of items from particular local or foreign sources. To varying degrees and in varying circumstances, each country recognizes some trust-law allocations but overrides others with tax-law formulae. In relation to supplementary distribution taxation, those countries differ significantly in their recognition or otherwise of prior taxation of trust income as a basis for double tax relief (Section 5.2.2). Each country in its own way also seeks to recapture the benefit of tax deferral, at least where the risk of deliberate deferral is perceived as significant (Section 5.2.3).

The other principal model combines limited beneficiary attribution of vested trust income with relatively extensive recognition of trust distributions as a separate form of income, except to the extent that they represent the mere delivery of beneficiary-attributed trust income. This is the approach of the UK income tax (Section 3.1, 5.2 and A.1.1.1). In a purely domestic context, it includes a specialized imputation regime that integrates the taxation of trust income and distributions. In a significant range of international circumstances, however, an extra-statutory concession causes UK taxation of distributions to switch to a quasi-attribution paradigm (Sections 5.3.2 and 5.3.4). This indicates a level of dissatisfaction with the statutory settings and a preference for transparent international taxation of trust income, even if it is produced by unorthodox means.

A third model can be seen in the UK capital gains tax, under which trust-level gains are not attributed to a beneficiary at all in a domestic context,[772] but a matching of capital distributions to a beneficiary with trust gains outside the UK tax net that accrued when the beneficiary was resident is recognized as taxable in the year when the match is made (Sections 3.3.2, 5.3.5 and A.1.1.2). This mixed approach combines elements of current attribution and supplementary outbound taxation.

UK taxation of distributions differentiates between income and capital. The income tax requires a distribution to have income character from the perspective of the beneficiary. Unlike the other surveyed countries, the representation of trust income in a distribution is not an element of this analysis.

[772] The United States takes a more nuanced approach to the attribution of capital gains as between the trust and beneficiaries (Section A.1.2.2) which does not entail departure from the general US model of international taxation.

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The models described earlier do not cover all possible ways in which a country could apply a beneficiary principle in its international taxation of trust-related income. They do, however, demonstrate a bifurcation between two general approaches. The first entails a broad view of current attribution that seeks to tax trust income on a transparent basis as far as it may be practicable to do so. If residual trust-attributed income is taxed at a rate with which the country is satisfied as final taxation and if it does not desire to grant relief in the event of subsequent distributions to beneficiaries in lower tax brackets, distribution taxation need only be applied on a complementary international basis.[773] Analysis of the Australian, US and New Zealand rules is indicative of the issues that are likely to arise under this approach. The second general approach entails a more limited view of current attribution coupled with a second taxing point when a trust makes distributions other than of beneficiary-attributed income. This raises issues that resemble the problems of company/shareholder taxation and integration. The range of possible responses is equally wide. The UK rules discussed here are but one response.

9.1.4 Trust

The trust principle entails attribution to the trust of current trust income that is not attributed to participants in the trust. The corresponding international claim to tax depends on analogizing the trust to a resident or non-resident person. If the trust is taxed as a fiscal proxy for the grantor, as it is in New Zealand, the trust principle merges with the grantor principle. In the other surveyed countries, the trust is taxed as proxy for unascertained beneficiaries (Section 6.4). In some permutations, where a refund is available by reference to tracing of the income into a subsequent distribution, taxation of the trust is analogous to taxation of a non-final withholder for initially unascertained beneficiaries.[774]

[773] If a country applies broad rules of current attribution but modest rates of entity taxation that are unsatisfactory as final taxation, or if it wishes to grant compensatory adjustments on distribution, it will have to use a broader form of distribution taxation such as would be needed in conjunction with limited rules of current attribution. This implies a top-up tax or crediting adjustment at the time of distribution.

[774] Under the UK domestic tax pool arrangements and where international relief is granted under the extra-statutory concession (ESC B18; cf SP 3/86), and where Australia gives a refund under ITAA 1936 s 99D.

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Trust residence serves as the criterion by which a country asserts a claim to tax worldwide trust-attributed income. Less uniformly, it may also serve as the criterion by which that country taxes locally sourced trust-attributed income on a specifically inbound basis (Section 4.3). Such inbound taxation may involve final gross-basis withholding, in some cases at a zero or concessional rate, depending on the country's particular inbound tax settings. The New Zealand settlor nexus principally focuses on the residence of the grantor in the current year or the year of death. The other surveyed countries tend to focus on connections of the trustees or the management or judicial oversight of the trust, but differ considerably among themselves. Even if the trust principle does not merge, New Zealand style, with the grantor principle, those two principles serve complementary functions to protect a country's tax base in circumstances that are beyond the reach of the beneficiary principle (Sections 4.2 and 6.1.4).

9.1.5 Double Tax Relief

Double tax relief is an issue common to all of the residence-based taxing principles. Each of the surveyed countries allows its residents unilateral relief by credit for qualifying foreign taxation. The general conditions for relief vary from country to country. Each of the surveyed countries also recognizes that credit may apply to foreign tax imposed on trust income. Each recognizes that foreign taxation imposed on its own taxpayer or on the trust by the foreign country may qualify for credit. Whether credit is available for foreign tax imposed on a beneficiary or grantor who is not also the taxpayer seeking credit is generally not explicit. The position appears to be that the United States denies such credit, but the laws of the other surveyed countries would allow it.[775]

9.2 Non-Taxation and Double Taxation

This section summarizes the main situations of double taxation and non-taxation that can arise from the interaction of national tax systems in treaty and non-treaty situations. It draws together earlier findings

[775] See discussion in Sections 2.5, 3.3.3 and 4.4 and the summary in Table 6.1 (p 27). A country that unilaterally exempts foreign-taxed income would presumably be unwilling to recognize foreign taxation of a beneficiary or grantor that is not its own resident taxpayer.

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concerning the interaction of national laws of the surveyed countries (Sections 6.2 and 6.3) and more general analysis of the interaction of national laws (Chapter 7) and the operation of tax treaties (Chapter 8) having regard to international tax scholarship, the OECD Model and the BEPS project.

9.2.1 Non-Taxation

Global non-taxation of trust-related income can arise in a diversity of ways. The main cases identified in this book are listed below, together with the most promising cures. There is no unifying concept, but mismatches involving trust residence or attribution of income and the circumstances relating to its derivation are recurrent themes.

9.2.1.1 Fiscally Homeless Trust

Trust income escapes residence taxation if no country claims the trust as its resident and no country that taxes on a residence basis attributes its income to a resident grantor or beneficiary. Fiscal homelessness of the trust is a real possibility because of the diversity of national trust residence rules; the ease with which some countries permit a trust to qualify as non-resident although it is based or substantially administered in its territory; the ease with which the trustees, trust situs and proper law can usually be changed; the relatively light degree of connection that is required between trust residence and trust business or income-producing investments; and the primary discretion that a grantor exercises when the trust is established or capitalized. Even among the surveyed countries, which have sophisticated tax systems and are familiar with the trust form, a number of homeless trust scenarios have been identified (Section 6.3).

Recommendation 5.2 of the BEPS Action 2 Report would have the establishment jurisdiction of an otherwise homeless trust claim the trust as its resident in respect of trust income that would otherwise escape residence taxation and tax that income by attribution to the trust. The recommendation as expressed in the Report only addresses accrued income of an investor in the same control group as the entity – it has been argued in this book that the requirement for that nexus should be relaxed for a trust that is donative, closely held or fiscally homeless.[776]

[776] See Section 7.2; Brabazon, *Trusts as Hybrids*, n 431. It appears likely that New Zealand in particular will act on the recommendation (n 284, 443).

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9.2.1.2 Negative Attribution Conflict

Diversity in the current attribution of trust income creates the possibility that no country may attribute particular income to its own resident, with the result that the only tax on that income is whatever is levied by a source country and whatever is levied on subsequent distribution.[777]

A number of causes have been identified. First, the countries concerned may classify the trust arrangement differently for tax purposes. A beneficiary's country may treat the particular trust as opaque, like a company, while the trust residence country perceives it as a trust and as differentially transparent. If the trust country attributes particular income to the beneficiary, neither country taxes the trust income as such on a residence basis, although economic non-taxation is avoided if the beneficiary's country recognizes a taxable dividend.

Secondly, both countries may recognize the arrangement as a trust for tax purposes, but apply different criteria to the attribution of its income. The trust residence country may take a wide view of beneficiary attribution, while the beneficiary's country takes a narrow view. Particular trust income may be attributed to the beneficiary on the wide view but not on the narrow view, so that neither country taxes that income on a residence basis. Economic non-taxation is avoided, however, if the beneficiary's country recognizes the same facts as giving rise to a taxable distribution of income from the trust. Another possibility is that the residence country of a trust or beneficiary may attribute particular trust income to a non-resident grantor[778] but the grantor's country may have no equivalent rule or, in any event, none that produces attribution to its resident. If the trust income is actually distributed to the beneficiary, it will have escaped current residence taxation,[779] and if the beneficiary's country attributed that income to the grantor, it is likely also to escape distribution tax.

Thirdly, two countries may take broadly similar approaches to the attribution of trust income, but differences in their rules may result in particular items being attributed differently among the beneficiaries and

[777] The case of homeless trust income, considered above, may be seen as a particular instance of negative attribution conflict, since non-taxation depends on the countries of grantors and beneficiaries also declining attribution to their residents.

[778] The issue arises if foreign income is untaxed or local income attracts concessional inbound treatment because it is attributed to a non-resident. It is most obviously associated with IRC s 672(f)(2), which preserves US grantor trust treatment of a revocable trust with a non-US grantor.

[779] Provided that the trust residence country does not attribute the income to the trust.

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the trust. Countries take different approaches to trust-law allocations of income and the use of tax-law formulae or tracing rules in the attribution of trust income, and those differences can produce gaps in the attribution of particular items. Non-taxation due to differences of this kind can arise incidentally or by planning; it is unlikely to justify fiscal countermeasures unless it is planned and substantial. If a tax planning element is obvious or artificial, a country's general anti-avoidance rules or principles may also be relevant.

Outbound grantor attribution regimes and grantor attribution regimes generally, to the extent that they apply to residents, preclude negative attribution conflicts within the scope of their operation. This is consistent with recommendation 5.1 of the BEPS Action 2 Report.

Recommendation 5.2 of the BEPS Action 2 Report also addresses cases of negative attribution conflict. If adopted in the form proposed in this book (Section 7.2.2.2), the affected income will be attributed to the trust in its residence country. It would also negate a trust country's attribution of foreign-sourced income to a non-resident grantor[780] if no other country attributes that income to its own resident and would replace it with trust attribution. But if the beneficiary's country would have attributed the income to its resident, absent the grantor, the better solution is to negate grantor attribution in the beneficiary's country.

9.2.1.3 Warehousing

A trust that is resident in a tax haven and derives trust-attributed income in that jurisdiction or under concessional inbound taxation elsewhere avoids significant current taxation of that income. Attribution of accumulating trust income to discretionary or contingent beneficiaries is unviable. The only realistic taxing possibilities are grantor attribution by the grantor's country and distribution taxation by a beneficiary's country.

9.2.1.4 Distribution Tax Lacuna

Whether it serves as an international complement to an inclusive current attribution regime for trust income or as an integral part of a tax system's trust rules, distribution taxation is a country's last opportunity to tax the economic benefit associated with trust income that may have escaped substantive or single taxation.[781] It is also the only opportunity to tax any

[780] As may presently occur in the United States under IRC s 672(f)(2).
[781] See Chapter 5.

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associated benefit of tax deferral. To the extent that distribution tax rules allow trust income that has been capitalized within the trust without substantive taxation to be economically delivered in non-taxable form, the result is economic non-taxation. An approach that characterizes distributions by reference to their character in the hands or from the perspective of the recipient allows for this result. The alternative is to adopt or include a rule by which distributions are taxable unless they can be traced to untainted or low-risk origins. To design effective distribution tax rules without overreach is a task of some difficulty.

9.2.1.5 Double Relief

A possibility has been identified that two countries may each give relief for the other's tax.[782] To prevent this, principles of priority should to be developed as between taxation imposed on a grantor, a beneficiary and a trust. Both domestic law and tax treaties have a role to play. Domestic laws providing relief may refer to tax treatment in other countries, and tax treaties may serve as a primary or secondary method for delivering double tax relief without creating unintended non-taxation.

9.2.1.6 Failure of Internal Coherence

If a country attributes trust income to a non-resident beneficiary but taxes it on a basis that does not reflect the circumstances of its derivation at the trust level, including its association with a business structure that would be recognized as a taxable presence of an ordinary non-resident investor, that country's tax base may be eroded. This may be an issue where DIR income attributed to a non-resident beneficiary is derived through a local trust-level business but is taxed as if the business did not exist or were located offshore (Section 3.2.4). Another failure of internal coherence has been found in Australia's inbound settings for taxing beneficiary-attributed capital gains of a trust (Section 3.2.5). Whether global non-taxation ensues depends on tax settings in the beneficiary's country, but the tax design issue is primarily one for the source/host country. In broad terms, the solution is to maintain parity between the treatment of non-residents who are treated as deriving income through a trust and analogous non-resident investors.

[782] See Section 6.1.3 (Table 6.1) and discussion in Sections 2.5, 3.3.3 and 4.4.

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9.2.1.7 Treaty Arbitrage

Tax treaties generally serve to relieve against double taxation. A small number of situations have been identified in Chapter 8 in which they can become vehicles for unintended double non-taxation in trust situations. All of these are remediable.

Anomalous treaty residence: Treaty shopping is possible if a treaty adopts domestic law concepts of residence for treaty purposes, a country's domestic law does not identify a concept of trust residence, and the view is taken that the personal residence of trustees qualifies as trust residence. The problem can be avoided by expressly identifying a trust as a person and by ensuring that domestic laws identify trust residence and/or that liability to tax is included as a treaty residence criterion (Section 8.2).

Wrong reference point for treaty attribution: Treaty shopping is possible if income attribution is determined for treaty purposes by reference to source-country rather than residence-country tax law (Section 8.3.2). This is a general feature of entities, including trusts, that function as reverse hybrids in respect of particular income. It can be prevented by adopting a transparent entity clause or applying an equivalent interpretive principle, such as was done for partnerships in the Partnership Report.

Unattributed PE: The country in which a trust has a PE can suffer base erosion if the PE and business structure are not attributed for treaty purposes to a non-resident grantor or beneficiary who is entitled to treaty benefits in respect of corresponding income. This can best be prevented by elaboration of the treaty definition of 'enterprise of a Contracting State' (Section 8.3.10).

Unilateral relief after treaty relief: Treaty shopping is possible if a trust country gives unilateral relief by reference to the non-residence of a beneficiary and the foreign source of trust income traced into a distribution, the effect of which is to deliver the advantage of benefits previously obtained by the trust under a treaty between the trust country and a source country (Section 8.4). This may happen if the trust country originally recognizes trust-attributed income which it taxes on a residence basis but then associates that income with a distribution in a way that is analogous to conduit treatment by credit or refund of its own previous tax. The original trust income is effectively delivered to the beneficiary with the benefit of source-country exemption or rate limitation under a treaty to which the beneficiary's

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country is not a party. To prevent such non-taxation, a treaty may provide for retroactive denial of benefits in relation to the original income (such as by negating its qualification as income of a resident of the trust country), or the trust country may tailor the terms of any unilateral relief that is available at the point of distribution under its national law so as to exclude relief corresponding to treaty benefits. Either approach requires close attention to information and reporting.

9.2.2 Double Taxation

This section summarizes the ways in which international double taxation of trust-related income is found to arise, including the ways in which prima facie double taxation is avoided in treaty and non-treaty situations.

Double taxation can arise in several ways where two countries tax the same trust income to the same or different taxpayers: both countries may agree on attribution and tax the same taxpayer; a source country and a residence country may disagree on attribution and tax different taxpayers (a pure source–residence attribution conflict); the source country in such a case may also have a residence taxing claim (a compound attribution conflict); or two residence countries may disagree on attribution where neither has a source taxing right (a pure residence–residence attribution conflict). Double taxation can also arise where two countries make overlapping claims to tax trust income and distributions that represent the same economic benefit, but which they perceive as different incomes with different sources.

9.2.2.1 Trust Income, Same Taxpayer

Where both countries agree on attribution of trust income to a beneficiary, a grantor or the trust and one country taxes on a source basis while the other taxes on a residence basis, double taxation is generally avoided by unilateral relief in the residence country and/or by treaty in the same way as if that taxpayer had invested and derived income directly.

The position is more complex if both countries claim to tax on a residence basis or on a source basis.

Dual resident trust: If two countries claim the trust as their resident, both will tax its trust-attributed income. This is the converse of the homeless trust. The terms, if any, on which countries give their residents unilateral double tax relief for foreign residence-based taxation are variable. If such a case arises in a treaty context, treaty residence is resolved by tiebreaker or by the mutual agreement process and the taxing

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claims of the 'losing' country are limited as they would be for a company or individual whose treaty residence is resolved in favour of the other country.

Source–source conflict: If a trust country recharacterizes foreign-sourced trust income attributed to a non-resident beneficiary so that, as income of the beneficiary, it is sourced in the trust country,[783] the original source country and the trust country will both tax on a source basis. The beneficiary may reside in a third country or in the original source country. Any relief depends on the terms of unilateral double tax relief rules in the residence country and on the application of treaties between the beneficiary's country and each of the source countries or, if the beneficiary is resident in the original source country, between the that country and the trust country.[784] Source–source conflicts of this kind appear to be relatively uncommon.

9.2.2.2 Source–Residence Attribution Conflict

The next case concerns overlapping claims to tax the same trust income by attribution to different taxpayers, one country taxing on a residence basis and the other on a source basis. Such a situation can arise in several different ways. The countries may disagree about classification of the trust entity as differentially transparent or inherently opaque; they may both regard the trust as differentially transparent, but their criteria for differentiating between trust- and beneficiary-attributed income may differ in broad principle or in detailed application to the particular income in question; or the residence country may be applying a grantor attribution rule to its own resident while the source country attributes the income to the trust and/or its beneficiaries. The significant question is not how the conflict comes about, but whether double taxation remains after applying the two countries' inbound and outbound tax settings and the terms of any relevant treaty.

The case is one of economic double taxation because the taxpayers are different. A treaty between a source country and a residence country nevertheless provides relief if the treaty includes a transparent entity clause or if equivalent principles of interpretation are applied, as was done for partnerships in the Partnership Report. Otherwise, treaty benefits may be denied or an inappropriate treaty may be applied where (for example) source country S attributes trust income to a trust resident in

[783] As Canada does: see n 167.
[784] See n 544, 545 and corresponding text.

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country T, but a beneficiary's residence country B attributes the same income to its resident – only the S–B treaty should apply.[785]

The distributive articles of a tax treaty strike a balance between source and residence countries by allocating taxing rights between them. They may also have the effect of reducing overall taxation if the country that would otherwise tax more heavily is required to grant exemption by those articles or (where source taxation is permitted) by a double tax relief article.

The primary allocation of taxing rights by the distributive articles of a treaty in a trust context, and thus their ability to avoid double taxation, is governed by the terms of those articles and, if the treaty follows the OECD Model, the principles of the transparent entity clause and the saving clause. A preliminary question, however, is whether the operative residence-country attribution regime is within the contemplation of the treaty and the transparent entity clause. The question is most likely to arise in the context of grantor attribution, and particularly where the rules in question have a specifically outbound operation or may be characterized as anti-avoidance rules. Analysis of the OECD Model and Commentary does not provide a clear answer or clear principles for determining an answer. The conclusion of this book is that, where either party to a treaty has a grantor attribution rule, the question should be addressed specifically in treaty negotiations (Section 8.3.4). If particular attribution regimes are to be quarantined from treaty-based avoidance of double taxation, it is preferable for the point to be clear and consciously determined.

Some interpretive questions remain in relation to the transparent entity clause and its relationship with other criteria in some of the distributive articles. Chapter 8 has argued for an essentialist interpretation of that clause and related criteria, particularly those relating to beneficial ownership and PE attribution, the general effect of which is to make access to treaty benefits in most trust situations depend on the attribution of trust income in a residence country. If that interpretation is accepted, double taxation due to source–residence attribution conflicts in a trust context is generally addressed on a basis that is consistent with the treatment of a direct investor. If not, double taxation may remain where the attribution criteria of the source country are consulted in addition to those of the residence country for the purpose of engaging treaty benefits.

[785] See Sections 8.3.2 and 8.3.9; this is also the case under Partnership Report principles (Brabazon, *Treaties & Transparent Entities*, n 474, §1.2.6).

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Where the distributive articles of a treaty recognize taxing rights in the source country, double tax relief in a residence country depends on its national law (Section 9.1.5) and on treaty provisions for double tax relief (Section 8.3.13). There is a degree of variation between the national rules of the surveyed countries. One cannot say a priori whether unilateral relief or treaty relief is more extensive:

- *Identity of income*: Unilateral provisions may require identity of income taxed in the two countries or some other form of identity, such as identity of income by reference to which tax-law income is calculated.[786] The OECD Model requires identity of income. This implicitly allows a residence country to determine, by the terms of its national law, whether income attributed to a beneficiary or grantor by reference to trust income is recognized for treaty purposes as having sufficient identity with that trust income.[787] This gives the grantor's or beneficiary's residence country an effective right of veto over the application of a transparent entity clause and, it seems, over treaty benefits more generally for that resident with respect to that income. But some treaties, notably of the United Kingdom, depart from the OECD Model by requiring only identity of income by reference to which tax-law income is calculated.[788] If national law indirectly attributes trust income to a grantor in terms that deny the identity of grantor-attributed income with that trust income, the grantor has access to benefits under the double tax relief article although the trust income does not attract relief under the distributive articles by reference to the grantor.
- *Identity of taxpayer*: Unilateral provisions may or may not require identity between the claimant for relief and the taxpayer who is subject to the foreign tax (trust, beneficiary or grantor). The OECD Model does not require identity of taxpayer.

9.2.2.3 Compound Attribution Conflict

Attribution conflicts and double taxation can also arise where the source country attributes the trust income in question to its own resident trust, beneficiary or grantor. Overlapping tax claims are made by a source+residence country and a residence country. The national tax law of the

[786] See the 'calculated by reference to' rule in TIOPA s 9(1), (2) (see Section 3.3.3, n 215).

[787] See discussion in Section 8.3.7; Baker, *Finance Act Notes*, n 37, 409.

[788] See e.g. Australia–UK 2003 Art 22(2)(a); New Zealand–UK 1983 Art 22(1), (2); UK–US 2001 Art 24(4)(a) (n 148, 722).

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source+residence country may perceive a purely domestic situation or, if it attributes to a beneficiary or grantor and the trust is resident in the other country, a round-trip situation. Although this is still a case of source–residence attribution conflict, it also involves a residence–residence attribution conflict.

In broad terms, the onus of giving double tax relief falls on the country of residence without source, but may be limited by reference to the source-taxing rights of the source+residence country. The precise outcome will vary from case to case, dependent on the terms of unilateral double tax relief given by each country and whether they have negotiated a tax treaty.

The source+residence country is unlikely to grant unilateral double tax relief. Countries generally do not allow such relief for foreign tax on income from sources within their own territory, although the method by which they achieve this result varies from one to another.[789] In a treaty situation, a saving clause or (if recognized) an equivalent interpretive principle will prevent the source+residence country from being required to give treaty benefits under any of the distributive articles, and the double tax relief article[790] will not require relief for residence taxation in the other country.

The availability and extent of unilateral double tax relief in the residence country depends on how its domestic rules are structured, on the respective roles (trust, beneficiary or grantor) of the taxpayers in each country, and on the extent to which foreign residence-based taxation qualifies for such relief in circumstances where the foreign country could also exert a source taxing claim.[791]

In a treaty situation, the residence country will be obliged to give double tax relief corresponding to any source taxing rights allocated to the source+residence country.[792] This generally strikes a sensible balance

[789] See Section 3.3.3.

[790] Both before and after the 2017 Update – see Section 8.3.13; *Bayfine UK Ltd* v *HMRC* [2011] STC 717; (2011) 13 ITLR 747; Brabazon, *Treaties & Transparent Entities*, n 474, §4.6.1.

[791] See Section 3.3.3 and Table 6.1 in Section 6.1.3. In New Zealand, for example, credit is only available for tax on foreign-sourced income and, if paid by the New Zealand taxpayer on a residence, domicile or citizenship basis in the other country, only to the extent that the foreign tax would have been paid without that personal connecting factor (Section 3.3.3.1).

[792] Based on 2017 amendments OECD Model Art 23 A and B. If the amendments differ from the previous meaning of the article, that difference is relatively minor. See Section 8.3.13; Brabazon, *Treaties & Transparent Entities*, n 474, §4.6.1.

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between source and residence taxation, particularly by requiring relief in one residence country with respect to income associated with a PE in the other residence country. If both countries have source+residence taxing claims, however, it is necessary to quarantine their treaty source-taxing rights from erosion by overlapping credit or exemption referable to source-taxing rights in the other country if double non-taxation is to be avoided.[793]

To the extent that residence taxation in the source+residence country exceeds its treaty-based source taxing rights, the OECD Model requires no benefit or relief in either country. The remaining double taxation, which is based on the residence–residence aspect of the attribution conflict, is not avoided by the model treaty. Any relief depends on the unilateral rules of the residence country or special bilateral treaty provisions.

9.2.2.4 Residence–Residence Attribution Conflict

Where two countries each tax their own resident on the same trust income without or beyond the scope of source taxing rights, double taxation is unrelieved by the OECD Model treaty. In the absence of special bilateral treaty provisions or voluntary mutual agreement between the competent authorities, any double tax relief depends on unilateral rules in the two countries.

Unilateral relief depends on the terms of the rules in the country concerned and the respective roles of the taxpayers in each country. A particular issue is the extent to which foreign residence-based taxation qualifies for relief where the foreign country does not also exert a source taxing claim. Some unilateral rules appear to allow credit to a resident beneficiary for purely residence-based taxation of the trust or grantor in another country on income sourced in a third country[794] – this result is not irrational, but it is not clear whether those who drafted the rules considered the issue. The desirability of double tax relief needs to be balanced against the undesirability of double relief (Section 9.2.1) by establishing an order of priority based on the roles of the different taxpayers and their connection with the relevant income.

A potential treaty mechanism has been identified that will avoid double taxation due to residence–residence attribution conflicts in trust and other transparent entity situations (Section 8.3.13). This can be

[793] Ibid, §4.6.1.
[794] See Section 3.3.3.

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achieved by adding a residence–residence clause to the double tax relief article of the OECD Model and determining an order of priority between residence-based taxing claims in relation to the entity and its participants.

9.2.2.5 Taxation of Trust Income and of Distributions

Double taxation of a trust distribution by the trust country and the beneficiary's residence country is readily avoided by a tax treaty between them or, at least in the surveyed countries, by unilateral foreign tax credit. Economic double taxation of underlying trust income in the trust country and/or a source country and of a distribution supported by that income in the beneficiary's country is a different matter. Particularly if the trust has been taxed at a rate equal or close to the top personal rate, the extent of double taxation is significant.

The OECD Model provides no relief against double taxation of these different incomes. Some bilateral treaties recharacterize distributions from a trust or deceased estate to reflect the character of underlying entity-level income.[795] This superimposes a transparent paradigm for treaty purposes on the nontransparent taxation of trust income in the trust country and of the distribution in the beneficiary's country. Such a strategy implicitly requires a process for tracing income to distribution and, unless relatively prompt distribution is required, creates a possibility of tax deferral.

Otherwise, the avoidance of double taxation depends on whether the beneficiary's country recognizes a distribution as representing particular trust income and allows an adjustment based on previous taxation of that income in one of the countries concerned and/or a third country. National laws in the surveyed countries take a wide diversity of approaches, from the reconstruction of a foreign tax credit calculation to flatly denying recognition of tax on underlying income.[796]

Delay between the derivation of trust income and a corresponding distribution creates a benefit of tax deferral if the trust income attracts no current taxation or very light current taxation. Measures that seek to tax the benefit of tax deferral may take the form of an interest surcharge or higher rate being applied to distribution taxation in the beneficiary's country. No solution has been found that is both accurate and robust. A measure that is robust against circumvention is likely to be overly

[795] For example, the UK treaties with Hong Kong, Norway and the United States (n 731, 748).

[796] See Sections 5.2.2, 5.3.3 and 5.3.4.

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broad; one that avoids overreach is likely to be vulnerable to circumvention. Countries that are concerned about deferral each strike their own balance.[797]

9.3 Tax and Treaty Design

Two main phenomena distinguish the taxation of trust-related income from income related to other types of entity: differential transparency of the trust and the role of the grantor. These phenomena give rise to a particular set of international tax issues and risks of unintended non-taxation or double taxation, examined in earlier chapters and in the preceding section of this chapter. Those issues lead in turn to a set of potential solutions that may be implemented in the design of national tax laws and tax treaties. This section approaches the subject of tax and treaty design by examining how differential transparency and/or the role of the grantor inform those issues and solutions in three main areas: conflicts of attribution of current trust income (Sections 9.3.1 and 9.3.2), successive taxation (or non-taxation) of trust income and distributions (Section 9.3.3), and the need for internal coherence in the design of tax laws and treaties (Section 9.3.4).

9.3.1 Conflicts of Attribution

Differential transparency in the first instance implies that a trust may be resident in a country that taxes on a residence/source basis, but not fiscally responsible for all trust income; likewise it may be non-resident, but locally sourced trust income may be attributed to beneficiaries or grantors who are resident in the taxing country or in a third country where the trust is non-resident. It follows that, particularly in a treaty context, the tax treatment of trust income should be addressed on an item-by-item basis insofar as that treatment depends on the residence status of a taxpayer to whom it is attributed. This is the approach of the transparent entity clause of the OECD Model. Unintended treaty-based non-taxation that might otherwise arise from applying that clause where a source country also attributes the subject income to its own resident is prevented by a general saving clause, also now part of the OECD Model, or by the application of an equivalent principle of treaty interpretation

[797] See Sections 5.2.3 and 5.3.5.

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saving rights of residence-based taxation. The significant possibility of attribution conflicts in a trust context warrants the inclusion of both clauses in tax treaties where one country or the other recognizes trust taxation (Sections 8.3 and 9.2). The inclusion of such clauses will be assumed in further discussion of treaties in this section.

Differential transparency creates the possibility that the same trust income may be differently attributed in different countries. The trust may function as a hybrid entity, such that the same income is attributed to the trust in its residence country and to a participant, such as a beneficiary, in that person's residence country, with a consequent risk of double taxation. Or it may function as a reverse hybrid, with income attributed by each country to a resident of another, with a consequent risk of double non-taxation. A particular variant involves the fiscally homeless trust: if a trust is resident nowhere and has income that is not attributed to a participant in the latter's country, such income will escape current residence-based taxation. Fiscally homeless trusts present a significant risk of unintended global non-taxation.

In the area of attribution conflicts, differential transparency interacts significantly with grantor attribution. A grantor's residence country may include in its tax system a general or specifically outbound rule of grantor attribution which, if applied to particular trust income, effectively prevents the trust from functioning as a reverse hybrid in respect of that income. This is so, regardless of whether the grantor's country is also the residence country of the trust or of a beneficiary.[798] Grantor attribution is a powerful strategy against double non-taxation. Equally, such attribution enhances the possibility that a trust may function as a hybrid entity. Grantor-attributed income may also be attributed to the trust or a beneficiary in the latter's residence country, which may give rise to double taxation of the same income to different taxpayers in different countries on a current basis.

Attribution to a non-resident grantor may also operate to negate a country's claim to tax on the basis of attribution to a resident trust or beneficiary. This may give rise to non-taxation of foreign-sourced income or the application of special and possibly concessional inbound tax settings to locally sourced income that would otherwise attract full

[798] The US outbound rule in IRC s 679 requires residence of a potential beneficiary, but that is not a necessary element of outbound grantor attribution rules and is not found in equivalent measures in the other surveyed countries.

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residence-based taxation. If permitted, such settings create a significant risk of arbitrage and unintended non-taxation.

The risks of unintended double non-taxation and double taxation associated with conflicts of attribution have been answered by a range of potential solutions in addition to the adoption of a transparent entity clause and a saving clause:

- Adoption of an expansive definition of trust residence. This results in taxation by the trust residence country.
- Definition of trust residence by reference to the residence of the grantor. This results in taxation by the grantor's residence country qua trust residence country.
- Adoption of a general rule of grantor attribution, not focused on outbound situations but capable of so applying. This results in taxation by the grantor's residence country.
- Adoption of a specifically outbound grantor attribution rule. This also results in taxation by the grantor's residence country.
- Adoption of a defensive trust residence and attribution rule for income that would otherwise escape full taxation globally. This results in taxation by the trust establishment country.
- Adoption of a robust distribution taxing rule applicable to a resident beneficiary and a presently or formerly non-resident trust. This results in taxation by the beneficiary's residence country.

By providing for residence taxation in each of the potential residence countries, these strategies deliver a theoretically complete set of measures against unintended non-taxation and should be considered by a country wishing to avoid trust-related erosion of its own and other countries' tax bases. The strategies that focus on trust residence and attribution or grantor attribution address current taxation of trust income, and are considered next. Distribution taxation is qualitatively different and will be considered separately (Section 9.3.3).

9.3.1.1 Trust Residence

The adoption of an expansive definition of trust residence[799] reduces the scope for a trust to be locally controlled or influenced by a resident grantor, beneficiaries or their associates and yet to avoid worldwide taxation of trust-attributed income and thus to accumulate foreign-sourced income

[799] As seen in Australia (Section 4.2.1).

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free of taxation in the country in question. The efficacy of this strategy is limited by the difficulty of establishing onshore control[800] and the possibility that a grantor may lawfully avoid such rules, but it may nevertheless have a proper role as an anti-base-erosion strategy.

Trust residence (including what has been referred to in this book as functional trust residence) by reference to grantor residence, such as applies in New Zealand, provides strong and effective protection for the tax base of the country that adopts the rule, although it may contribute to a trust established in that country for a foreign grantor being fiscally homeless if the grantor's country does not have a similar rule or a grantor attribution rule that covers the particular situation. Grantor-based trust residence is thus an effective strategy from a national viewpoint; to be internationally justifiable, it should be accompanied by defensive measures where the grantor is non-resident (Section 9.3.1.3).

9.3.1.2 Grantor Attribution

The adoption of general grantor attribution rules has generally been driven by domestic tax policy. Such rules generally take priority before beneficiary or trust attribution and require a measure of broadly defined retention of influence on decision-making or potential economic benefit.

General grantor attribution has international implications. First, it may apply in an outbound context, where the grantor is resident and the income foreign sourced. Subject to satisfying the conditions for its application, this provides effective protection for the tax base of the grantor's country and precludes international non-taxation during the grantor's life.

Secondly, depending on how the rule is designed, it may result in attribution to a non-resident grantor. Non-taxation may result if non-resident grantor attribution applies in lieu of attribution to a resident trust or beneficiary with respect to foreign-sourced income or local income under a favourable inbound taxing regime. These outcomes appear undesirable because they invite international arbitrage, although resulting base erosion and horizontal inequity is mainly, if not completely, confined to the country that allows such attribution.

[800] Even if the onus of proof rests on a taxpayer, revenue authorities will not conclude that a trust is resident without a plausible basis. This implies the possession of information from which the appropriate inference may be drawn, a matter which is affected by international information-sharing arrangements. The real locus of control may be easier to establish now than in former times; see, e.g., *Bywater Investments Ltd* v *FCT* (2016) 260 CLR 169.

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A country may adopt a specifically outbound grantor regime in the absence of general grantor rules or as a supplement to those rules. In either case, taxation of or by reference to the grantor applies in circumstances where the same claim to tax would not apply with respect to locally sourced income. In this respect, its capacity to preclude trust-based arbitrage and non-taxation may be stronger than that of a general grantor rule. Outbound grantor attribution is consistent with the application of BEPS Action 2 recommendation 5.1 in the form proposed by this book (i.e., if double non-taxation would otherwise result, without requiring deductibility to the payer of the subject income). As a matter of design, an outbound grantor rule may be expected to start with a broad claim to tax trust income corresponding to the voluntary contribution of the grantor and to address any limitation of the claim by exclusion or exemption of otherwise taxed income and/or by credit for such taxation.

In negotiating tax treaties, a country that has a grantor attribution regime and another country that is contemplating a treaty with such a country need to consider whether and how that regime should interact with the treaty and its transparent entity clause, bearing in mind that the saving clause only addresses residence taxation and does not address the double tax relief article.

The inclusion of an outbound grantor rule as such is most readily achieved in a country that recognizes trusts in its tax system. Countries in which the trust is an unfamiliar institution may prefer to approach the matter in different ways. The risk of base erosion still exists for those countries, because their residents may transfer assets to a trust established in a trust jurisdiction. As the surveyed countries are all trust jurisdictions, the issues that would arise for a non-trust jurisdiction contemplating outbound grantor attribution are outside the scope of this book and have not been identified. This is an area that may warrant further investigation.

9.3.1.3 Defensive Trust Residence and Attribution

A defensive rule based on BEPS Action 2 Report recommendation 5.2 serves as a fallback to catch and tax in the establishment jurisdiction of a trust any trust income that escapes substantive taxation elsewhere due to a conflict of attribution or fiscal homelessness of the trust. This is desirable in the case of a donative or closely held trust or one that would otherwise be fiscally resident nowhere. The rule is particularly required if the establishment jurisdiction follows the New Zealand model and taxes trust-attributed income by reference to the residence of the grantor.

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9.3.2 *Attribution Conflict Strategies and Double Taxation*

The strategies described earlier are intended to prevent unintended non-taxation and/or to protect the tax base of the taxing country, but the primary trust- and grantor-focused strategies (Sections 9.3.1.1 and 9.3.1.2) can contribute to international double taxation if another country taxes the same income by direct or indirect attribution to its own resident. An assessment of whether and in what form to implement or retain such settings should therefore involve a consideration of whether and to what extent the country in question regards such double taxation as an appropriate outcome (a) in the general case where it has no tax treaty with the other country and (b) in a treaty situation. In particular, it should include consideration of the practicability of double tax relief mechanisms and their consistency with the fiscal objectives of the countries concerned. Generally speaking, it is preferable that double taxation should be relieved if that can be done without compromising the integrity of tax systems or other, higher-level tax policies.

9.3.2.1 Trust Residence

Where expansive trust residence applies, double taxation due to dual trust residence is unlikely to be relieved in a non-treaty situation unless the other country is also a source country. The outcome depends on the precise double tax relief settings of each country's national law;[801] the issue is not specific to trusts. In a treaty situation, dual trust residence is addressed by tiebreaker or mutual agreement procedure. It remains to be seen whether the latter, which is now the default position of the OECD Model, will work efficiently. No further modification to these settings is proposed in this book.

9.3.2.2 Grantor Attribution

Where the outbound application of a general grantor rule coincides with attribution of the same income in the other country to a resident trust or beneficiary, there is no clear policy case for the grantor's country unilaterally to defer to the other country by granting exemption or credit unless the other country is a source country. Under a specifically outbound grantor attribution rule, however, where the grantor's country would not tax the grantor in an equivalent domestic situation, there is a respectable case for unilateral restraint or relief by the grantor's country if

[801] See esp Section 3.3.3.1.

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it can be satisfied that tax is really imposed by the residence country of the trust or a beneficiary. Some countries may be unwilling to take this step outside a treaty relationship.

If the foreign taxing country is also a source country, there is a case for relief in the grantor's country. To the extent that the grantor's country would generally grant relief to its residents for equivalent taxation directly imposed by a source country, it should not matter whether that tax is imposed on the grantor, the trust or a beneficiary because the foreign tax burdens the income that is available to carry out the grantor's purposes through the trust. Whether relief should be granted unilaterally or only by treaty may be regarded as a policy question for the country concerned.

Correspondingly, countries that attribute trust income to a trust or beneficiary face the question of whether and on what basis they should recognize general or outbound grantor taxation in the grantor's country for the purpose of granting double tax relief to their residents. In a non-treaty situation or in the absence of other reciprocity, there is no compelling policy reason to do so unless the grantor's country is a source country and its taxation diminishes the assets of the trust.

Any attempt to devise a unilateral order of priority between general grantor taxation and corresponding taxation of a beneficiary or trust faces the considerable difficulty that any such order remains rationally contestable in the absence of agreement between the countries concerned. This suggests that conflicts of priority are better resolved by treaty.

In a treaty context, the first question is whether and to what extent the treaty engages with the general grantor attribution rules of the grantor's country so as to attract the operation of a transparent entity clause and thus the treaty generally, including its distributive articles or, alternatively, to attract the operation of the double tax relief article in the grantor's country. As the OECD Model and Commentaries do not clearly resolve this question, and as it is possible for a country to sidestep the treaty by designing its own grantor rules in such a way as to deny technical identity between trust income and grantor-attributed income,[802] the countries concerned should address the question in their negotiations if either of them has a grantor attribution rule. This provides an occasion to consider the relief of double taxation due to residence–residence attribution conflicts as well as source–residence attribution

[802] This is more likely to be done if the grantor rule is specifically outbound (Sections 8.3.7 and 8.3.8.2).

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conflicts and the relative priority of taxing claims on the grantor, the trust and the beneficiaries.

There is a case for recognizing general grantor attribution as giving rise to treaty rights. Such attribution represents a judgment that the grantor remains the proper owner of the affected income for tax purposes generally, not only where foreign-sourced income is concerned. Even if the countries concerned are reluctant to apply the distributive articles by reference to grantor attribution, general grantor attribution to a resident in one treaty country would appear to warrant treaty-based double tax relief in that country to the extent of actual taxation consistent with treaty-based source-taxing rights in the other country, since such actual taxation diminish the trust fund available to pursue the grantor's purposes through the trust and is pro tanto inconsistent with any anti-avoidance justification that might otherwise be thought to warrant a denial of treaty benefits. For similar reasons, the relief of double taxation due to a pure conflict of residence also appears desirable. The order of priority would have to be agreed; it has been argued that the fact of relief may be more important than how it is allocated between the taxing countries (Section 7.3.6).

Where specifically outbound grantor attribution rules apply, there is a greater likelihood that the grantor's country may regard those rules as sui generis or as an anti-avoidance regime. It may therefore wish to retain unilateral control over any international double tax relief measures applicable to that regime and may be reluctant to recognize the impact of a tax treaty. On the other hand, outbound grantor attribution rules may be attracted in non-avoidance situations, and there may be sound policy reasons to limit their application to cases that would otherwise involve double non-taxation[803] or to allow credit for foreign taxation of the trust or its beneficiaries. A case may also be made for giving lower priority to specifically outbound grantor taxation than to ordinary foreign taxation of trusts or beneficiaries precisely because a specifically outbound rule does not take priority over local taxation of resident trusts or beneficiaries.[804] If treaty relief is allowed, either generally or by access to a double tax relief article, the case for extending double tax relief to

[803] This thinking is evident in an Australian rule excluding trust income from grantor attribution if it is otherwise fully taxed in Australia or a listed country (ITAA 1936 s 102AAU(1)(b), (c)(i), (ii)).

[804] See also the discussion in Section 2.6.

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residence–residence situations appears at least as strong as in the case of general grantor attribution.

The avoidance of double taxation arising from grantor-related attribution conflicts is a complex problem which may be addressed, or allowed to stand, in several different ways. The analysis in this book has proposed a number of qualified principles but has not identified a single, right answer or proposed a single method to deal with the problem. The bottom line, so to speak, is that countries should address the issue consciously in their national laws, particularly but not only if they impose grantor taxation, and in the negotiation of tax treaties where one of the parties has a grantor attribution rule. Grantor attribution may be attracted without culpable conduct or an intention to avoid tax on the part of the grantor; whether by unilateral national rules or by treaty, it is submitted that provision should be made for the avoidance of double taxation, but not so as to facilitate avoidance or ultimate non-taxation.

9.3.2.3 Defensive Trust Attribution and Residence

The defensive rule as formulated in this book does not apply if full taxation is imposed in one or more other countries. This precludes double taxation, except where a source country imposes a more limited form of taxation on the subject income. In that case, it would be appropriate for the trust country to allow double tax relief by credit.

9.3.2.4 Double Taxation and Attribution Conflicts Generally

The previous discussion of grantor attribution addressed the avoidance of double taxation arising from attribution conflicts where one of the countries taxes a resident grantor. Economic double taxation can also arise from attribution conflicts between the residence countries of a trust and a beneficiary. The avoidance of double taxation, whether unilaterally or by treaty, is a simpler subject than its grantor-related counterpart. Generally speaking, in a trust-beneficiary context, the preliminary question of whether the relevant attribution and taxation regime engages treaty rights at all is unlikely to arise. It remains the case, however, that countries need to consider whether they will allow unilateral double tax relief for foreign taxation of a different taxpayer, and which class of taxpayer – particularly where the question relates to foreign taxation of a beneficiary. If both countries were to allow relief, non-taxation would result. In a treaty context, consideration should be given to relief from double taxation due to residence–residence attribution conflicts and to

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the priority that should apply between taxation of the trust and of the beneficiary (Section 8.3.13).

9.3.3 Trust Income and Distributions

A separate area of potential non-taxation or double taxation concerns the accumulation of income in a trust resident or established in one country coupled with distributions to a beneficiary resident in another country. Distribution is the last point at which trust-related income may be taxed, and may be the only point at which the beneficiary's country can realistically tax such income.

If trust income has escaped substantial current taxation, there is a risk of overall non-taxation if the beneficiary's country does not recognize a distribution that delivers corresponding value as tax-law income of the beneficiary. If trust income has attracted substantial current taxation at source or in the trust country, economic double taxation eventuates if the beneficiary's country recognizes a corresponding distribution as income but does not give relief by reference to that earlier tax and the trust country does not allow a favourable adjustment at the point of distribution. These propositions do not depend on which of the beneficiary attribution/distribution taxing models the beneficiary's country adopts.

The prevention of arbitrage and unintended non-taxation requires a robust regime for taxing distributions from a non-resident or formerly non-resident trust, including a process for recognizing trust income that has been recharacterized as capital within the trust. The classification of distributions by reference to their character in the hands of a beneficiary is not sufficient to achieve this objective; if that approach is taken in a domestic context, it should be supplemented by an international tracing rule.[805]

A perfect balance between the goals of preventing unintended non-taxation and avoiding economic double taxation is probably impossible to achieve.[806] The regimes examined in this book reveal different compromises in different countries. No satisfactory treaty mechanism for the avoidance of double taxation has been identified, other than with respect to the relatively limited subject of juridical double taxation of the distribution itself. The tax treatment of distributions and the avoidance of

[805] This relates to the distribution tax lacuna referred to in Sections 6.3 and 9.2.1; cf Section 5.3.1.

[806] See Chapter 5.

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economic double taxation remains predominantly an issue for national tax systems. A beneficiary's country may have more reason to recognize underlying taxation of trust income if measures to prevent international non-taxation of such income on a current basis are strengthened globally and may have greater confidence in the reality of underlying taxation if the movement towards global strengthening of regimes for the exchange of information[807] proves effective.

A secondary risk of unintended treaty-based non-taxation has been identified if a trust residence country gives tax relief on the occasion of a distribution to a non-resident beneficiary (Section 8.4). The primary rationale for such relief is to avoid double taxation where the trust has been taxed on an entity or proxy basis, and its practical effect is to switch to a transparent paradigm. The problem is that source-country treaty relief may already have applied in relation to current taxation of original trust income; subsequent trust-country tax relief may inappropriately deliver the benefit of that treaty relief to a beneficiary who would not have been entitled to it as a direct investor in the source country. To prevent this unintended effect, treaties may provide for the reversal of treaty benefits in the event of such subsequent relief and/or trust-country relief should be so designed as to prevent the passing on of treaty benefits.

9.3.4 *Internal Coherence of Tax Laws and Treaties*

Another cluster of potentially anomalous results of over- or under-taxation may be observed or inferred where a tax system fails to coordinate its rules of trust taxation with its general rules of international taxation or where a tax treaty fails to coordinate its rules relating to the relationship between treaty resident and income in a consistent and coherent way.

The need for coherence may be recognized and expressed as a generalization, but its manifestations are specific. Thus, in the context of national laws, a local taxable presence of a trust should be attributed to

[807] The international exchange of information on request or automatically in response to the OECD/G20 sponsored common reporting standard (OECD, *Standard for Automatic Exchange of Financial Account Information in Tax Matters* (2nd edn, 2017)) is beyond the scope of this book. It is, however, of considerable practical importance for tax authorities testing the veracity of what they have been told by taxpayers or seeking to discover the economic reality behind complex or layered international arrangements.

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a beneficiary to the extent that the tax system attributes corresponding income to the beneficiary;[808] the jurisdictional test for taxing trust gains attributed to a non-resident beneficiary should be consistent with the test for taxing gains attributed to a non-resident investor directly;[809] and so on. In a treaty context, it has been argued that the recognition of current attribution of income of a trust or other fiscally transparent entity under the transparent entity clause by reference to the tax law of a residence country should be recognized without unnecessary doctrinal complexity;[810] a trust-level PE and business should be attributed to a treaty-resident for treaty purposes to the extent that the attribution of its income is so recognized;[811] and beneficial ownership of DIR income of a trust or other transparent entity should be interpreted primarily by reference to residence-country attribution.[812]

9.3.5 *Recommendations Generally*

This book recommends a range of strategies for consideration in the design of national tax laws[813] and tax treaties.[814] The diversity of national

[808] See Section 3.2.4 concerning inbound taxation of beneficiary-attributed DIR income associated with a trust-level taxable presence.

[809] See Section 3.2.5.

[810] See Sections 8.3.2, 8.3.3 and 8.3.4.

[811] See Section 8.3.10.

[812] See Section 8.3.11.

[813] The principal strategies which this book recommends for consideration in tax design are set out below with cross-references to corresponding text:

Distributions from non-resident or formerly non-resident trusts, taxation of: Chapter 5; Sections 7.3.3; 9.2.1.4; 9.2.2.5; 9.3.3.
Double tax relief where a different taxpayer is liable to the foreign tax: Sections 6.1.3; 7.3.6; 9.2.1.5; 9.2.2.2; 9.2.2.3; 9.2.2.4; 9.3.2.2; 9.3.2.3; 9.3.2.4.
Grantor attribution, general: Sections 2.1; 2.3; 7.3.3; 9.2.1.2; 9.3.1.2.
Grantor attribution, outbound: Sections 2.5; 2.6; 7.2.2.1; 7.3.4; 9.2.1.2; 9.3.1.2.
Grantor attribution, selective switch-off for non-residents: Sections 2.4; 9.3.1.2.
Internal coherence (trust rules and international rules): Sections 3.2.4; 3.2.5; 3.2.6; 3.4; 9.2.1.6; 9.3.4.
Taxable presence of trust, attribution to beneficiary: Sections 3.2.4.5.
Trust residence and attribution, defensive: Sections 7.2.2.2; 7.3.4; 9.2.1.1; 9.3.1.3.
Trust residence, grantor-based: Sections 4.2.4; 4.4; 4.5; 9.3.1.1.
Trust residence, wide definition: Sections 4.2.1; 4.5; 9.3.1.1.

[814] The principal strategies which this book recommends for consideration in treaty design are set out below with cross-references to corresponding text:

Beneficial ownership of income generally to follow residence–country attribution: Sections 8.3.11; 9.3.4.

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approaches to trust taxation, the fact that many countries do not recognize trusts in their general law and the principles of fiscal sovereignty have dictated an approach that recognizes the inevitability of continuing differences between national tax laws with respect to trust-related income and that seeks to build incrementally on existing structures in national laws and current treaty practice.

9.4 Conclusion

This book has demonstrated a complementary policy relationship from the viewpoint of a single taxing country in the current taxation of trust income between grantor attribution (both general and outbound), beneficiary attribution and trust residence and attribution. It has shown that this complementarity extends also to the taxation of resident beneficiaries on international trust distributions insofar as they may represent previously untaxed foreign-sourced income.

Current attribution and taxation of trust income occupies the main ground in the international taxation of trust-related income. Mismatches in those settings are shown to be a major cause of unintended international non-taxation, and hence of opportunity for arbitrage, or international double taxation of trust income. The book has identified a case for countries to act cooperatively, and not only for the protection of their own tax bases, to prevent or neutralize trust-based tax arbitrage. It has proposed a method by which countries may approach that goal while also seeking to avoid inappropriate double taxation. At a high level of generality, the method involves recognition and consideration of those attribution and taxing strategies which can be applied where the relevant trust has international features and consideration of the proper order of priority that should apply between them. Bearing in mind the

Definition of person, inclusion of trust in: Sections 8.2.1.
Definition of residence, alignment with functional trust residence: Section 8.2.2.
Derivative treaty rights, need for domestic procedure to assert: Section 8.3.9.
Double tax relief article, extension to residence-residence attribution conflict cases: Sections 8.3.13; 9.2.2.4; 9.3.2.2; 9.3.2.4.
Grantor attribution rules in either country, need for express consideration: Sections 8.3.7; 9.3.1.2; 9.3.2.2.
Internal coherence of treaties: Sections 8.3.2, 8.3.3, 8.3.4 (transparent entity clause); Section 8.3.10 (business and PE); Section 8.3.11 (beneficial ownership); Section 9.3.4.
PE and business attribution to follow income attribution: Sections 8.3.10; 9.3.4.
Saving clause: Sections 8.3.5; 9.3.1.
Transparent entity clause: Sections 8.3; 9.3.1.

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considerable differences that exist between national approaches to the taxation of trust-related income, the fiscal sovereignty of each country, and the balancing of policy issues that is involved in prioritizing taxing claims, the method is presented as a guide and not a prescription. Differences of approach are inevitable, particularly in relation to the conditions on which one country may yield priority to the taxing claim of another. There is nevertheless clear headway to be made, both in the rationalization of national taxing laws and in the design of tax treaties. The recent inclusion of a fiscally transparent entity clause in the OECD Model provides a useful framework for the adjustment of international taxing claims in relation to trust income without facilitating unintended non-taxation.

International taxation of trust distributions is also within the scope of the proposed method. The main issues in that area relate to the recognition of underlying trust income and underlying taxation of trust income, both of which are treated as questions for the national law of the beneficiary's country.

A grantor capitalizes a trust voluntarily and for his or her own purposes; trustees derive income; the beneficiaries – or some of them – will eventually receive the proceeds. The interaction of the potential taxing claims of the respective residence countries and of the source countries of its income mark the trust as the most challenging of fiscally transparent entities. The challenge, which this book has sought to answer, is to make visible the range of realistically possible tax claims and their interactions in a way that facilitates the development of strategies to avoid harmful outcomes of international non-taxation and double taxation.

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Appendix

Detail of Beneficiary Attribution and Taxation

This appendix presents a comparative account of particular tax settings in the surveyed countries concerning the attribution of trust income to beneficiaries and the taxation of beneficiary-attributed income. Each section of this appendix considers a different topic, and addresses the relevant tax settings of each country separately. Conclusions based on these findings are collated and presented at corresponding points in Chapter 3.

Section A.1 considers the general beneficiary attribution rules applicable to trust income generally and to trust-level capital gains. These are the rules that apply in purely domestic situations and, unless modified, in international ones. The findings of this section support comparative analysis in Section 3.1.

Section A.2 considers inbound tax settings relating to business income of a trust that is attributed to a non-resident beneficiary. It addresses the basic claim to tax and the availability or otherwise of unilateral double tax relief by foreign tax credit – an issue that may arise if the trust derives foreign-taxed income through a local business. This supports Section 3.2.2.

Section A.3 considers inbound tax settings for DIR trust income attributed to a non-resident beneficiary. For each country, it addresses general inbound DIR tax settings and their interaction with inbound tax settings for trust beneficiaries. The findings of this section support Section 3.2.4.

Section A.4 considers how the identity of taxpayer requirement for foreign tax credit may be relaxed in a trust context. This is only relevant to Australia and the United States. The findings of this section support Section 3.3.3.

A.1 General Attribution

A.1.1 United Kingdom

A.1.1.1 Income Tax

In the absence of clear statutory rules, the governing principles of UK trust income attribution and taxation were developed by the courts as a practical

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accommodation between tax law and trust law.[815] Most of the foundational principles were settled in the 1920s. The United Kingdom had restricted remittance basis taxation for non-domiciliary residents in 1914, and income tax rates increased significantly to pay for the war. These events flushed out many issues that had previously lain dormant or not existed at all. Although statute law was not entirely silent on the subject, it was largely left to the judges to work out how the tax system should apply to trusts. The resulting judge-made rules created a paradox which remains at the heart of UK trust taxation. Trustees are generally chargeable with tax on trust-level income because they are persons who receive or are entitled to it,[816] but a beneficiary who has an indefeasibly vested[817] equitable right in possession to particular trust income as it arises in the trust[818] is also chargeable on the basis of receipt or entitlement. The paradox is solved by treating the trustees as taxable on behalf of the beneficiary and, therefore, only if the beneficiary is within the claim to tax.[819] From a UK tax perspective, the beneficiary's interest 'renders the trust

[815] The judge-made rules have been described as 'sensible efforts to adapt the tax system to the trust': Loutzenhiser, n 53, §29.1.

[816] *Reid's Trustees* v *IRC* [1929] SC 439; 14 TC 512; cf *Williams* v *Singer* [1921] AC 65, 71, 72. The precise statutory criteria that identify the person liable for tax vary between categories of income. The commonest formula imposes liability on 'the person receiving or entitled to' the chargeable item (see, e.g., ITTOIA ss 8, 271, 371, 385(1)(b), 404, 425, 554, 581, 611, 616, 685, 689). The 'receiving' limb of this formula has been regarded as sufficient to catch trustees, notwithstanding that equitable entitlement to particular income may belong to a beneficiary: see Avery Jones, *Beneficial Ownership*, n 696. There are other criteria in other provisions (e.g., ss 385(1)(a), 413, 417, 429, 659), many of which may equally point to trustees.

[817] A vested but defeasible interest is insufficient to support beneficiary attribution – for example, an accumulation of trust income which is vested in a particular beneficiary subject to a condition subsequent, such as the beneficiary reaching a particular age: *Stanley* v *IRC* [1944] KB 255. On the subject of vested rights, see Loutzenhiser, n 53, §29.3.2.1.

[818] *Baker* v *Archer-Shee* [1927] AC 844. This now also includes indefeasibly vested income that the beneficiary cannot demand until a future date, such as the attainment of majority: Loutzenhiser, n 53, §29.3.3.1.

[819] The particular resolution of the attribution issue may be gleaned from the speech of Viscount Cave in *Williams* v *Singer* [1921] AC 65, 73: 'In short, the intention of the Acts appears to be that where a beneficiary is in possession and control of the trust income and is sui juris, he is the person to be taxed; and that while a trustee may in certain cases be charged with the tax, he is in all such cases to be treated as charged on behalf or in respect of his beneficiaries, who will accordingly be entitled to any exemption or abatement which the Acts allow.' See also *Baker* v *Archer-Shee* [1927] AC 844; *Reid's Trustees* v *IRC* [1929] SC 439; 14 TC 512, SC 447; *Kelly* v *Rogers* [1935] 2 KB 446. Trustees are treated as being taxable (or non-taxable) on behalf of beneficiaries who satisfy the criteria for attribution. Loutzenhiser, n 53, §29.2.2.2, regards the dependency of trustee liability on beneficiary liability as an exception 'which cannot be said to be firmly grounded' to a general rule of trustee liability that disregards the personal

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transparent because as a matter of UK trust law it gives the income beneficiary an entitlement to trust income (allowing one to look to the underlying assets and income of the trust for the purposes of assessment)'.[820] Tax paid by the trustees is consequently creditable to the beneficiary.[821] This situation should therefore be recognized as one of beneficiary attribution, rather than mixed or dual attribution.

Whether a beneficiary has such an interest in possession depends on the proper law of the trust. The law of trusts of England and Wales recognizes that a beneficiary may have such an interest in particular trust income; this is also the position in Australia and New Zealand. But some significant trust jurisdictions, including Scotland, New York and a number of other US states, give the beneficiary a comparable level of legal protection without conceiving that a beneficiary may have an equitable proprietary interest in particular trust assets. UK tax law treats this distinction as important, and only applies beneficiary attribution if the proper law of the trust characterizes the beneficiary's interest in the requisite way.[822] An exception is made for UK-resident Scots-law trusts, which are treated on this point as if they were English.[823] This pragmatic accommodation highlights the difficulty of finding a policy basis for the general requirement as a condition of beneficiary attribution that the proper law of the trust include a doctrine of equitable title.

UK beneficiary attribution of an item of tax-law income of a trust is treated as a logical corollary of the beneficiary having a particular trust-law entitlement to that item. The fiscal characteristics of an item of income as derived by the trust, including source, are retained in the hands of the beneficiary without the need for an express character-retention rule. It also follows that an item of purely deemed tax-law income which is not recognized by trust law is incapable of beneficiary attribution.

The relatively limited scope of UK beneficiary attribution is balanced by a wider rule of beneficiary taxation on trust distributions, resulting in two layers of taxation and related provisions for double tax relief (Section 5.2).

Trust-level depreciation and losses (which may be generated in relation to business or property rental income) are recognized as being available to an interest-in-possession beneficiary in reduction of attributed income,[824] but there is no provision for a trust-level loss to be passed on as such.

circumstances of the beneficiary (§29.2.1.1). Be that as it may, the trustees are not treated as taxable if the attributable beneficiary is not.

[820] Malcolm Gammie, 'The Origins of Fiscal Transparency in UK Income Tax' in John Tiley (ed), *Studies in the History of Tax Law* vol 4 (Hart, 2010) 33, 52, discussing the effect of *Baker* v *Archer-Shee* [1927] AC 844.

[821] See TSEM 3765 (at 27 December 2017).

[822] *Archer-Shee* v *Garland* [1931] AC 212.

[823] ITA UK s 464.

[824] TSEM 3772 and 3773 (at 27 December 2017).

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A.1.1.2 Capital Gains Tax

UK capital gains tax treats trusts as fiscally opaque. Trust-level gains are attributed to the trust itself, and tax liability falls on the trustees at the upper capital gains tax rate; there is no further tax on a corresponding distribution to a beneficiary.[825]

This setting reflects the practical realities that operate during most of the lifespan of a trust unless it has reached the end of that life and is being wound up or distributed: first, trust-level gains are usually retained within a trust and reinvested; secondly, in the case of a donative trust, it is unusual to be able to identify a beneficial owner or recipient of a trust-level capital gain at the time when the gain is realized.

A.1.2 United States

A.1.2.1 Income Generally

The US rules for taxing non-grantor trust income reflect three primary ideas: first, the trust is treated as a person[826] with tax liability for its income;[827] secondly, the trust is recognized as a conduit by which beneficiaries derive the trust-level income to the extent that it is distributed or sufficiently allocated to them;[828] thirdly, gifts are not income.[829] Tension between the first two ideas is resolved by a complex tax accounting mechanism adopted in the 1954 revision of the *Internal Revenue Code*. The primacy of the conduit principle taxation is achieved by giving the trust a deduction[830] for distributions and equivalent entitlements ('distribution deductions') and by treating the corresponding trust income as tax-law income of the respective beneficiaries.

An important goal of the new accounting mechanism was to avoid the need to trace particular items of trust income into beneficiary entitlements and distributions, which had generated undesirable complexity under the previous Code. The new system was intended to simplify the process while retaining the conduit principle and the attribution of entity-level income to

[825] Regarding trust tax rates, see TCGA s 4(3); Loutzenhiser, n 53, §40.1.2.2. Distribution taxation may apply if the beneficiary is resident and the trust non-resident, but not by reference to gains that have already borne UK taxation. See Section 5.3.5.

[826] IRC s 7701(a)(1).

[827] IRC s 641(a).

[828] IRC ss 652, 662.

[829] IRC s 102 provides that '[g]ross income does not include the value of property acquired by gift, bequest, devise, or inheritance', but not so as to exclude income from such property or a gift, etc, of income from property.

[830] IRC ss 651, 661.

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beneficiaries.[831] The present regime is descended from the 1954 rules, and may be seen as a modified and somewhat formularized system of tracing.[832]

The mechanism is organized around 'distributable net income' (**DNI**),[833] which serves as an upper limit on distribution deductions for a trust and on the attribution of its tax-law income to beneficiaries. DNI is essentially the net taxable income of the current year,[834] subject to a number of modifications which affect the potential attribution of trust-level income to beneficiaries. Any excess of distributions, etc, over DNI is regarded as a gift, and therefore not income of a beneficiary. The trust is only left with taxable income if DNI exceeds distributions (e.g., by accumulating income) or if particular tax-law income is excluded from DNI. There is, clearly enough, no capacity for trust-level losses to be attributed to a beneficiary. The formulary nature of the mechanism sometimes produces anomalous results.[835]

Trust income is attributed by a tiered process which consumes DNI as it goes along. The first tier of the process attributes income to beneficiaries up to the level of the trust-law income that is required to be distributed currently,

[831] Holland et al., n 64, 317–321, 329–339 and passim; Stanley S Surrey and William C Warren, 'The Income Tax Project of the American Law Institute: Partnerships, Corporations, Sale of a Corporate Business, Trusts and Estates, Foreign Income and Foreign Taxpayers' (1953) 66 *Harvard Law Review* 1161, 1192; Sherwin Kamin, Stanley S Surrey and William C Warren, 'The Internal Revenue Code of 1954: Trusts, Estates and Beneficiaries' (1954) 54 *Columbia Law Review* 1237, 1240, 1242, 1246 ff; Alex Evans, 'The "Economic Benefits Model" for Trusts – Fool's Gold?' (2014) 43 *Australian Tax Review* 162, 171–173, 181–182. References in the Code to amounts distributed, etc, do not imply that the distribution itself is income of the beneficiary.

[832] It was recognized at the time of the revision that 'any tracing rule involves a statutory grant of authority to the trustees to dictate, to some extent, the tax consequences of a distribution': Kamin, Surrey and Warren, n 831, 1242. This suggests that the formulary aspects of the tax accounting system may also serve an anti-avoidance purpose.

[833] IRC s 643(a)(3).

[834] The capping of DNI by reference to current trust income indicates an important difference between the distribution deduction system and a corporate dividend deduction system. The present US trust rules assume that, in a domestic situation, current trust income will be finally taxed only once and in the current year, whether to the trust or to its beneficiaries.

[835] In *Brigham* v *US*, 160 F 3d 759 (1st Cir, 1998) a widow elected to receive a statutory one-third share of her husband's estate (to which the DNI rules applied) in lieu of provision under his will. His executors made payments in the subject years on account of the principal of her elected share which, as it happened, exceeded DNI. There were evidently no other distributions, and she was held taxable on estate income equal to the amount of DNI. The result was anomalous because the widow ended up paying tax on income that benefited the whole estate. An anti-avoidance aspect of the rule (see n 832) simply misfired in the particular case.

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whether actually distributed or not.[836] If the trust is required to distribute all its current income (even if a discretion may be exercised as to its destination) and makes no capital distributions in a particular year, it is described as a simple trust for that year and only the first tier is engaged. Otherwise, if there is DNI left over, the second tier of the process attributes income to beneficiaries up to the level of 'any other amounts properly paid or credited or required to be distributed' for the relevant year.[837] This expression is apt to cover discretionary distributions and distributions of corpus. Actual payment is not required, but the beneficiary must at least have a right to demand payment.[838]

Specific non-discretionary gifts are excluded entirely from the process.[839] Additionally, if substantially separate and independent shares of different beneficiaries are present in one trust, they are treated as if they were separate sub-trusts for the purposes of attribution and distribution deduction.[840]

The principles for attributing particular items to particular beneficiaries differ between the first and second tiers:

- At the first tier, specific allocation of different income classes to different beneficiaries by the terms of the trust or applicable trust law are respected in the corresponding fiscal attribution. Otherwise, all items are attributed

[836] IRC ss 651(a), 661(a)(1); cf 26 CFR ss 1.652(b)-2, 1.662(b)-1 referring to 'local law' (i.e., applicable trust law).

[837] IRC s 661(a)(2). The trust or estate has an elective period of 65 days into the next fiscal year to complete the 'paid or credited' process: s 663(b).

[838] Case law establishes that a mere book entry is not sufficient for an amount to be properly credited or required to be distributed to a beneficiary: 'The income must be so definitively allocated to the [beneficiary] as to be beyond recall . . . If the fiduciary's accounts be stated inter partes, that would probably be enough . . .' (*CIR* v *Stearns*, 65 F 2d 371 (1933), 373); the income must be 'received constructively' by the beneficiary, it must have 'become so far subject to the [beneficiary's] demand that its nonreceipt is a matter of his own choice' (*Lynchburg Trust & Savings Bank* v *CIR*, 68 F 2d 356 (4th Cir, 1934), 359). Australian readers will recognize a degree of similarity with the concept of a beneficiary's present entitlement to trust income. The widespread Australian practice of building up large unpaid entitlements in a trust does not appear to be common in the United States. There is a question whether a US court would disregard a beneficiary's entitlement to a large unclaimed balance as a sham (as that term is understood in US tax law) or as lacking economic substance, particularly if it is not accruing interest or any other return.

[839] IRC s 663(a) excludes any gift under the terms of the governing instrument of a specific sum of money or specific property that is paid or credited all at once or in no more than three instalments and is not required to be paid from the income of the trust or estate from distribution deductions (s 661(a)) and from beneficiary income for tax purposes (s 662(a)).

[840] IRC s 663(c).

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proportionately. If the quantum of trust-law distribution is less than DNI, beneficiary attribution of all tax-law items abates rateably.[841]

- The attribution and allocation of second tier items generally proceeds proportionately. The same principles apply,[842] but second tier items are, by their nature, not specifically mandated. Discretionary appointments of income or corpus consequently attract formulary apportionment of income for tax purposes.

Character retention consistently applies to those items of trust income which are attributed to beneficiaries.[843] It follows that trust income is attributed with its fiscal characteristics to and among beneficiaries by reference to a combination of trust-law entitlements (particularly relevant to those with vested or fixed entitlements) and proportionate formulary apportionment (particularly relevant to discretionary appointments).

In a domestic context, beneficiary-attributed income is taxable to the beneficiary by assessment in the usual way. The trust must make a return, but is not involved in liability or collection.

A.1.2.2 Capital Gains

Capital gains of a trust are recognized as tax-law income, but are generally excluded from DNI of a domestic trust if they are on trust-law capital account unless they are paid, credited or required to be distributed to a particular beneficiary in the same year.[844] Gains may be recognized at the level of the trust by conventional sale or, in some circumstances, by distribution of an appreciated asset.[845]

The general result of non-exclusion of capital gains from DNI is that such gains are attributed to the trust and not to beneficiaries. Conversely, those gains which are paid, etc, in the year of realization participate in the DNI

[841] IRC ss 652(b), 662(b); cf s 661(b). Section 643(b) relevantly defines the unqualified term 'income' by reference to the terms of the governing instrument of the trust and applicable local law (i.e., trust law).

[842] IRC ss 661(b), 662(b).

[843] IRC ss 652(b), 662(b), which stipulate that attributed entity-level income 'shall have the same character in the hands of the beneficiary as in the hands' of the estate or trust.

[844] IRC s 643(a)(3), (contrast s 643(a)(6)(C) regarding foreign trusts). Some gains destined for charity are also excepted from DNI exclusion.

[845] See Zaritsky, Lane and Danforth, n 295 (at 27 December 2017) [4.11]. The applicable rules are relatively complex. Specific gifts mandated by the terms of the trust generally result in a pure rollover to the beneficiary with no trust-level gain or loss (IRC ss 643(e)(4), 663(a)(1)). Other distributions generally result in the recognition of a capital gain in the trust as if on market value sale; if that would result in a loss, in some situations the loss is recognized in the trust, while in others the original cost base is rolled over to the recipient beneficiary.

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accounting process described earlier and are generally dealt with at the second tier of that process. The precise attribution of any particular gain depends on the matrix of DNI, mandatory and permissive distributions, etc, during the year, and the interplay between fixed trust-law rights and the proportionate statutory formula of attribution. In a broad sense, if the participants in a trust want to ensure that trust gains are attributed to beneficiaries rather than to the trust, they generally need to ensure that those gains are realized and distributed, etc, in the same year.

The US approach is more complex and more technical than the UK approach, and possibly more nuanced. If gains are realized and retained in the trust, they are attributed to the trust. But when the time comes for the assets of a trust to be realized and/or distributed, capital gains that are recognized in that process can (with reasonably careful management) be attributed to beneficiaries. The precise attribution of those gains and other second-tier income among multiple beneficiaries may be affected by the proportionate allocation formula and may differ from the trust-law allocation of corresponding items.

A.1.3 Australia

A.1.3.1 Income Generally

The general Australian trust taxing rules[846] attribute the tax-law income of a trust to its beneficiaries by reference to the proportion of trust-law income earmarked for or appointed to them in the relevant year.[847] For a given year, the net worldwide tax-law income of a trust is described as the 'net income of the trust estate'.[848] Subject to special streaming rules for capital gains and franked dividends, considered in this section and the following section, this tax-law income is attributed to beneficiaries in proportion to their present entitlements to trust-law income, and taxation is imposed to the extent that the income is attributable to a period of beneficiary residence, or to a period of beneficiary non-residence and sources in Australia.[849] If there is any trust-law

[846] ITAA 1936 Part III Div 6.

[847] ITAA 1936 ss 97, 98A, 100.

[848] ITAA 1936 s 95(1). A small number of modifications apply, such as the exclusion of loss deductions where losses fall exclusively on corpus and the relevant beneficiary is only a life tenant. The Australian concept of net income of a trust estate is not equivalent to the US concept of distributable net income/DNI. The functions they perform are significantly different.

[849] The attribution criteria and jurisdictional limitations are embedded and repeated in combination in each of the taxing rules. See ITAA 1936 ss 97, 98, 98A, 100. Thus, in s 97 (1)(a): '(1) Subject to Division 6D [relating to inadequate trustee beneficiary statements in relation to closely held trusts], where a beneficiary of a trust estate who is not under

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income to which no beneficiary is presently entitled, a corresponding proportion of tax-law trust income is attributed to the trust.[850] The method of the general rule involves two distinct stages: first, the calculation of each beneficiary's proportionate share and the trust's residual share of trust-law income by reference to the concept of present entitlement; secondly, the attribution and allocation of tax-law income in the proportions calculated at the first stage.

Present entitlement primarily connotes a present legal entitlement to require the trustees to pay over the income in question,[851] determined as at the end of the income year,[852] and extends by implication to include the interest of a beneficiary who would have such an entitlement, but for legal disability.[853] There are also explicit statutory extensions.[854] A beneficiary is deemed to be presently entitled to current trust law income that is paid to the beneficiary or applied for his or her benefit by exercise of the trustees'

any legal disability is presently entitled to a share of the income of the trust estate: (a) the assessable income of the beneficiary shall include: (i) so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was a resident; and (ii) so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was not a resident and is also attributable to sources in Australia'. Section 98, which imposes initial tax liability on trustees on behalf of (mainly) non-resident or legally disabled beneficiaries, has similar wording. Other provisions refer to the 'individual interest of the beneficiary' in the exempt income (s 97 (1)(b)), the non-assessable non-exempt income (s 97(1)(c)) or the net income (ss 98A, 100) of the trust estate. It would make sense to interpret this in ss 98A and 100 (which stand behind s 98 and impose ultimate liability on the beneficiary) in a similar sense, connoting the share of net income corresponding to the beneficiary's presently entitled share of the income of the trust estate, although that meaning is not available in s 97(1) (b) (as to which see *FCT* v *Australia and New Zealand Savings Bank Ltd* (1998) 194 CLR 328) or s 97(1)(c) because exempt income and non-assessable non-exempt income are not part of the net income of a trust estate (s 95(1)).

[850] ITAA 1936 ss 99, 99A. Exceptionally, it may be that foreign-sourced items of purely notional tax-law income which cannot in themselves be the subject of present entitlement or form part of trust-law income, to the extent that they are not attributed to resident beneficiaries, will be attributed and taxable to a resident trust. See the references to present entitlement in ss 99(2)(c), (3)(c), 99A(4)(c), (4A)(c) which, in contrast to such references elsewhere in Div 6, appear to relate to tax-law income rather than trust-law income. If so, Australian taxation may apply to income attributed to a resident trust as the grantor of a non-resident trust, notwithstanding that all its presently entitled income beneficiaries for the current year are non-resident. The writer is grateful to Daryn Moore for drawing attention to this point.

[851] *FCT* v *Whiting* (1943) 68 CLR 199. For the provenance of the statutory expression see Alex Evans, 'The Legislative Origins of Present Entitlement in Australia' (2011) 40 *Australian Tax Review* 235.

[852] *Harmer* v *Federal Commissioner of Taxation* (1991) 173 CLR 264.

[853] *Taylor* v *FCT* (1970) 119 CLR 444; cf ITAA 1936 ss 98, 100.

[854] ITAA 1936 ss 95A and 101, discussed later.

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discretion.[855] Present entitlement is consequently established by vested rights of a beneficiary to trust income as it arises or by trust income being paid to or applied for the benefit of a beneficiary in the current year by the trustees' discretionary appointment. The irrevocable appointment of income is sufficient.[856] A discretion must be exercised within the income year if it is to support a present entitlement,[857] although its dollar value may not be known until the accounts are finalized. In each of these situations, present entitlement is determined by direct reference to trust-law principles.

The full ramifications of treating discretionary appointments in the same way as vested income may not have been appreciated when the statutory rule was adopted,[858] but it is now a deeply entrenched feature of Australian trust taxation.[859] Discretionary trusts are accepted as a lawful means of fiscally

[855] ITAA 1936 s 101. Discharge of an entitlement by payment does not matter: s 95A(1). There is also a simplified rule in s 95AB for 'special disability trusts' which provide for the care of a disabled primary beneficiary and a special rule in s 95A(2) designed to cater for injury compensation trusts (explained by Alex Evans, 'Dispelling the Urban Myth around s 95A(2)' (2012) 42 *Australian Tax Review* 173).

[856] See *Re Vestey's Settlement* [1951] Ch 209; *IRC (NZ)* v *Ward* (1969) 1 ATR 287; *Chianti Pty Ltd* v *Leume Pty Ltd* (2007) 35 WAR 488; *Fischer* v *Nemeske Pty Ltd* (2016) 257 CLR 615.

[857] *Colonial First State Investments Ltd* v *FCT* (2011) 192 FCR 298. For a contrary view, see Andrew Mills, 'Trusts Update: What the ATO Thinks and Why You Should Care' (Paper presented at the Taxation Institute of Australia, Western Australia State Convention, Bunker Bay, WA, 22 August 2013); Mark L Robertson, 'Discretionary Trusts: An Illusory Problem' (1996) 5 *Taxation In Australia, Red Edition* 19.

[858] The rule had been present in ITAA 1922 as s 31(4) and was repeated in the original text of ITAA 1936. The intervening Royal Commission recommended its continuance without discussion, which suggests that the authors identified no issue of policy beyond simple neatness (*Ferguson Report*, vol 3 [710], [719]). (The original Commonwealth income tax in 1915 had not distinguished between distributions under fixed entitlement and discretionary distributions either, but took a different structural approach. It taxed trustees on trust income (ITAA 1915 s 26) subject to proportionate reduction of tax for distributions to beneficiaries (s 27(2)).) The drafters of the 1936 Act would not have foreseen the evolution of modern discretionary trusts in the last quarter of the twentieth century into a device for splitting income from family businesses and investment. The more obvious application of discretion in the 1930s related to testamentary trusts and inter vivos settlements with powers of advancement for infants and other beneficiaries not able or not trusted to manage wealth intended for their benefit.

[859] Of 823,488 trusts that lodged 2015 tax returns, 642,416 (78%) were discretionary trusts: Australian Taxation Office, *Taxation Statistics 2014–2015* (2017) Trusts – Table 4.1. A further 8,970 (1%) were described as 'hybrid' trusts – in a domestic Australian context, this term usually connotes a unitized trust, the income of which can nevertheless be allocated on a discretionary basis. It may be surmised that tax treatment plays a significant causal role in these statistics.

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effective income splitting within a family and its associated entities[860] and avoiding the higher tax rates that apply to trust-attributed income. The strategy is not unconstrained, but the chief constraints are not trust-specific.[861] Actual payment to the beneficiary is not required, and it is common in practice for discretionary trusts (in particular) to be heavily capitalized by unpaid present entitlements from earlier years.

A particular difference between the US deduction system and the Australian proportionate system emerges where tax-law income differs from trust-law income. Assume for simplicity that trust-law income is fully distributed or subject to present entitlement: if trust-law income exceeds tax-law income, both systems attribute only the tax-law income to beneficiaries; but if tax-law income is greater, the US rule caps beneficiary attribution at the amount of trust-law entitlements and distributions and attributes the excess to the trust, while the Australian rule attributes the whole tax-law income to the beneficiaries. The Australian approach more strongly favours a pass-through of tax to the beneficiaries.

The Australian rule accepts character retention. To the extent that tax-law trust income is attributed to a beneficiary, it retains its original, trust-level fiscal characteristics.[862] The attribution of particular items to or among particular beneficiaries under the general rule is purely proportionate; it is not influenced by their trust-law entitlements to specific income items.[863] The

[860] See, e.g., Australia, *ANTS*, n 98, 105, 113, 115, proposing that income splitting through trusts be preserved. (Although the government's proposed changes to trust taxation were not implemented, the use of trusts for income splitting was recognized and condoned.) A common strategy is to appoint trust income to individuals on low marginal rates and/ or to a corporate beneficiary as a 'bucket company' (the corporate tax rate being well below the top personal rate). Cash not required for personal use or other purposes of the beneficiaries is frequently left in the hands of the trustees as an unpaid present entitlement. Unpaid present entitlements are often an important source of working capital for closely held businesses conducted through trusts.

[861] ITAA 1936 Part III Div 6AA applies the top marginal tax rate to children's income from most non-testamentary sources; this captures most income of an inter vivos trust attributed to a minor beneficiary. In broad terms, the rules target non-testamentary sources of income of the kind that would otherwise be obvious candidates for income splitting, including most income from inter vivos trusts. Less significantly, the personal services income rules in ITAA 1997 Part 2-42 (Divs 84 to 87) allocate a class of quasi-employment income to the individual whose labour produces it. These rules have relatively little impact on business income, even if it reflects a large component of labour value. Older and more general principles prevent purely personal income of a grantor from being treated as trust income; see *Leighton* v *FCT* (2011) 84 ATR 547, 556; *FCT* v *Everett* (1980) 143 CLR 440, 452; *Stewart Dawson Holdings Pty Ltd* v *FCT* (1965) 39 ALJR 300, 301.

[862] *Charles* v *FCT* (1954) 90 CLR 598.

[863] *Colonial First State Investments Ltd* v *FCT* (2011) 192 FCR 298. This follows from the proportionate method of attribution recognized in *Zeta Force Pty Ltd* v *FCT* (1998)

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result resembles proportionate attribution at the second tier of the US DNI mechanism.

The dividend streaming rules, as they are called, override the general attribution rule and allow the trust-law appointment of specific dividend income with attached Australian imputation credits ('franked distributions') to be recognized for tax purposes.[864] They deliberately facilitate discretionary allocation of such dividends to those beneficiaries who can make best fiscal use of credits attached to them.

In most domestic situations, beneficiary-attributed income is taxable to the beneficiary directly[865] and the only role of the trust is to file an information return. If the beneficiary is an infant or otherwise under legal disability or is non-resident at the end of the tax year,[866] however, tax is imposed in the first instance on the trustees by reference to the beneficiary's characteristics[867] and the beneficiary is taxable with credit for trustee taxation.[868] As far as the internal administration of the trust is concerned, tax paid by the trustees is debited to that beneficiary.[869] The inference that the trustees are taxed on

84 FCR 70 and *FCT* v *Bamford* (2010) 240 CLR 481 and the absence of any other tracing rule.

[864] ITAA 1997 Sub-div 207-B; ITAA 1936 Part III Div 6E (esp s 102UX). Franked distributions are attributed by reference to the 'specific entitlement' of beneficiaries (see n 876 – a similar concept is used for streaming of capital gains); present entitlement to trust-law income is only consulted to the extent that specific entitlements do not account for a particular franked distribution. Imputation credits reflect prior Australian taxation of the company concerned.

[865] ITAA 1936 s 97(1).

[866] The tax treatment of a non-resident beneficiary properly belongs to inbound beneficiary attribution (Section 3.2). The subject is adverted to here because of its assimilation in significant respects to the treatment of beneficiaries under legal disability.

[867] ITAA 1936 s 98. Taxation applies at progressive rates as for a resident or non-resident individual beneficiary without regard to the beneficiary's other income, or at the corporate rate for a non-resident corporate beneficiary. Rates are prescribed by the *Income Tax Rates Act 1986* (Cth).

[868] ITAA 1936 s 98A (non-resident beneficiary), s 100 (beneficiary under disability); cf n 849. A resident beneficiary under disability with no other income has no separate s 100 liability.

[869] As a matter of trust law, tax imposed under ITAA 1936 s 98 on or by reference to the characteristics and trust-law entitlements of a beneficiary should be seen as a burden personal to that beneficiary. This is reinforced by the existence of a corresponding personal liability in the beneficiary under s 98A or s 100. It has the effect of giving equal treatment to unmediated beneficiary liability and attribution under s 97 and mediated attribution and liability via s 98. Anomalies in the tax-law attribution of trust income and allocation of tax burdens are allowed to lie where they fall. Any other approach that might attempt to rearrange the trust-law burden of tax-law liabilities under s 98 seems indefensible in principle as well as practically unworkable. It may be

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behalf of the particular beneficiary (not the trust as a whole) is confirmed by legislative history and extrinsic parliamentary material.[870]

If one trust has another as its beneficiary, the attribution of current trust income may have to be traced through multiple trust layers by repeated application of the attribution rules. The phenomenon is significant in Australia,[871] although it does not appear to be so in the other surveyed countries. In purely domestic situations with full information[872] and legally competent beneficiaries, trust income may be attributed through any number of intermediate trusts to an ultimate beneficiary without any tax being payable by a trustee. If an intermediate trust is offshore, tax may be provisionally collected at the border.[873]

Trust losses are important in Australia because trusts are commonly used as business entities. Non-capital tax-law losses are generally carried forward within the trust for application against future income, subject to complex integrity measures against trading in trust losses.[874]

conceded, however, that the references to 'individual interest' in ss 98A and 100 instead of the form of words in s 97(1)(a) create interpretive difficulties: see n 849.

[870] ITAA 1936 s 98 as originally substituted in the 1979 rewrite of Div 6 only dealt with entitlements of beneficiaries under legal disability (*Income Tax Assessment Amendment Act 1979* (Cth) s 13). Contemporaneous parliamentary material referred to the 'beneficiary's share' of the net income of the trust estate (Explanatory Memorandum, Income Tax Assessment Amendment Bill (No 5) 1978 (Cth) note to cl 13). Non-resident beneficiaries were still taxed directly under s 97 until 1983, when trustee taxation on behalf of beneficiaries who were non-resident at year end and the corresponding s 98A beneficiary tax and credit were enacted (*Income Tax Assessment Amendment Act 1983* (Cth) ss 17, 18, 19). The change was made to overcome difficulties of collection (Explanatory Memorandum, Income Tax Assessment Amendment Bill 1983 (Cth), note to cl 17) and the trustees' s 98 tax liability was explained as being on behalf of the particular beneficiary (notes to cll 18, 19).

[871] The importance of nested trusts is primarily domestic. Income shifting between trusts (particularly discretionary ones) serves as a self-help form of tax consolidation. It also increases the difficulty of an audit.

[872] Default top-rate taxation applies if a closely held trust with trustee beneficiaries does not provide the information necessary to identify the next link in the attribution chain (ITAA 1936 Part III Div 6D).

[873] The tax and credit provisions are modified where income is traced through a chain of trusts and one of the intermediate trusts has a non-resident trustee at year end: see ITAA 1936 s 98(4), s 98B and related provisions. In broad terms, if income of a trust is attributed to another trust as beneficiary and the beneficiary trust has a trustee who is non-resident at year end, tax is collected at the border at the top personal rate but remains creditable for the benefit of an ultimate beneficiary. This feature limits the fiscal attraction of cross-border multilayered trust structures. It serves as an integrity measure in round-trip situations (Section 3.3.4).

[874] ITAA 1936 Sch 2F. (The definition of net income in s 95(1) also precludes an income beneficiary with no interest in capital from taking the benefit of carried forward losses.)

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A.1.3.2 Capital Gains

Australia has struggled to find a satisfactory way of dealing with the fiscal attribution of capital gains derived by trusts. When capital gains were included in the income tax base in 1986, the rule for attributing trust income was left unchanged. Currently realized capital gains were consequently attributed in proportion to present entitlements to trust-law income, even if the income beneficiaries to whom the gains were attributed had no legal or economic interest in trust capital. This clearly unsatisfactory situation persisted until 2011, when capital gains streaming rules were enacted.[875]

In most respects, the streaming rules for capital gains and franked distributions are equivalent. Both recognize ad hoc discretionary appointments of the trust-level items to which they apply on the basis of 'specific entitlement' – a concept that does not require present payment but does require a factual and objective reasonable expectation that the beneficiary will eventually receive the relevant benefit.[876] In default of specific entitlement, a capital gain is attributed either to beneficiaries in the same way as general income – still anomalously ignoring the difference between trust-law income and capital – or, if the trustees so elect, to the trustees on behalf of the trust as a whole.[877] The trustees' election makes sense as far as a rational allocation of tax burdens is concerned, but it may result in a higher tax burden overall which trust participants would find unattractive.[878]

The vesting of trust assets in a beneficiary or the distribution of an asset in specie may trigger the tax-law recognition of a capital gain at the level of the trust.[879] Whether the gain is attributed to that beneficiary depends on how the attribution rules apply to the particular facts: the circumstances of the vesting or distribution may or may not establish that the recipient beneficiary has a

[875] ITAA 1997 Sub-div 115-C, ITAA 1936 Part III Div 6E, substituted/inserted by the *Taxation Laws Amendment (2011 Measures No 5) Act 2011* (Cth). See Brabazon, *Trust Gains*, n 35, for fuller description of the rules and their history.

[876] ITAA 1997 ss 115-228 (capital gain), 207-58 (franked distribution). The receipt or expected receipt must be 'in accordance with the terms of the trust', whether by express provision or by an exercise of power under the trust, and statutory record keeping requirements must be complied with. The statute does not say how or in relation to what frame of reference one determines whether an expectation of receipt is reasonable.

[877] The trustees' right of election (ITAA 1997 s 115-230) has no equivalent in the dividend streaming rules.

[878] Beneficiaries are taxed at their own progressive or corporate rate, which may be lower than the top personal rate applied to most inter vivos trusts under ITAA 1936 s 99A. Individual resident beneficiaries are also entitled to a 50% discount on the taxable amount of most capital gains, a benefit which is not available to trusts taxed under s 99A.

[879] This may happen, for example, under CGT event E5 (ITAA 1997 s 104-75), E6 (s 104-80), E7 (s 104-85) or conceivably A1 (s 104-10).

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specific entitlement to the trust-level gain.[880] But it also seems to be contemplated in the streaming rules that a trust-level capital gain may be abstracted from the asset to which it relates and appointed to a beneficiary as if it were an item of income.[881]

Overall, in the design and enactment of the streaming rules, Parliament has been at pains to enable the participants in a trust to exert discretionary control over the fiscal attribution of trust gains.

It remains briefly to consider capital losses. Particular trust-level capital losses are not themselves attributed to beneficiaries, but reduce trust-level capital gains of the same year, thus affecting what gains may be attributed to beneficiaries. A net capital loss is carried forward until it is consumed by later trust-level gains.[882]

A.1.4 New Zealand

A.1.4.1 Income Generally

New Zealand divides the current tax-law income of a trust into two categories: beneficiary income and trustee income.[883] This division, quite simply, is fiscal attribution. Beneficiary income is taxable to the beneficiary on the same basis and to the same extent as if it had been derived directly.[884] It is also taxable to the trust (trustees) as statutory agent for the beneficiary,[885] who consequently has credit for tax paid on his or her behalf. Beneficiary income and trustee

[880] Suppose that a beneficiary is entitled to $Z and that the trustees transfer an asset worth $Z in satisfaction of that entitlement. These bare facts imply no more than that the asset is a convenient form in which to convey $Z of value. On the other hand, the point of a transfer or vesting may be to make or complete a gift to the beneficiary of the subject asset, including any hitherto unrealized appreciation in its value.

[881] Suppose that a trust owns a capital asset with a cost base of $X and sells the asset for $X+Y. The trustees appoint the resulting gain ($Y) to a particular beneficiary but say nothing more, leaving the balance ($X) as part of the general trust capital. Assuming that this is within power under the trust deed, that the trust has no capital losses that would offset the gain for tax purposes and that the specific entitlement criteria are satisfied, Australian tax law accepts the attribution of the gain to the beneficiary.

[882] This follows from the ordinary provisions relating to capital losses (see ITAA 1997 Div 102) and the absence of any provision for trust capital losses to be attributed away from the trust.

[883] ITA NZ s HC 5.

[884] ITA NZ s HC 17(1). This is subject to one qualification, which is not internationally significant. Beneficiary income of a resident child is in some circumstances taxed to the trust at the trust rate (ss HC 17(2), HC 35 and related provisions); the point of this is to limit the fiscal attraction of income splitting.

[885] ITA NZ ss HC 32, HD 12(1); cf s HD 4. In a domestic context, the trust may also have non-final withholding obligations under subpart RE in respect of beneficiary income that is also dividend or interest income.

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income are not primary categories of income in the way that business income or interest income may be. Speciation between beneficiary and trustee income is secondary and serves to identify the taxpayer to whom the income in question is attributed and to engage those fiscal consequences which depend on the characteristics of the taxpayer. Character retention is implicit in the basic structure of the attribution rule.

The general rule is that an item of trust-level tax-law income is beneficiary income to the extent that it vests absolutely in interest in a beneficiary in the year of its derivation or is paid or treated as paid to a beneficiary within the year plus a further period (generally six months).[886] As income of the beneficiary, it is allocated to the year of trust-level derivation.[887]

Vesting and payment are determined by reference to who owns or receives each item of tax-law income from a trust-law perspective. The vesting concept is technically precise and reflects trust-law entitlements.[888] The payment concept is broad and includes crediting an amount to a person or otherwise dealing with it in the interest of the person or on his or her behalf.[889] In the view of the IRD,

> [a] payment of an amount of income does not require possession of the amount to be transferred to the beneficiary. The trustee can 'pay' an amount to a beneficiary by giving the beneficiary an absolute indefeasible interest in the amount, even if the trustee retains possession of the amount. In this regard, the definition of 'pay' and 'vest absolutely in interest' overlap significantly.[890]

It is not necessary that the dollar value of an indefeasible vesting or constructive payment be expressly stated, although it must be objectively measurable and irrevocable.[891] In combination, these concepts are practically indistinguishable from the Australian concept of present entitlement,[892] but they are applied directly to tax-law income rather than trust-law income of the trust. Where a trust derives tax-law income that does not qualify as trust-law income in the relevant year, the IRD takes the accommodating view that such income may qualify as beneficiary income, even if it has not been factually

[886] ITA NZ s HC 6(1), (1B).
[887] ITA NZ s HC 6(3).
[888] See IS 18/01 [5.20]–[5.27]; IRD, *Explanation*, n 196, [5.14]–[5.18] and authorities there cited.
[889] ITA NZ s YA 1 (definition of 'pay' para (a)(ii), (iii)).
[890] IS 18/01 [5.37]; to similar effect, see IRD, *Explanation*, n 196, [5.22], [5.24].
[891] See IS 18/01 [5.17]; IRD, *Explanation*, n 196, [5.28], citing *Davidson* v *CIR* [1976] NZLR 705; see also Ammundsen, n 49, §3-090.
[892] But not their timing aspect; the Australian rule requires present entitlement to be established by the end of the year of trust-level derivation.

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received by the trustees, provided that the condition of vesting or payment is able to be satisfied; this depends on the terms of the trust and the factual circumstances.[893]

The general attribution criteria are modified in two respects. First, a small category of tax-law income is treated for integrity reasons as per se trustee income and therefore cannot qualify as beneficiary income.[894] Secondly, in certain principally (though not necessarily) outbound circumstances, the trust-level subject of a vesting or payment may be determined by statutory ordering rules and not by trust-law principles.[895] This modification is ancillary to the distribution taxing mechanism, which is itself complementary to the principal New Zealand approach of taxing trust income only once, in the year of its trust-level derivation (Section 5.2). It also limits strategies that might otherwise exploit the general deference of New Zealand's attribution rule to the trust-law allocation of particular items of trust income. Under the modified rule, if a trust has current tax-law income and if the trust is classified as 'foreign' or 'non-complying', its distributions (by vesting or payment) are usually[896] traced to current income first, regardless of their trust-law characteristics. To the extent that distributions can be matched in quantum by current tax-law income, they result in attribution of beneficiary income 'consisting of'[897] that tax-law income and therefore sharing its characteristics, even if their trust-law character is capital. There is some uncertainty about how items of trust income with different characteristics might be allocated to and among beneficiaries under this rule; insofar as the statute is silent or prescribes no clear rule, the IRD practice is to accept a method of characterization chosen by the trustees provided that the method is reasonable.[898]

New Zealand classifies trusts as 'complying', 'foreign' or 'non-complying'. These are not trust residence concepts. Their function is to determine the tax treatment of distributions other than of current trust income (which, by definition, is beneficiary income). A trust is 'complying' if, broadly speaking, it has never derived trustee income that escaped New Zealand tax as foreign

[893] ITA NZ s HC 5(2); Interpretation Statement IS 12/02 Income tax - whether income deemed to arise under tax law, but not trust law, can give rise to beneficiary income. The trust must have sufficient available assets to make a meaningful present appropriation in favour of the beneficiary.

[894] ITA NZ ss HC 4(3)–(5), HC 7(2)(b), (3) (deductible settlements, settlements that would otherwise have been assessable income, distributions matched by debt forgiveness).

[895] ITA NZ s HC 16(2)(a). The modification has greatest impact if the beneficiary is resident and the income in question is foreign sourced.

[896] The rule is subject to some exclusions. See esp ITA NZ s HC 16(6)(b), (8) relating to non-discretionary trusts.

[897] ITA NZ s HC 16(2).

[898] See IS 18/01 [8.121], [10.21] Examples 27, 28; IRD, *Explanation*, n 196, [13.9].

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income of a non-resident or that comprised New Zealand–sourced DIR income that was treated as belonging to a non-resident.[899] A trust that has only ever had resident grantors and trustees is usually complying. A trust is 'foreign' if it has never had a resident grantor,[900] and 'non-complying' if it is neither 'foreign' nor 'complying'.[901] A trust is non-complying inter alia if a grantor has fiscally immigrated or emigrated and the trust has not acquired or retained complying status[902] by a qualified person having electively accepted personal liability for tax on worldwide trustee income. Historical grantor non-residence is associated with the possibility that a trust may have accumulated trustee income offshore free of New Zealand tax.

Trust losses cannot be passed on to beneficiaries, but are quarantined within the trust and can be carried forward to be set off against future income.[903]

A.1.4.2 Capital Gains

Although New Zealand does not generally tax capital gains, a small class of such gains is reclassified as tax-law income.[904] The IRD accepts that beneficiary

[899] ITA NZ s HC 10(1)(a) (assuming actual compliance in terms of para (a)(ii)). Section HC 10(1)(ab) has a similar effect where a grantor, beneficiary or trustee has made a s HC 33 election and all relevant tax has been paid. Sections HC 10(2) and HC 30 allow a foreign trust to become complying by election when a formerly non-resident grantor immigrates, in which case the relevant tax must be paid on trustee income after the election date.

[900] ITA NZ s HC 11, counting only the time since the threshold date for the present trust rules, 17 December 1987.

[901] ITA NZ s HC 12.

[902] ITA NZ s HC 10(1)(ab); cf s HC 33.

[903] This is achieved by a rule which, perhaps inadvertently, creates the possibility that a trust may have both beneficiary income and net tax losses in the same year, although the circumstances would have to be quite unusual for such a thing to happen. A person who derives beneficiary income 'is denied a deduction for expenditure or loss that a trustee incurs in deriving the income', and for the purpose of determining a trustee's deductions, beneficiary income is treated as if it were trustee income (ITA NZ s DV 9). Income is a gross concept. Deductions only come into play when they are subtracted from assessable income for a tax year ('gross income') to calculate 'net income' on the way to 'taxable income' (ss BD 1(1), (5), BC 2–BC 5). Unlike Australia and the United States, New Zealand does not identify a net amount of tax-law income of a trust before working out the attribution of trust income. This does not seem to have created any difficulty in practice.

[904] See ITA NZ ss CB 9–CB 15, relating to land disposed of within 10 years of its original acquisition where the owner or an associate was then a dealer in land, a developer or a builder, or where at least 20% of the increase in value is attributable to town planning changes. See also ss CB 2–CB 7, relating to disposals in circumstances where there is a more direct nexus with business, profit-making, or a purpose of disposal without positively requiring 'income' character under general principles, and the financial arrangement rules (subpart EW). Deemed income can also arise where residential land

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income may include such gains, provided that the condition of vesting or payment is able to be satisfied – this depends on the terms of the trust and the factual circumstances.[905] It does not matter whether the beneficiary's right or payment is classified as income or capital for trust-law purposes. Given the limited scope of this taxation, it is not included in the analysis of international taxation of capital gains in this book.

A.2 Inbound Taxation of Business Income

As previously mentioned, this section considers tax settings relating to trust-level business income attributed to a non-resident beneficiary. For each of the surveyed countries, it addresses the basic claim to tax and the availability or otherwise of unilateral double tax relief by foreign tax credit. The findings of this section support Section 3.2.2.

A.2.1 Australia

A.2.1.1 Claim to Tax

Business income does not represent a separate head of Australian taxation, but is treated under the general heading of income. Australia generally taxes non-residents on income 'from all Australian sources'.[906] Trust income has its own jurisdictional rules, and Australia generally imposes net-basis taxation on trust income attributed to a non-resident beneficiary to the extent that the income is 'attributable to sources in Australia'.[907] There is some interpretive difficulty with the concept, but the better view is that it refers to trust-level income that is fiscally attributed to the non-resident beneficiary and has an Australian source.[908] This reflects the general proposition that Australia applies a principle of character retention between trust and beneficiary.

is disposed of within five years (s CB 6A), subject to a main residence exception (s CB 16A).

[905] IS 12/02 [15], [104]–[124].

[906] ITAA 1997 ss 6-5(3)(a), 6-10(5)(a).

[907] ITAA 1936 ss 6B, 97(1)(a), 98(2A), 98A.

[908] The difficulty arises from the wording and history of the statute. The concept of income being 'attributable to' a source is elaborated in ITAA 1936 s 6B. That section is mainly concerned with dividends, passive income and interest, but it also contains a more general rule in s 6B(2A)(a)(ii) which applies to income of all other kinds and stipulates that '[f]or the purposes of this Act, an amount of income derived by a person shall be deemed to be income from a particular source . . . if the person derived the amount of income as a beneficiary in a trust estate and the amount of income can be attributed, directly or indirectly, to income derived from that source or to an amount that is deemed, by any other application or applications of this subsection, to be an amount

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There are few relevant statutory source rules, and the source of business income is generally determined item by item on a factual basis under principles developed by case law.[909] The location of an establishment or of economic activity is material but not determinative. This situation is regularly modified, however, in the presence of a tax treaty with the residence country of the person who derives the income in question, such that income which Australia *could* tax under the treaty is deemed for the purposes of Australian tax law (and not just the purposes of the treaty) to have an Australian source.[910] Australia's jurisdictional taxing claim is thus expanded to include

that is income derived from that source '. The form of words replicates a pattern set by earlier subsections dealing with dividends, passive income and interest. These provisions are then linked to the concept of present entitlement by s 6B(3): 'Where a beneficiary in a trust estate is presently entitled to income of the trust estate, that income shall, for the purposes of this section, be deemed to be an amount of income derived by the person.'

The difficulty is that present entitlement, which refers to a beneficiary's trust-law interest in trust-law income, performs a different function in the attribution of general income and the attribution of particular DIR income. In the general trust rules in Part III Div 6, present entitlement to trust-law income is part of the first stage of the two-stage formula for the attribution of tax-law trust income (see Section A.1.3.1). In Div 11A, present entitlement to a particular item of DIR income *is* the test for attribution of that item (see s 128A(3), considered in Section A.3.1.2).

The curious wording of s 6B reflects difficulties created by *FCT* v *Angus* (1961) 105 CLR 489, a dividend case, the effect of which was reversed by that section and related provisions. The reversal of *Angus* was intended to affirm the generality of the principle of character retention, previously recognized in *Charles* v *FCT* (1954) 90 CLR 598 (see Explanatory Memorandum, Income Tax Amendment Bill (No 4) 1967 (Cth), notes on cl 5). (Whether the 'attributable to' formulation in s 6B was really necessary to preserve character retention is questionable, given the subsequent explanation of *Angus* in *FCT* v *Tadcaster* (1982) 13 ATR 245 at ATR 249–250, but the section and its wording have been retained.)

Section 6B(2A) was added by the *Taxation Laws Amendment (Foreign Tax Credits) Act 1986* (Cth) s 4 in the context of Australia moving to a general foreign tax credit system, credit relief having previously been confined to dividend income. The difference between the roles of present entitlement in Div 6 and in Div 11A seems to have been lost sight of in the drafting of that provision, or perhaps that difference was not appreciated at all, with the result that s 6B(2A) is unworkable if it is interpreted literally. The interpretation proposed in the principal text strains the statutory language in order to arrive at a workable meaning for classes of income outside the scope of Div 11A, such as business income.

[909] See Michael Dirkis, *Is it Australia's? Residency and Source Analysed* (Australian Tax Research Foundation, 2005) 278–285. (Some of the statutory rules considered in that work are no longer in force. ITAA 1936 Part III Div 2 Sub-div C was repealed by the *Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006* (Cth) Sch 1 cl 57.)

[910] This arises from the combined operation of IntTAA s 4, which integrates treaties with domestic tax law and gives them superior force, and Australian treaty policy, which results in the adoption of treaty provisions that have the stated effect. For example: 'Income or gains derived by a resident of the United Kingdom which, under any one or

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worldwide income attributable to an Australian PE of a non-resident that is within Australia's right to tax under the business profits article of a treaty with that person's country of residence.

These principles are also relevant to beneficiary-attributed business income. Australian tax treaties typically contain a provision attributing an Australian trust PE to a beneficiary resident in the other country to whom such income is fiscally attributed, which gives Australia the right to tax that income in accordance with the business profits article of the treaty.[911] The modified source rule mentioned in the preceding paragraph has the effect that such income is treated by Australian domestic law as having an Australian source, and Australia's claim to tax extends to include the worldwide beneficiary-attributed income of an Australian trust PE. This analysis is not confined to cases where the trust is non-resident. The standard treaty definition of a PE refers to 'a fixed place of business through which the business of an enterprise is wholly or partly carried on'.[912] It carries no implication that the PE is subsidiary or that the enterprise is owned by a non-resident of the host country. Nor is there any evident policy reason to differentiate between a non-resident beneficiary in a resident trust and in a non-resident trust.

It is important to observe that such treaty-related modification of domestic law is limited to determining the source of income: it does not attribute a trust PE to a beneficiary for purposes of domestic law or change the basis on which Australia taxes the income that is attributed to a beneficiary.[913]

The beneficiary is the relevant taxpayer from the viewpoint of Australian tax law, although the trust may also pay tax in a representative capacity. If the beneficiary is non-resident at year end, liability falls on the trust with reference

more of Articles 6 to 8 and 10 to 16 and 18, may be taxed in Australia shall *for the purposes of the laws of Australia relating to its tax* be deemed to arise from sources in Australia' (Australia–UK 2003 Art 21 (emphasis added)). There are variations in wording and design from treaty to treaty, but the basic policy is pursued with great consistency. That such treaty provisions modify the primary Australian source rule was accepted without evident dispute in *Tech Mahindra Ltd* v *FCT* (2015) 101 ATR 755; 18 ITLR 239, 765 [36] (Perry J) (appeal on other grounds dismissed: *Tech Mahindra Ltd* v *FCT* (2016)103 ATR 813; 20 ITLR 70).

[911] See Section 8.3.10.1.

[912] OECD Model, Art 5(1).

[913] See Section A.3.1.3 and *GE Capital Finance Pty Ltd* v *FCT* (2007) 159 FCR 473; 9 ITLR 1083, rejecting the Commissioner's argument that interest income of an Australian trust PE attracted net-basis taxation of the US beneficiary to which it was attributed rather than taxation by gross-basis withholding. (The Australian source of the income was not in issue.)

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to the character and residence of the particular beneficiary, and on the beneficiary with credit for tax paid by the trust.[914]

A.2.1.2 Foreign Tax Credit

A non-resident beneficiary is entitled to foreign tax credit on the same basis as a resident beneficiary.[915] The statute does not in terms require residence of the claimant for credit or foreign source of the foreign-taxed income. It does however preclude credit for tax paid 'to a foreign country because you are a resident of that country for the purposes of a law relating to the foreign income tax . . . in respect of an amount derived from a source outside that country'.[916] In this way, foreign source-based taxation of beneficiary-attributed income of an Australian trust PE, including initially foreign income that acquires deemed Australian source by the route described earlier, is capable of supporting a foreign tax credit for a non-resident beneficiary.

A final question is whether the role of the person on whom the foreign tax is imposed – grantor, beneficiary or trust – affects the entitlement of a non-resident beneficiary to credit. This will presumably be answered in the same way as for a resident beneficiary (Sections A.4.1 and 3.3.3.1): credit is available for foreign taxation of the trust or, in most situations, of a grantor.[917]

A.2.2 United States

A.2.2.1 Claim to Tax

US taxation of non-US persons distinguishes between income that is 'effectively connected' with the 'conduct of a trade or business within the United States', which attracts net-basis taxation by assessment,[918] and passive investment

[914] ITAA 1936 ss 98(2A), 98A; see n 866 and corresponding text. See also s 97(1)(a), which provides for direct taxation of a beneficiary who has become resident during the year.

[915] ITAA 1997 Div 770 'Foreign income tax offsets'; see Sections 3.3.3 (n 227) and A.4.1. The primary requirements are the imposition of a foreign income tax, payment of that tax by the taxpayer claiming Australian credit or the attribution of such payment to that taxpayer, and imposition of the foreign tax on income that Australia identifies as assessable income of that taxpayer. Beneficiary tax credits are provided for by s 770-130, which specifies circumstances in which a beneficiary is treated as if he or she had paid foreign tax in respect of attributed income.

[916] ITAA 1997 s 770-10(3).

[917] For reasons explained in Section 3.3.3.1, the view is taken that residence-based foreign taxation of the trust or grantor is not disqualified from credit to a beneficiary, although residence-based foreign taxation of the beneficiary would be disqualified to the extent that it exceeds any applicable source taxation by the same country.

[918] IRC s 871(b) (non-resident aliens, taxable at progressive rates), s 882(a) (foreign corporations).

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income that is not so connected, which attracts gross-basis taxation if it has a US source.[919] For brevity, the former class is commonly referred to as 'effectively connected' income.

The concept of a trade or business within the United States is mostly undefined;[920] although it is not identical to the treaty concept of a permanent establishment, most business presences that satisfy one description may be expected also to satisfy the other. Broadly speaking, the concept of effective connection catches all active business income from US sources,[921] and also a class of active business income from foreign sources if conditions including a sufficient connection with a US office or fixed place of business are established.[922]

Where a trust or partnership is engaged in a US trade or business, that activity is expressly attributed to a non-US beneficiary or partner, as the case may be.[923] In this way, a non-US beneficiary attracts net-basis taxation on so much of the trust income attributed to him or her as is effectively connected income of the trust, regardless of whether the trust itself is resident or non-resident. Some but not all US tax-law trusts can carry on an active business directly,[924] but such a trust may more readily be a partner in a partnership. If a partnership with a US business has a trust-partner and income of the US business is fiscally attributed through the trust to a non-US beneficiary, the US business is also attributed through the trust to the beneficiary, and the corresponding beneficiary-attributed effectively connected income attracts net-basis taxation of the beneficiary.[925]

Active business income of a non-US person without a US trade or business is not taxed, even if (in US terms) it has a US source. Correspondingly, active

[919] IRC ss 871(a), 881(a).

[920] See Joseph Isenbergh, *International Taxation* (Thomson/Foundation Press, 3rd edn, 2010) ch 6; Joel D Kuntz and Robert J Peroni, *US International Taxation* (RIA/Westlaw, electronic looseleaf) (at 27 December 2017) §C1.04[4] and case law cited. Cf the partial definition in IRC s 864(b).

[921] IRC s 864(c)(3). This represents a vestigial force-of-attraction rule which applies if the non-resident has a US trade and also happens to derive unrelated but US-sourced active business income.

[922] IRC s 864(c)(4)(B).

[923] IRC s 875.

[924] See n 43, 45.

[925] See Goldberg and Shajnfeld, n 687, commenting on Rev Rul 85-60; IRS, General Counsel Memorandum 39361 (20 Jan 1982), (1985) 27 Tax Notes 1034. The ruling arose in a treaty context, denying Art 7 exemption to the non-US beneficiary. The tax from which the beneficiary sought protection depended on IRC s 875. The issue was whether a US PE of the partnership should be attributed through the trust to the beneficiary. Congruence with the attribution of a US business under s 875 was part of the reasoning that led the IRS to an affirmative answer. The treaty issue is considered in Brabazon, *Treaties & Transparent Entities*, n 474, §4.3.4.; cf Section 8.3.10.2.

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business income of a trust that is attributed to a non-US beneficiary is outside the claim to tax unless it is effectively connected with an actual or attributed US business at the trust level.[926]

A.2.2.2 Foreign Tax Credit

Foreign tax on effectively connected income, particularly if it is foreign sourced, can generate foreign tax credits for a non-US beneficiary. A non-US person may claim credit in respect of foreign tax on effectively connected income,[927] though foreign tax on US-sourced effectively connected income is not eligible to the extent that it depends on residence or similar criteria.[928] The practical capacity of foreign tax on US-sourced income items to deliver credits is further limited by the general credit limitation formula.[929] A non-US beneficiary has access to credit on the same basis as a non-US person who derives effectively connected income directly.[930] Creditable foreign tax may have been imposed on the beneficiary or the trust. The statute contemplates credit for foreign taxation of a grantor in limited circumstances,[931] but the regulations that would be required to implement that credit have never been promulgated.

A.2.3 United Kingdom

Trading trusts are almost unknown in the United Kingdom. One may speculate about why this is so. It may be related to the high rate of tax that initially applies to the income of a discretionary trust; the special trust rate has remained well above the corporate rate since its introduction in 1997.[932] It may reflect a degree of satisfaction with other business structures or the unfamiliarity of the trust as a business entity (despite the role of trust law in

[926] At least in the absence of a separate US business of the beneficiary – a possibility which seems sufficiently remote to be discounted for present purposes.
[927] IRC ss 901(b)(4), 906.
[928] IRC s 906(b)(1) (residence, citizenship, corporate creation or organization, corporate fiscal domicile).
[929] For a US person, foreign tax credit is limited to the taxpayer's average US tax rate on US-taxable income multiplied by foreign-sourced income (IRC s 904). For a non-US person, the average US tax rate in that formula is calculated with reference only to effectively connected income (s 906(b)(2)). If all the effectively connected income is US-sourced, the credit limit is zero.
[930] IRC s 901(b)(5) (n 1064 and corresponding text).
[931] IRC s 901(b)(5), second sentence, referring to notional US grantor attribution (n 1066, 1067 and corresponding text).
[932] Loutzenhiser, n 53, §29.2.3.2.

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the nineteenth-century development of the joint stock company). Be that as it may, it is possible for a resident or non-resident trust with a non-resident interest-in-possession beneficiary to carry on a UK trade. This section considers how UK tax law would treat such an arrangement.

A.2.3.1 Claim to Tax

The UK tax system applies a doctrine of source rather than explicit source rules. Its claim to tax non-residents under the income tax is separately expressed for each category of income to which the tax applies, reflecting the schedular structure of that tax. Trading income 'arising to' a non-resident is chargeable if it arises from a trade of dealing in or developing UK land or 'from a trade carried on wholly in the United Kingdom' or from that part of a broader trade which is carried on in the United Kingdom,[933] and not otherwise. The situs of the subject matter of a trade involving UK land serves as the source criterion for taxing the income of such a trade. Otherwise, trading income arising abroad from a UK trade is taxable, and that arising within the United Kingdom from a foreign trade is non-taxable. Where the income arises is not the chosen jurisdictional source criterion – that role belongs to the place of the trade.[934] Trading income is generally taxed on a net basis by assessment and, in the case of an individual, at progressive rates. If income arises through or from a UK branch or agency of the non-resident, the branch or agency is collaterally taxable as that person's 'UK representative',[935] but the presence of a trade from which the income arises is the necessary and sufficient

[933] ITTOIA s 6(2), applicable also to professions and vocations by sub-s (3).

[934] See Loutzenhiser, n 53, §72.3: 'This all-or-nothing approach [i.e., place of trade] applies to determine the source of the income for the purposes of the UK's schedular system; however, this is quite separate from the question where the income arises. Although the trade is the source and must have only one place, its income may arise in more than one place'. Place of trade is governed by judge-made principles which accord great reverence to the place where contracts are thought to be made, particularly in a non-manufacturing context (ibid).

This indicates a difference – at least in terminology – between UK and US tax jurisprudence. The US approach regards items of business income as having a 'source' which may differ from the place where the business is carried on but does not necessarily treat that source as the inbound taxing criterion for business income. The UK approach regards trading income as 'arising' in a place which may differ from the place of the trade but treats the trade itself as the 'source' of the income and adopts the location of that source as the inbound taxing criterion. The difference of terminology is generally washed out in the practical result. (The United Kingdom does not, however, associate a local trade with unrelated but locally arising active business income in the manner of the force-of-attraction rule mentioned in n 921.)

[935] ITA UK Part 14 chapters 2B, 2C. Section 835E constitutes the branch or agency as the non-resident's UK representative in relation to branch income, etc.

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jurisdictional nexus.[936] A concessional regime applies to a non-resident's income from trading in the United Kingdom through a qualifying broker or investment manager, provided there is no relevant UK representative: such income is 'disregarded' and UK taxation is limited to that which is deducted at source.[937]

The corporation tax takes a different but analogous approach. A non-resident company is only within the charge to corporation tax if it carries on a trade of dealing in or developing UK land or 'if it carries on a trade in the United Kingdom . . . through a permanent establishment in the United Kingdom'.[938] In the latter event, it is generally chargeable on such of its worldwide profits as comprise trading income, income from property or rights, or chargeable gains; have the required nexus with the permanent establishment; and are attributable to the permanent establishment; these are designated as 'chargeable profits'.[939]

Non-resident individuals are subject to income tax. Non-resident companies are subject to corporation tax and/or income tax, depending on the nature and source of their income. Income within chargeable profits attracts the corporation tax, but is excluded from the income tax; other income attracts the income tax, subject to the applicable UK source rule for the relevant class of income.[940] In this way, income tax is chargeable on the income of a non-resident company from a trade to the extent that it is carried on in the United Kingdom without a UK permanent establishment.

These principles apply to trust income of a UK trade that is attributed to a non-resident interest-in-possession beneficiary with modifications reflecting the intermediate taxation of the trust on behalf of the beneficiary.

In the first instance, the trust is taxed on the income in question at the basic rate.[941] The beneficiary, if an individual, is taxed directly under the general

[936] See Loutzenhiser, n 53, §72.3. In UK tax jurisprudence, the presence of a trade or part of a trade in the United Kingdom does not require a branch or agency. Conversely, the presence of a UK branch or agency does not of itself imply local presence of the relevant trade. See *F L Smidth & Co* v *Greenwood* [1921] 3 KB 583; *Greenwood* v *F L Smidth & Co* [1922] 1 AC 417.

[937] ITA UK ss 811, 813(1)(e), 814 ('disregarded transaction income'), 816(1)(c), (d) and related provisions. Cf HMRC, *International Manual* INTM 269180.

[938] CTA 2009 s 5(2).

[939] CTA 2009 s 19. The charge is imposed by s 5(3) subject to s 5(4). The income nexus requirements are expressed in s 19(3)(a) and (b): trading income must arise directly or indirectly through or from the permanent establishment, income from property or rights is limited to property or rights used by or held by or for the establishment. The attribution rules are elaborated in ss 20–32, including a separate enterprise principle and an arm's length criterion in relation to intra-entity dealings.

[940] See ITA UK s 5(b), CTA 2009 s 3(1)(b)(ii).

[941] ITA UK s 11. Given that the object of taxation is income of a UK trade, the fiscal residence of the trust is immaterial. The absence of rate progression is of long standing.

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charging rule for a non-resident as a person to whom the income arises,[942] as if he or she had derived the income directly; as with a resident beneficiary, trust-level tax is treated as paid on his or her behalf. The charging rule does not require the UK trade to be conducted by the taxpayer concerned; there is therefore no need to ask whether the trade of the trust is attributed to the beneficiary for the purpose of establishing liability to tax. The provisions relating to UK branches and UK representatives do not deal expressly with non-resident beneficiaries. This, together with the contrasting fact that they deal expressly with non-resident partners,[943] creates significant doubt whether a non-resident beneficiary may be taken to have a UK representative by reference to the affairs of the trust; the question may arise where the trust is resident and conducts a UK trade or where the trust is non-resident and has a UK branch as UK representative of the trust. That affects the mechanism of collection, but for reasons already given, it does not affect the jurisdictional claim to tax.

A non-resident corporate beneficiary is taxable on currently attributed trading income of a trust under the income tax rather than the corporation tax. Although beneficiary-attributed trust profits are treated for the purposes of the charge to corporation tax as accruing directly to the company,[944] that charge only applies (and the income tax is only excluded) in respect of chargeable profits.[945] No provision attributes the UK trade of a trust to a non-resident beneficiary, corporate or otherwise; the factual presence or establishment of a trust business (as distinct from that of the company itself) in the United Kingdom is not within the definition of a permanent establishment of a corporate beneficiary for the purposes of the corporation tax.[946] The company is consequently taxed on the same footing as an individual, with credit for trust-level taxation, but only at the basic rate.[947] If the trust meets its UK tax obligations, the company has no further tax to pay.

See *IRC* v *Countess of Longford* [1928] AC 252, affirming *IRC* v *Countess of Longford* [1927] 1 KB 594, holding that trustees were not liable to super tax. There is no question of beneficiary-attributed trading income attracting the higher trust rate under s 479 (accumulated or discretionary income); the other cases where that rate applies under s 481 reflect specific integrity concerns.

942 ITTOIA s 6(2) (n 933).
943 ITA UK ss 835E(1), 835F.
944 CTA 2009 s 7.
945 See n 940.
946 See *Corporation Tax Act 2010* (UK) s 1141 and related provisions.
947 ITA UK s 11.

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A.2.3.2 Foreign Tax Credit

The UK foreign tax credit is available to non-residents in limited circumstances. As in the case of a resident, if credit is available or expressly denied under a tax treaty, the treaty provision applies to the exclusion of unilateral relief.[948] Where unilateral relief arrangements apply, credit against income tax for a qualifying foreign tax is generally allowed if it is 'calculated by reference to income arising, or any chargeable gain accruing, in the [foreign taxing] territory'.[949] If the taxpayer is non-resident, relevant credit is only available if he or she is not liable to tax in the other country by reason of residence or similar criteria and the foreign-taxed income is that 'of a branch or agency in the United Kingdom of a non-UK resident person'.[950] While the claim to tax a non-resident depends on a UK trade, entitlement to credit depends on a UK branch or agency. As indicated earlier, there is some doubt whether the UK branch of a trust is attributed to a beneficiary, but the unilateral credit provisions do not require identity between the taxpayer claiming relief and the owner of the branch. This suggests that the UK branch of a non-resident trust can provide access to credits for both the trust and a non-resident interest-in-possession beneficiary where UK branch income arising in another country attracts tax in that country, subject to the trust or beneficiary (as the case may be) not being fiscally resident, etc, in that country. In this way, the non-resident beneficiary can use unilateral relief in respect of non-UK tax on the profits of a PE in the UK of a non-resident trust.

If the trust in question is resident and conducts a UK trade, the trust may claim unilateral foreign tax credits on the basis of residency,[951] but a non-resident beneficiary can only claim corresponding credit if the UK presence and activities of the trustees qualify as 'a branch or agency in the United Kingdom of a non-UK resident person'. This condition is not satisfied where the trust is resident. In the absence of statutory provision or extra-statutory concession, the credit that is won by the trust is lost by the beneficiary. The result seems anomalous and is difficult to justify in policy terms. That said, it does not appear to have generated complaint or controversy (which may well be explained by the rarity of UK-resident trading trusts).

As has already been observed, the UK foreign tax credit is equally available regardless whether the foreign tax is imposed on a beneficiary, the trust or a grantor.

[948] TIOPA s 11.
[949] TIOPA s 9(1).
[950] TIOPA s 30(2), (3); cf s 26.
[951] TIOPA s 26.

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A.2.4 New Zealand

A.2.4.1 Claim to Tax

New Zealand only taxes non-residents on income that has a source in New Zealand.[952] This includes income 'derived from a business' carried on to any extent in New Zealand[953] and income 'derived by a person from a contract' performed to any extent in New Zealand,[954] subject to an apportionment rule where the business is carried on or the contract performed to some extent outside New Zealand which hypothesizes a 'separate and independent person' carrying out 'the person's activities in New Zealand and dealing at arm's length' as the basis for apportionment.[955] The source rules operate collaterally. Thus, New Zealand source attaches to 100% of the income derived from a business that is wholly carried on in New Zealand, including income from performing contracts abroad, and 100% of the income from performing a contract wholly in New Zealand, including a contract of a foreign business. Active business income attracts taxation on a net basis by assessment.[956]

These rules apply in a corresponding way to business and contract income of a trust that is attributed to a non-resident beneficiary. The bifurcation of trust income into beneficiary-attributed income (beneficiary income) and trust-attributed income (trustee income)[957] makes character retention automatic. Trust-level source is also expressly preserved;[958] there is consequently no need to ask whether a trust business is carried on by or attributed to the beneficiary; the only question is whether the trust business is carried on in New Zealand. As in the case of a resident beneficiary, the trust is taxable as a non-resident beneficiary's deemed agent and the beneficiary is taxable as principal with credit for tax paid on his or her behalf.[959]

[952] ITA NZ s BD 1(4), (5); s YA 1 (definition of 'foreign-sourced amount').

[953] ITA NZ s YD 4(2).

[954] ITA NZ s YD 4(3). The place where a contract is made has limited relevance, e.g., if it could be said that income is derived from the contract without performance.

[955] ITA NZ s YD 5. There is also an apportionment rule for interest on offshore borrowings with mixed applications.

[956] ITA NZ s BC 1(2); s YA 1 (definitions of 'filing taxpayer', 'non-filing taxpayer'). The derivation of active business income from a source in New Zealand precludes a person from qualifying as a non-filing taxpayer under any of the heads of the definition of that term.

[957] ITA NZ s HC 5; cf s HC 17.

[958] ITA NZ s YD 4(13).

[959] ITA NZ ss HC 32, HD 4, HD 12(1).

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A.2.4.2 Foreign Tax Credit

New Zealand foreign tax credit is only available to a resident,[960] and a resident beneficiary may claim credit for tax on beneficiary-attributed trust income (Section 3.3.3). No unilateral credit is given for foreign tax borne by trust income attributed to a non-resident beneficiary. The position may be different in a treaty situation. This depends on whether the treaty contains a suitably worded non-discrimination article[961] and whether the beneficiary can claim the protection of that provision in respect of beneficiary-attributed income of a trust PE.

A.3 Inbound Taxation of Dividend, Interest and Royalty Income

This section considers inbound tax settings for beneficiary-attributed DIR trust income. For each country, it addresses in turn the general inbound tax settings for DIR income in a non-trust situation, the settings applicable to non-resident beneficiaries and beneficiary-attributed income, the treatment that applies where the trust has a local taxable presence such as would affect the basis of inbound taxation in a non-trust case and, finally, whether the interaction of rules relating to DIR income and rules relating to trusts produces gross-basis taxation of what are effectively net-basis amounts attributed to beneficiaries (described as net versus gross issues). The findings of this section support Section 3.2.4 and the summary in Table 3.1.

A.3.1 Australia

A.3.1.1 General Settings

Australia has two main systems for taxing non-residents on DIR income. The first is the general claim to tax non-residents on Australian-sourced income, which results in net-basis taxation by assessment.[962] The second is international withholding tax.[963] In the application of withholding tax to DIR

[960] ITA NZ s LJ 1(2)(a).

[961] New Zealand has entered a reservation to OECD Model Art 24 and its general policy is against the inclusion of a non-discrimination article, but it has done so (not necessarily following the OECD Model) in over half of its tax treaties. See Elliffe, n 218, §6.4.5. The relevant provision is OECD Model Art 24(3) relating to PE taxation, which (as Elliffe observes) is understood by OECD Commentary Art 24 [67] as requiring the allowance of foreign tax credits where such credits would be allowed to a resident enterprise.

[962] ITAA 1997 ss 6-5(3), 6-10(5).

[963] Under ITAA 1936 Part III Div 11A. The design and drafting of Div 11A are uncommonly intricate. The description given here is simplified, and disregards features (such as the treatment of income derived by a foreign PE of an Australian resident) that have low

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income 'derived by' a non-resident, the claim to tax depends on Australian residence of the payer or, in the case of interest or royalties paid by a non-resident, an association with the payer's Australian PE.[964] This jurisdictional connection replaces the source concepts that would apply in an assessment context.[965] Withholding tax on such income is final, and excludes net-basis taxation.[966] The withholding rates are 30% (dividends), 10% (interest) and 30% (royalties).[967] Collection of the tax is supported by withholding and remittal obligations in the tax administration legislation.[968]

Dividends 'paid to a person who is a non-resident carrying on a business in Australia at or through a permanent establishment of the person in Australia' and attributable to the PE[969] and interest 'derived by a non-resident in carrying on a business in Australia at or through a permanent establishment of the non-resident in Australia'[970] are generally excluded from withholding tax; their tax treatment depends on the general claim to tax and on net-basis assessment.[971] Royalties, by contrast, are only so excluded if an applicable tax treaty excludes them from the operation of its basic royalty provision[972] – this will be the case if the property or right on which the royalty is paid is beneficially owned by a resident of the other treaty country and is effectively connected with that person's Australian PE.[973]

Leaving aside the dividend PE exception, Australia does not seek to tax dividends derived by a non-resident to the extent that they are fully franked by the attachment of imputation credits representing prior corporate taxation – the underlying corporate income tax effectively becomes the final Australian

or no ultimate relevance to the tax treatment of income attributed to non-resident beneficiaries.

964 ITAA 1936 s 128B(1), (2), (2B).
965 ITAA 1936 s 128B(10).
966 ITAA 1936 s 128D: Income 'upon which withholding tax is payable' other than because it is derived by a foreign PE of an Australian resident 'or upon which withholding tax would, but for paragraph 128B(3)(ga), (jb) or (m), section 128F, section 128FA or section 128GB, be payable, is not assessable income and is not exempt income of a person.' 'Non-assessable non-exempt' income is quarantined and disregarded: compare the UK concept of 'disregarded income'. The UK terminology gives a clearer sense of the tax treatment.
967 ITAA 1936 s 128B(4), (5), (5A); *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974* (Cth) s 7. Cf machinery provisions in *Taxation Administration Regulations 1976* (Cth) regs 40, 41, 42.
968 TAA Au Sch 1 Sub-div 12-F.
969 ITAA 1936 s 128B(3E); cf s 44(1)(b), (c).
970 ITAA 1936 s 128B(3)(h)(ii).
971 Worldwide dividend income attributable to a non-resident's Australian PE is taxable under ITAA 1936 s 44(1)(c); cf s 44(1)(b).
972 IntTAA s 17A(4).
973 E.g. Australia–UK 2003 Art 12(4); cf OECD Model Art 12(3).

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tax.[974] The franked part of dividends that otherwise satisfy the criteria for withholding are excluded from withholding tax and also from net-basis taxation.[975] A similar double exclusion applies to interest on certain classes of offshore borrowings.[976]

Such items of a non-resident's DIR income as may attract Australian source taxation although they are not paid by an Australian resident or PE fall within the general claim to tax.[977]

A.3.1.2 Beneficiary Settings

The application of DIR withholding tax in a trust context is governed by a special attribution rule that differs from the general attribution rule:

> For the purposes of this Division, a beneficiary who is presently entitled to a dividend, to interest or to a royalty included in the income of a trust estate shall be deemed to have derived income consisting of that dividend, interest or royalty at the time when he or she became so entitled.[978]

Non-resident beneficiary attribution under this rule displaces the trust or a trustee as the person deriving the relevant item of income.[979] To the extent that such an item is subject to withholding tax or otherwise excluded from net-basis taxation by reference to its derivation by the beneficiary, it is also

[974] The main corporate tax rate is still 30%, but a lower rate (28.5%) applies to 'small business entity' companies for the 2016 income year under amendments made by the *Tax Laws Amendment (Small Business Measures No 1) Act 2015* (Cth). Deeper and broader rate reductions apply in later years under amendments made by the *Treasury Laws Amendment (Enterprise Tax Plan) Act 2017* (Cth). There is no proposal to alter the 30% dividend withholding rate.

[975] ITAA 1936 ss 128B(3)(ga), 128D. The 'franked part' of a distribution (dividend) is defined by ITAA 1997 s 976-1. See n 966.

[976] ITAA 1936 ss 128F (publicly offered corporate debentures etc), 128FA (publicly offered unit trust debentures etc), 128GB (offshore borrowings of offshore banking units) with s 128D. As with franked dividends, net-basis taxation is not excluded if the PE exclusion from withholding (s 128B(3)(h)(ii)) applies.

[977] For example, dividends paid to a non-resident shareholder by a non-resident company out of profits derived in Australia (ITAA 1936 s 44(1)(b); cf ITAA 1997 ss 6-5(3)(b), 6-10(5)(b)).

[978] ITAA 1936 s 128A(3). The Division referred to is Part III Div 11A. The special rule only affects income that is paid by an Australian resident or (in some cases) an Australian PE and derived by a non-resident or (in some cases) a foreign PE within the scope of that Division.

[979] *ABB Australia Pty Ltd* v *FCT* (2007) 162 FCR 189, 229 [185] (Lindgren J): 'In my opinion, s 128B(1) and (4) apply to income consisting of a dividend derived by a person as trustee, unless one of the exceptions to be found in Div 11A applies. Thus, if a non-resident beneficiary is presently entitled to the dividend that is included in the income of a trust estate, it is the beneficiary rather than the trustee who is deemed to have derived the income (s 128A(3)).'

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excluded from net-basis taxation to anyone else.[980] Thus, franked dividends and interest income that would attract concessional non-taxation if the beneficiary were a direct investor are similarly excluded from Australia's claim to tax to the extent that they are attributed under this rule to a non-resident beneficiary.

Attribution by deemed derivation of DIR income to a non-resident beneficiary under this rule displaces the general attribution rule (Section A.1.3.1), but the general rule remains operative in relation to other income or beneficiaries. To the extent that the special rule attributes DIR income to a non-resident beneficiary, it may be inferred that that income and the non-resident's entitlement to it must be disregarded at the first step of the general rule (determining proportionate trust-law income entitlements); the income is also necessarily disregarded at the second step of the general rule (attribution of tax-law income). The mechanism by which this happens is obscure and largely implicit, but it is necessary in order to prevent misallocation of other trust income or double taxation of the DIR item.

Although the concept of present entitlement has the same meaning in the special rule as in the general rule,[981] referring in both cases to vested or discretionary trust-law entitlements to trust-law income, its function in the two rules is quite different. In the general rule, present entitlement of beneficiaries to trust-law income and the residual absence of such entitlement serve to generate fractions for each beneficiary and for the trust as a whole; those fractions are then used at the second step of the rule to attribute the general body of tax-law trust income to and among the beneficiaries and the trust. In the special rule, present entitlement of a non-resident beneficiary to a specific item of current DIR income, whether by vesting or by the exercise of a distribution and with or without actual distribution, directly determines the fiscal attribution of that item for withholding tax purposes. In this way, the special withholding attribution rule for DIR income that is vested in or appointed to a non-resident beneficiary broadly resembles the domestic streaming rule for franked dividends: it follows trust-law rights and appointments, item by item.[982]

[980] Such an item is not assessable income and not exempt income 'of a person' (ITAA 1936 s 128D), i.e., of any person.

[981] The statutory modifications by ITAA 1936 ss 95A and 101 are not limited to their immediate context in Part III Div 6 but expressly apply for the purposes of the whole Act.

[982] See TR 92/13 *Income tax: distribution by trustees of dividend income under the imputation system* (withdrawn). The ruling refers to an earlier version of the dividend imputation rules as well as to Div 11A. There is some doubt whether the original dividend imputation rules had the streaming effect they were thought to have, but the

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A withholding tax obligation may arise at the point of trust-level income derivation or when the beneficiary subsequently becomes presently entitled to the income. If the beneficiary's entitlement exists as a fixed right when the trust derives the income, that is also the point of derivation by the beneficiary and the point when withholding tax liability arises, regardless of where the trust is resident or based. If the beneficiary's entitlement first arises after derivation by the trust (such as by a subsequent exercise of discretion), the subject income is derived by the beneficiary when the conditions for present entitlement are first satisfied. If the beneficiary is non-resident, withholding tax liability arises and attaches at that point. The withholding obligation attaches to the Australian payer and/or an Australian trustee, as the case requires.[983]

A.3.1.3 Taxable Presence

In the case of dividends and interest, the conduct of an Australian business and the maintenance of an Australian PE by a resident or non-resident trust are not attributed to a non-resident beneficiary so as to exclude beneficiary-attributed income from withholding tax or shift it into the realm of net-basis taxation.

The dividend PE provision is expressly disengaged for a non-resident trustee-shareholder,[984] and there is no other basis for imputing a trust business to a beneficiary. The interest formulation 'derived … in carrying on a

point is clearly resolved by the present version of ITAA 1997 Sub-div 207-B. (See n 864 and corresponding text.)

[983] TAA Au Sch 1 Sub-div 12-F. For example, a resident company paying a dividend to an address outside Australia or a shareholder with a foreign address must withhold under s 12-210 – this is apt to catch dividend payments where the trust is based overseas, regardless of whether a presently entitled beneficiary can then be identified – and a person in Australia who receives an Australian company dividend must withhold if and when a non-resident is or becomes presently entitled to the benefit of the dividend under s 12-215 – this catches an Australian trustee when the beneficiary's present entitlement arises, by whatever method. This account accords with IT 2680 *Income tax: withholding tax liability of non-resident beneficiaries of Australian trusts*. (The ruling refers to ITAA 1936 s 221YL, a statutory predecessor of Sub-div 12-F.) See also *FCT* v *Tadcaster* (1982) 13 ATR 245 with respect to 'derivation'.

Where non-resident trustees derive Australian DIR income to which a resident beneficiary is, or becomes, presently entitled, the Commissioner accepts that any withholding tax in fact collected under Sub-div 12-F is credited to the beneficiary: TR 93/10. Where trust income is accumulated and no beneficiary becomes presently entitled, the trust is taxable by assessment under ITAA 1936 s 99 or 99A and not under Div 11A – in that situation, Sub-div 12-F withholding must be credited to the trust.

It must be admitted that a logically consistent reconciliation between Sub-div 12-F, Div 11A, and ordinary assessment of beneficiaries and/or the trust under Div 6 remains elusive: source principles in Div 6 are not identical with those in Div 11A and, more significantly, fiscal attribution operates differently.

[984] ITAA 1936 s 128B(3E)(c).

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business' must be satisfied by the non-resident beneficiary, which is not the case where the trust carries on business. It follows, for example, that a non-resident beneficiary, having no business or establishment of its own in Australia, that is presently entitled to all the income of an Australian trust carrying on business through an Australian PE and earning interest income from Australian borrowers attracts final tax liability by withholding at 10% on the interest income to which it is presently entitled, and not (as one might have expected) on a net basis by assessment.[985] This analysis says nothing about whether an applicable tax treaty between Australia and the beneficiary's country of residence may reduce the amount of Australian tax, or whether it may do so by reference to net profit under the business profits article or gross income under the dividend or interest article.

Whether these settings favour a taxpayer or favour the revenue depends on the circumstances of a particular case, but as such circumstances are generally controllable by taxpayers, the statutory settings clearly present a tax planning opportunity.

By contrast, withholding tax treatment for beneficiary-attributed royalty income may be negated in favour of net-basis taxation by assessment, but only if Australia has a tax treaty with the beneficiary's residence country, the treaty contains a general rate limitation on source-country taxation of royalties, and the particular royalty would be excluded from that limitation by another provision of the treaty – typically because they are effectively connected with an Australian PE of the trust. This is the combined effect of the general rule that switches withholding tax off for directly derived royalties that would be excluded from rate limitation for treaty purposes[986] with the Australian practice of including a trust PE clause in its tax treaties (Section 8.3.10.1). Thus, Australia's treaties with the United States,[987] the United Kingdom[988] and New Zealand[989] contain provisions that expressly impute

[985] These were the facts of *GE Capital Finance Pty Ltd* v *FCT* (2007) 159 FCR 473; 9 ITLR 1083. The point of dispute in the case was whether the trust PE would be attributed to the beneficiary under IntTAA s 3(11) by reference to Australia's treaty with the United States, where the beneficiary was resident. That was resolved in the negative, favourably to the taxpayer, on the basis that s 3(11) expressly applied for the purposes of the treaty and was correspondingly limited in its effect. Contrast the express modification by treaty provisions of Australian source rules in primary Australian law via s 4 of the same Act (n 913 and corresponding text).

[986] IntTAA s 17A(4) (n 972).

[987] Australia–US 1982 (as amended by Protocol 2001) Art 7(9). Art 12(3) disengages the basic royalty provision in Art 12(2).

[988] Australia–UK 2003 Exchange of Notes (3)(b). Art 12(4) disengages the basic royalty provision in Art 12(1), (2).

[989] Australia–New Zealand 2009 Art 7(7); cf Art 1(2). Art 12(4) disengages the basic royalty provision in Art 12(1), (2).

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the conduct of a trust business through a trust PE to a person who is 'beneficially entitled' to (USA, UK) or 'beneficially owns' (NZ) a share of the relevant business income; subject to the interpretation of beneficial entitlement or ownership, beneficiary-attributed Australian PE royalties attract ordinary net-basis assessment. Where a trust PE clause is engaged, full net-basis taxation applies,[990] regardless of whether the resulting tax burden is greater or less than under simple withholding.

A.3.1.4 Net versus Gross Issues

The mechanism by which tax law translates trust entitlements into tax consequences creates the possibility that gross-basis withholding tax may be applied to something that is really a net amount – an outcome that the beneficiary could not achieve by comparable direct investment without a taxable presence in Australia. This is particularly significant if the applicable withholding rate is lower than the rate that would be applied on net-basis assessment.

Trust law permits trustees to deduct proper trust expenses before paying trust income to beneficiaries, and the Commissioner (correctly) accepts that the present entitlement of a beneficiary to DIR income is net of that deduction.[991] Once this step is taken, there is no basis on which to deny the deduction in that calculation of trust-level expenses, including interest, incurred in deriving the relevant income.[992] Trust-level expenses relevant to earning beneficiary-attributed DIR income may thus be effectively laid off against that income as if they were a deduction for the beneficiary.

A technical question remains about the tax treatment of gross assessable income and outgoings under the general trust rules. Suppose that a trust has $200 of Australian interest income and $120 of related and prima facie deductible outgoings. The remaining $80 of that income is vested in or appointed to a non-resident beneficiary and attracts withholding tax at 10%. Clearly enough, the $80 is excluded from the 'net income of the trust estate', but how are the other $120 of gross assessable income and $120 of outgoings treated? The simplest and perhaps the correct view is that they are both subsumed in the disregarded $80 because they are both necessary elements in generating that net profit. Alternatively, it might be argued that the

[990] Under ITAA 1936 ss 98(2A), (3), 98A.

[991] IT 2680 [11], [43].

[992] *GE Capital Finance Pty Ltd* v *FCT* (2007) 159 FCR 473; 9 ITLR 1083 is illustrative; the Commissioner fought the case on a different point (see n 985). The hypothetical example given in IT 2680 at [43] contemplates interest expenses being set off against rental income (which attracts taxation by assessment) and trust management expenses being deducted from both rental income and interest income, implying that a borrowing was taken out in relation to the rental property investment. Similar reasoning could equally be applied to expenses relating to DIR income.

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remaining $120 of income minus some proportion of the $120 of prima facie deductions should still be recognized as net income of the trust estate[993] and attributed (assuming that the trust has no other trust-law income) to the trust.[994] The point has not been determined. Either view (but particularly the second) can produce anomalous consequences. For the purpose of the present analysis, it will be assumed that the first view is correct.

The significance of using a net amount as the withholding tax base is magnified by the circumstance that Australia does not attribute a local trust PE to beneficiaries for the purposes of taxing income associated with the PE except in the context of royalties and a suitably worded tax treaty. With that exception, DIR income of an Australian trust PE attributed to a non-resident beneficiary attracts net-basis taxation at withholding rates.

The foregoing analysis has assumed that the relevant administrative withholding obligation arises at the level of the trustees – i.e., that the trustees are resident or operating onshore.[995] The analysis is equally valid if the trustees are offshore but, if the original payer withholds, a refund application to the Commissioner is required in order to recover the overpaid tax. It will therefore be more practical for non-resident investors to route a relevant investment through local trustees.

In summary, a non-resident beneficiary may be subjected to final gross-basis taxation on what is effectively an amount of net income by the interposition of a trust. A fiscal advantage is most likely where the withholding rate is significantly below the otherwise applicable personal or corporate rate of net-basis taxation: that is to say, in relation to interest income (10% statutory withholding) and in treaty cases.[996] It is unlikely that the ramifications of the settings considered in this section were appreciated when the statutory rules from which they arise were enacted.

In considering the policy implications of using a trust to attract net-basis beneficiary taxation of local DIR income, a distinction should be drawn between two elements: the adoption of a net benefit as the tax base, and the application of a tax rate designed for gross-basis withholding which, in some situations, may be lower than the rate that would be applied on net-basis assessment. The first is not inherently anomalous: from an economic viewpoint, income is a net concept. The second element engages different considerations. If a rate of gross-basis taxation reflects the unavailability of deductions

[993] See ITAA 1936 s 95(1) (Section A.3.1.1; n 848).

[994] There is no indication that the Commissioner has ever adopted such a view, although the issue would presumably have arisen on the facts of *GE Capital Finance Pty Ltd* v *FCT* (2007) 159 FCR 473; 9 ITLR 1083.

[995] See TAA Au Sch 1 Sub-div 12-F.

[996] Australia's tax treaties usually stipulate headline withholding rate limits of 15% for dividends, 10% for interest, and 5% or 10% for royalties.

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because the taxing country lacks the capacity to make a reliable and convenient assessment of net income, the switch to net benefit as the tax base should attract taxation at ordinary net-basis assessment rates. Similarly, if the justification for using a lower rate is related to limited participation in the local economy corresponding to the absence of a local taxable presence, the existence of such a presence at the trust level should result in net-basis taxation of beneficiary-attributed income at net-basis rates.

A.3.2 United States

A.3.2.1 General Settings

DIR income belongs to a broad class of passive income commonly referred to as 'fixed or determinable'.[997] This category includes virtually every form of income[998] other than sales income, capital gains and insurance premiums.[999] Fixed or determinable income of a non-US person is generally taxed on a gross basis at a flat rate of 30% if it is 'received from sources within the United States' unless it is also effectively connected with a US trade,[1000] in which case net-basis taxation prevails. Mere presence of a US trade is not enough; a relevant factual connection is required.[1001] The flat rate tax is a liability of the non-US person but is usually collected by international withholding.[1002] There are a number of international concessions, including the non-taxation of portfolio interest derived by a non-resident[1003] under which 'US persons

[997] Based on the wording of the final item listed in IRC ss 871(a)(1)(A) and 881(a)(1), 'other fixed or determinable annual or periodical gains, profits and income'.

[998] Isenbergh, n 920, 83–85.

[999] Gross income includes 'gross income derived from business', which contemplates recognition of the cost of goods, etc., sold (26 CFR s 1.61-3; Boris I Bittker, Martin J McMahon and Lawrence A Zelenak, *Federal Income Taxation of Individuals* (RIA/Westlaw, electronic looseleaf) (at 27 December 2017) [39.06]). These receipts are ones which do not allow assessment of the profit component that gives rise to 'gross income' (IRC s 61, modified for non-resident aliens by s 872 and foreign corporations by s 882 (b)) which, after allowance of deductions, yields net-basis taxable income (s 63).

[1000] IRC ss 871(a), 881(a).

[1001] IRC s 864(c)(2). The income must be 'derived from assets used in or held for use in the conduct' of the business or the activities of the business must be a 'material factor' in its realization. Contrast the vestigial force-of-attraction rule for business income in s 864 (c)(3) (n 921).

[1002] IRC ss 1441, 1442. The primary taxing provisions and the withholding provisions are not identical, and the primary tax obligation can be enforced even if there is no withholding obligation: *Central de Gas de Chihuahua SA* v *CIR*, 102 TC 515 (1994) (flat rate tax but no withholding due on notional equipment rent between related entities); Kuntz and Peroni, n 920 (at 27 December 2017) [C1.03[1]].

[1003] IRC ss 871(h), 881(c).

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regularly borrow vast sums of money without withholding any US taxes from interest payments'.[1004] In broad terms, interest derived by a foreign non-bank lender from a substantially unrelated borrower is exempt from the international flat rate tax; this valuable and attractive exemption is accompanied by a posse of integrity and anti-arbitrage measures.[1005]

A.3.2.2 Beneficiary Settings

A non-US beneficiary attracts the flat rate tax where trust income is fiscally attributed to that person under the usual beneficiary attribution rule via the DNI accounting process. At the first tier of that process, trust-law allocation predominates if that allocation is non-discretionary; otherwise and at the second tier, attribution is formulary and proportionate. If such income is fixed or determinable, has a US source and is not effectively connected, the flat rate tax prima facie applies.[1006] The practical business of collecting that tax is generally accomplished under the withholding provisions. Fiduciaries are mentioned expressly as withholding agents.[1007] Their withholding obligation is not limited to distributions actually paid, but is also triggered where the conditions for beneficiary attribution are satisfied without payment.[1008] It follows that there are at least two potential withholding points: payment of fixed or determinable income to the trust, and distribution or crediting of DNI by the trust to the beneficiary. The withholding obligations necessarily differ between cases where the trust is domestic or US-based and cases where it is foreign or offshore, but assuming full and adequate information, the primary tax liability for beneficiary-attributed income depends on the fiscal residence of the beneficiary.

[1004] Kuntz and Peroni, n 920 (at 27 December 2017) §C1.03[1]; see also §C1.03[2][c].

[1005] See Isenbergh, n 920, 86–92.

[1006] This basal proposition seems clear, although it arises to some degree by inference. It does not emerge directly from the text of IRC ss 871(a), 881(a), which do not refer to trusts, but from the way that beneficiaries are treated in the inbound taxing rules generally, including the US trade attribution rule in s 875. The few references to beneficiaries in the regulations under s 871 confirm this conclusion (see 26 CFR ss 1.871-7(d)(2)(iii), 1.871-10(b)(i), 1.871-14(g)(4)), as do the elaborate trust withholding provisions (n 1008).

[1007] IRC s 1441(a), picked up by reference in s 1442(a). The obligation is not limited to fiduciaries of domestic trusts and estates, although that is the main field of its operation.

[1008] See discussion in Kuntz and Peroni, n 920 (at 27 December 2017) C2.02[2][d] and regulations under IRC s 1441, particularly 26 CFR s 1.1441-5 with respect to payments to and distributions, etc, by partnerships, trusts and estates. The regulations depend on a matrix of presumptions and proofs regarding the foreignness or otherwise of the ultimate payee or beneficiary of particular income as they are known or available to a payer or withholding agent.

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Concessional treatment of particular types of fixed or determinable income, such as the portfolio interest exemption, extends to cases where the income is derived through a trust and attributed to a non-US beneficiary. One of the integrity measures of the portfolio interest exemption recognizes this explicitly: the 10% shareholder test (which excludes interest received by a 10% owner of the borrower)[1009] is applied at the level of an attributable beneficiary in respect of interest paid to a fully distributing trust.[1010] An exemption for interest on US bank and similar deposits may also pass through to a non-resident beneficiary.[1011]

A.3.2.3 Taxable Presence

The statutory rule attributing the US trade of a trust to beneficiaries[1012] has the effect that fixed or determinable income that is effectively connected at the trust level is treated as effectively connected for a beneficiary to whom such income is fiscally attributed. The income escapes the flat rate tax and attracts net-basis taxation instead, in the same way as if the beneficiary had pro tanto conducted the trust business directly or through a partnership.

A.3.2.4 Net versus Gross Issues

Section A.3.1.4 described a process by which Australian international gross-basis withholding tax could be massaged into a tax on net income by the interposition of a trust. A similar result may be achieved in the United States, provided that the trust is resident and that the income is not relevantly that of a US trade of the trust.[1013] This may be illustrated by two simplified scenarios.

- *Scenario 1 – foreign trust:* A foreign trust derives $200 of US-sourced DIR income that is not effectively connected and incurs $120 of related expenses that would be deductible under net-basis taxation. It has no other income.

[1009] IRC ss 871(h)(3), 881(c)(3)(B).

[1010] 26 CFR s 1.871-14(g)(4). The rule refers to interest paid to a 'simple trust', defined by 26 CFR s 1.651(a)-1 as one which '[r]equires that the trust distribute all of its income currently for the taxable year, and . . . [d]oes not provide that any amounts may be paid, permanently set aside, or used in the taxable year for the charitable, etc., purposes specified in section 642(c), and does not make any distribution other than of current income'. A simple trust does not engage the second tier of the DNI accounting process. A trust which provides for discretionary distribution of income among beneficiaries may be a simple trust if there is no power of accumulation. Cf the timing rules in 26 CFR s 1.871-14(g)(3).

[1011] IRC ss 871(i), 881(d); Kuntz and Peroni, n 920 (at 27 December 2017) §C1.03[2][h].

[1012] IRC s 875(2), discussed earlier in the context of business income (n 923 and corresponding text).

[1013] The latter element precludes the result in *GE Capital Finance Pty Ltd* v *FCT* (2007) 159 FCR 473; 9 ITLR 1083 (n 985) from being replicated in the United States.

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It distributes its income to a non-resident beneficiary, who receives or is credited with $80 as a trust-law entitlement. The distribution deduction for the trust is $80, which is also treated as tax-law income of the beneficiary. The trust is taxable by analogy with a non-resident alien who is never present in the United States;[1014] this includes liability to flat rate tax and corresponding denial of deductions. Flat rate tax applies to the beneficiary on $80 and to the trust on $120.

- *Scenario 2 – domestic trust:* A US domestic trust derives $200 of US-sourced DIR income and incurs $120 of related expenses that would be deductible under net-basis taxation. It has no other income. It distributes its income to a non-resident beneficiary, who receives or is credited with $80 as a trust-law entitlement. Assuming that the trust is properly characterized as a trust for US tax purposes and not as a partnership, division or corporation, it is necessary to determine whether the trust is conducting a US trade or business. If so, the income in question will be effectively connected if it has the required nexus with the local business, and the attribution of the trust's US trade to the beneficiary will result in net-basis tax liability. But if the trust does not have a US trade or if the particular income is not relevantly connected with that trade, a different result follows: the $80 qualifies as a distribution deduction for the trust and is attributed to the beneficiary, attracting flat rate tax, while the trust's own taxable income is reduced to zero by ordinary deductions ($120) and distribution deductions ($80).

A.3.3 United Kingdom

A.3.3.1 General Settings

The United Kingdom taxes non-residents' DIR income under several heads. The main ones, to which consideration in this section will be limited, are dividends and other distributions from resident companies,[1015] interest,[1016] and royalties and other income from intellectual property.[1017] The person receiving or entitled to the income is liable to tax,[1018] but income arising to a non-resident under these heads is only chargeable if it is from a source in the United Kingdom or, if it has no source, if it has a comparable connection to

[1014] IRC s 641(b).
[1015] ITTOIA Part 4 ch 3. (Dividends from non-resident companies under ch 4 and stock dividends from resident companies under ch 5 will not be considered.)
[1016] ITTOIA Part 4 ch 2. (Disguised interest under ch 2A will not be considered.)
[1017] ITTOIA Part 5 ch 2.
[1018] ITTOIA ss 371 (interest), 385 (dividends), 581 (royalties).

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that country.[1019] Such income is brought to tax as a gross amount;[1020] any related deductions, such as for interest, must be found elsewhere in the legislation.[1021]

If the non-resident is an individual and has a UK representative in relation to the income (i.e., a relevant UK branch or agency), net-basis taxation by assessment will apply.[1022] In addition to trading income derived through or from the branch or agency, this applies to income from property or rights which are used by or held by or for the branch or agency.[1023] If the non-resident is a company, DIR income is included in chargeable profits and attracts corporation tax by reference to a similar connection with its UK PE.[1024] Otherwise, UK-sourced income arising to a non-resident under each of the heads mentioned in the preceding paragraph (and other specified classes of passive income) is 'disregarded': disregarded income is quarantined from the non-resident's other income; the UK claim to tax is limited to tax, if any, deducted or deemed to be deducted at source; and any related tax deductions, etc, that would have been recognized under net basis assessment are ignored.[1025]

The United Kingdom has historically placed great reliance on deduction at source as a method for collecting tax on investment income. Deduction at source of income tax at the basic rate (20%) applies to many classes of interest and analogous income[1026] – there are also some significant exclusions[1027] – and to royalties and similar income.[1028] Amounts deducted are generally treated as income tax paid by the recipient of the income.[1029] Source deduction

[1019] ITTOIA ss 368(2), (3) (income within Part 4), 577(2), (3), 577A (income within Part 5).

[1020] ITTOIA ss 370 (interest), 384 (dividends), 580 (IP royalties).

[1021] Such as ITA UK Part 8 ch 1. Deductions of this kind enter the assessment process via ITA UK s 23. See Loutzenhiser, n 53, §10.2: 'Today, interest payments are deductible only if the interest is on a loan to defray money applied for certain defined purposes.'

[1022] ITA UK s 813(2); Part 14 ch 2B.

[1023] ITA UK s 385E(2).

[1024] CTA 2009 s 19(3)(a), (b).

[1025] ITA UK ss 811 (non-resident individuals), 813 ('disregarded income') 815 (non-resident companies), 816 ('disregarded company income'); s 825(1)(a) (dividends), s 825(1)(b), (2)(a) (interest), s 826(a) (royalties) ; cf s 989 and ITTOIA s 830 ('relevant foreign income').

[1026] ITA UK Part 15 chapters 3, 4, 5 (ss 874(2), 889(4), 892(2)).

[1027] See the exemptions from ITA UK s 874 stipulated by ss 875–888E in relation to bank and building society interest, qualifying private placements and various other interest-like investment returns and the exemption from s 892 for interest on gross-paying government securities (s 893).

[1028] ITA UK Part 15 chapters 6, 7 (ss 900(2), 901(3), 903(5), 906(5), 910(2)). Section 906 is only engaged if the usual place of abode of the owner of the relevant intellectual property is abroad; cf s 910(1).

[1029] ITA UK s 848, referring to deductions and deemed deductions under Part 15 of that Act.

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thus represent a form of non-final withholding, but it is converted to final taxation if the income in question is 'disregarded'. Dividends are not generally subject to source deduction or withholding. A non-resident whose income includes a dividend from a resident company is treated as having paid tax at the dividend ordinary rate (currently 7.5%) on terms that the tax treated as paid is not refundable.[1030] This survives the general abolition of the UK dividend tax credit[1031] and may affect the non-resident's tax calculation if the dividend is not 'disregarded'.

A.3.3.2 Beneficiary Settings

The UK conditions for beneficiary attribution mean that it is only necessary to consider the position of a non-resident beneficiary who has an indefeasibly vested interest in possession in trust income as derived by the trust. When a trust derives particular income, it should be possible to say whether it is attributed to a particular beneficiary.

If trust income is attributed to a non-resident beneficiary and 'disregarded' treatment does not apply, the trust is initially taxable at the basic rate on beneficiary-attributed income if it is within the UK charge to tax for the non-resident beneficiary, with credit in the usual way for tax deducted, deemed deducted or deemed paid at source. This is so, regardless of whether the trust is resident or non-resident. The beneficiary is also personally taxable at applicable progressive personal rates or (if a corporate beneficiary) at the basic rate, with credit for preceding layers of deemed or actual taxation. Whether such non-disregarded treatment can apply to DIR income is considered in Section A.3.3.3.

'Disregarded' treatment affects the income tax liabilities of non-resident trustees, corporate or individual, in respect of their trust in the same way as those of a non-resident individual, provided that the trust does not have an actual or potential beneficiary that is resident.[1032] The point of the rule is to prevent concessional treatment applying to income that might find its way back to a resident beneficiary in the form of a capital distribution. It would be

[1030] ITTOIA s 399. The dividend ordinary rate is prescribed by ITA UK s 8(1). The present dividend rate structure applies from 2016–17 (FA 2016 s 5(3)).

[1031] The dividend tax credit was abolished by FA 2016 s 5 and Sch 1. ITTOIA s 399 was amended by Sch 1 para 11. As summarized by the Explanatory Notes, Finance (No 2) Bill 2016 (UK), vol 1 'Clause 5 and schedule 1' [18], referring to that amendment: 'A non-UK resident person who receives a distribution from a UK resident company is treated as having paid tax on that distribution at the dividend ordinary rate. This amendment makes the consequential adjustments necessary following the abolition of the dividend tax credit. It also restores the meaning of the legislation to what it was before an inadvertent amendment was made under the Tax Law Rewrite project.'

[1032] ITA UK s 812; cf s 811(1).

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anomalous to read this as preventing disregarded treatment of income currently attributed to a non-resident interest-in-possession beneficiary. The view has been expressed, and will be accepted in the present analysis, that the proviso does not apply in relation to such income.[1033] This may be justified by treating the primary rule as being engaged by reference to the income tax liability of the non-resident beneficiary[1034] rather than that of the trustees. The next step, which is consistent with the basal UK view that trustees are taxed on behalf of an interest-in-possession beneficiary,[1035] is to ignore the proviso addressed to non-resident trustees where 'disregarded' treatment is engaged by the attributable beneficiary. The consequence is that no additional UK tax is payable by the trust or by the beneficiary.

If this reasoning is correct, a further consequence follows: attribution of income to a non-resident interest-in-possession beneficiary in a resident trust engages 'disregarded' treatment in the same manner.[1036]

A.3.3.3 Taxable Presence

The distinction between disregarded treatment and income taxation by assessment of a non-resident individual on UK-sourced DIR income depends, as has been mentioned earlier, on its connection with the individual's UK branch or agency. In the case of a non-resident company, a similar distinction between disregarded treatment and corporation tax depends on the connection of the income with the company's UK PE.

The UK branch or agency of a trust cannot plausibly be interpreted as the UK PE of a corporate interest-in-possession beneficiary by reference to the beneficiary's interest under the trust alone. As has been observed earlier, it is difficult to characterize the principal UK operations of a resident trust as a UK branch or agency of the trust, nor can the trust itself be characterized under

[1033] See Chamberlain and Whitehouse, n 50, §10.55: 'If the non-resident trust has no UK resident beneficiaries or there are potential UK resident beneficiaries but the trust gives a beneficiary who is not UK resident an interest in possession, then income tax is limited [under ITA UK s 811] to tax on rental or trading income.' The authors do not elaborate further.

[1034] By application of ITA UK s 811 or 815, as the case requires, to the income tax liability of the beneficiary.

[1035] Note 819 and corresponding text.

[1036] The interest of the beneficiary may, of course, be unknown to the payer of income to the trust. That is not a problem to the correct working of deduction at source where non-residence is irrelevant to the deduction obligation, or if a wide interpretation is being applied to the obligation so that it attaches to the trustees. Most of the deduction obligations are addressed to '[t]he person by or through whom the payment is made' (ITA UK s 874(2); similarly, ss 889(4), 892(2), 906(5), 910(2)). It is open to interpret this as applying to a trustee. Other provisions, however, refer to the person who makes the payment (ss 900(2), 901(3), 903(5)).

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the general law as the branch or agency of an interest-in-possession beneficiary. While a non-resident trust may have a UK branch or agency, there are also difficulties in the way of attributing this to a beneficiary,[1037] and such attribution to a non-resident individual beneficiary would be out of step with the settings applicable in comparable situations involving corporate beneficiaries or resident trusts. It may be concluded that the UK operations of a resident or non-resident trust do not qualify as the UK branch or agency of a non-resident beneficiary by reason simply of the income of those operations being attributed to that beneficiary.

It follows that a connection between DIR income and the UK branch or trade of a trust does not impede 'disregarded' treatment where the income is attributed to a non-resident beneficiary. This is so, even if net-basis taxation would have applied to that income, had the UK branch and trade belonged to the non-resident directly or through a partnership.

The previous analysis is premised on the view that the interest-in-possession beneficiary is treated as the owner of the income and that its tax treatment is determined by reference to that fact. UK tax doctrine in this area is conceptually unstable.[1038] If the view is taken that a non-resident trust entity is taxable by reference to a trust-level UK branch without regard to the beneficiary, a different result would follow, notwithstanding that the beneficiary-owner has no UK branch.

A.3.3.4 Net versus Gross Issues

The net versus gross issue does not arise in the United Kingdom. The schedular system of UK taxation with its historical emphasis on deduction at source, the related approach of charging DIR income with tax on a gross basis (leaving aside whether the rate is flat or progressive) and allowing deductions and reliefs at a separate point in the assessment process, and the attribution test that simply asks whether the beneficiary is already the beneficial owner of an item of income when the trust derives it ensure that any final withholding from non-resident beneficiary-attributed income is levied on the gross amount of the underlying income, even if the beneficiary suffers trust-law deductions for trust-level outgoings.[1039]

[1037] See n 943.
[1038] See n 819.
[1039] The UK tax system deals separately with trust management expenses which, broadly speaking, are deductible on assessment to a beneficiary but not deductible to trustees, with the result in a domestic situation that income corresponding to those expenses bears tax only at the basic rate (cf n 164). See Chamberlain and Whitehouse, n 50, §8.49–§8.58; Loutzenhiser, n 53, §29.2.1.3, §29.3.2.2. The discussion in the principal text is concerned with trust level outgoings and expenses of earning the income, not the

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A.3.4 *New Zealand*

A.3.4.1 General Settings

New Zealand taxes non-residents on New Zealand–sourced DIR income by a combination of net-basis assessment, final gross-basis withholding and minimum gross-basis withholding.[1040] Minimum withholding is supplemented by net-basis assessment if the latter yields more tax. There are two withholding regimes: resident withholding tax, which is non-final and applies in domestic contexts, and non-resident withholding tax (**NRWT**),[1041] which applies where the income in question is derived by a non-resident. The latter is described here.

Dividends generally[1042] attract final withholding at 30%, 15% or 0%. The rate is integrated with New Zealand's imputation system. To the extent that a dividend has attached imputation credits reflecting prior corporate taxation, it is said to be fully imputed. The 30% withholding rate applies to dividends to the extent that they are not fully imputed. If the non-resident to whom the dividend is paid has less than a 10% direct voting interest in the company, the 15% rate applies to dividends to the extent that they are fully imputed and capable of qualifying the company to add a targeted supplementary dividend. The supplementary dividend gives the company a foreign investor tax credit that effectively pays for and cancels out the withholding tax.[1043] With the cooperation of the company, corporate income tax is converted into dividend withholding tax, and the non-resident is armed with an argument for double tax relief at home. The 0% rate applies to fully imputed dividends that cannot qualify for supplementary dividend and foreign investor tax credit – under present legal arrangements,[1044] this only happens where the non-resident has a direct voting interest of 10% or more.

cost of managing the trust itself. No trust management expenses deduction can arise if the beneficiary-attributed income is 'disregarded'.

[1040] The description and analysis in Sections A.3.4.1 and A.3.4.2 are substantially drawn from Brabazon, *Ariadne*, n 235.

[1041] ITA NZ subpart RF.

[1042] ITA NZ s RF 2(1)(a), (3)(a), (4). Investment society dividends are treated separately, in a manner resembling interest. They will not be considered further in this book.

[1043] The 15% NRWT rate and the foreign investor tax credit provisions (ITA NZ subpart LP) only apply if the relevant post-treaty rate of tax, absent imputation credits, would be less than 15%. For further consideration of the foreign investor tax credit, see Brabazon, *Ariadne*, n 235, §3.1; Elliffe, n 218, §5.2.2; Andrew M C Smith, 'International Tax Policy Changes Arising from New Zealand's Latest Tax Treaties: New Perceptions of Being a Capital Exporter?' (2015) 69 *Bulletin for International Taxation* 3; Andrew M C Smith, 'Dividend Imputation and International Equity Investment: Unilateral Extension of Imputation to Non-Resident Investors' (1994) 11 *Australian Tax Forum* 248.

[1044] New Zealand's present treaty policy does not involve sub-15% dividend rates for sub-10% shareholders: see Brabazon, *Ariadne*, n 235, §3.1.

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Interest attracts net-basis taxation by assessment if the non-resident is engaged in business in New Zealand through a fixed establishment in that country; no particular nexus is required between the interest and the business or establishment.[1045] Otherwise, NRWT generally applies.[1046] It operates as a final tax unless the borrower and lender are associated, in which case it operates as a minimum tax. The prima facie withholding rate is 15%, but this is reduced to 0% if the parties are not associated and the borrower has engaged and paid the 'approved issuer levy', an elective alternative to NRWT. The levy is generally set at 2%. Bearing in mind that the cost of withholding is generally passed on to New Zealand borrowers, this creates an incentive to choose 15% NRWT if the lender can more or less fully recoup the cost of that taxation by foreign tax credit at home, and the approved issuer levy in other cases. New Zealand does not want to give up tax where it makes no difference to the participants in its economy, and the levy discourages them from opting out of NRWT if it would be credited to the lender and effectively borne by a foreign fisc.[1047]

Royalties attract final withholding if they relate to copyright or similar cultural intellectual property or minimum withholding in other, broadly industrial contexts. The rate is 15%.

A.3.4.2 Beneficiary Settings

The current attribution of trust DIR income to a non-resident beneficiary is governed by New Zealand's general rules of beneficiary attribution. It may be established by pre-existing indefeasibly vested entitlement or by subsequent timely distribution, including a constructive distribution by appointment and crediting without actual payment. The general beneficiary attribution rule ordinarily follows trust-law tracing or allocation principles.[1048]

DIR income may be identifiable as beneficiary-attributed income at the point of trust-level derivation or subsequent appointment to the beneficiary.

[1045] Elliffe, n 218, §5.1.5(2) n 88.

[1046] ITA NZ s RF 2(1)(d).

[1047] See Brabazon, *Ariadne*, n 235, §3.2; Elliffe, n 218, §1.3.3, §5.2.3. See also Minister of Finance, Michael Cullen, Minister of Revenue, Peter Dunne, 'New Zealand's International Tax Review: A Direction for Change: a Government Discussion Document' (IRD, 2006) [8.23]: 'The policy rationale behind [the approved issuer levy] is that the borrower can choose to pay the levy when the lender is unable or unwilling to obtain credits for NRWT.' The approved issuer levy provisions are principally found in ITA NZ s RF 7, TAA NZ s 32M and the *Stamp and Cheque Duties Act 1971* (NZ) Part 6B.

[1048] Subject to potential modification if the relevant trust has 'foreign' or 'non-complying' status for distribution tax purposes, the effect of which is to treat distributions as consisting first of current-year trust income: ITA NZ s HC 16(2)(a) (n 895). If the trust is minded to distribute income on a current basis, this modification is unlikely to provide a material constraint.

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In the former case, withholding obligations apply to the payer (subject to relevant knowledge) and to a resident trustee by reference to the residence of the beneficiary. In the latter case, a separate NRWT taxing point arises between a resident trustee and non-resident beneficiary. The application of NRWT is determined in these cases by reference to the non-residence of the beneficiary, and the question of association between borrower and lender is determined as between the borrower and the beneficiary (who is aggregated for this purpose with the trustees). Access to and application of the foreign investor tax credit and the approved issuer levy regimes are determined by reference to the non-residence of the beneficiary alone.[1049]

By applying and re-applying the trust income attribution rules at each relevant taxing or withholding point, the general settings of inbound DIR taxation are coordinated with the residence status of an attributable beneficiary. Where NRWT applies as a minimum tax and supplementary assessment is required, the usual New Zealand arrangements apply: the beneficiary is assessable directly, and the trustees as statutory agent.

A.3.4.3 Taxable Presence

New Zealand–sourced interest derived by a non-resident is only subject to NRWT if 'the non-resident is not engaged in business in New Zealand through a fixed establishment in New Zealand'.[1050] A fixed establishment is principally defined as 'a fixed place of business in which substantial business is carried on by a person'.[1051] As mentioned earlier, no nexus is required between the interest and the business: if the non-resident is engaged in a qualifying business, net-basis taxation applies to all his or her New Zealand–sourced interest. While a trustee is treated as a statutory agent of a beneficiary with liability to satisfy the latter's income tax liability for beneficiary income and taxable distributions,[1052] no wider agency is deemed to exist.

Where a trust is engaged in business in New Zealand through a fixed establishment in that country, it cannot be said that a particular beneficiary is engaged in that business by reason of that status or the attribution of income from the business, or that the trust business is attributed to the beneficiary for the purpose of determining whether NRWT is engaged.

[1049] See Brabazon, *Ariadne*, n 235, §5.1, §6.2. These conclusions have been reached by applying purposive statutory construction to overcome a number of gaps and interpretive difficulties in the legislation, some of which have crept in through the tax law rewrite. Note also that the 10% direct voting interest test (which is not a test of residence) in the foreign investor tax credit provisions now appears to be applied at the level of the trustees, not the beneficiary: ibid §5.1.1(2).

[1050] ITA NZ s RF 2(1)(d).

[1051] ITA NZ s YA 1.

[1052] ITA NZ ss HC 32(3), HD 12(1).

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Combining these conclusions with those reached earlier concerning the integration of NRWT with the trust rules, it follows that New Zealand–sourced interest income attributed to a non-resident beneficiary attracts simple net-basis assessment only if the beneficiary is separately engaged in a qualifying New Zealand business and that such a business conducted by the trust does not disengage NRWT.[1053]

A.3.4.4 Net versus Gross Issues

The net versus gross issue identified under Australian tax law plays out in a clearer way in New Zealand. This turns on the technical treatment of trust-level losses and outgoings and the manner in which they are quarantined in the trust. New Zealand distinguishes between 'beneficiary income' attributed to a beneficiary and 'trustee income' attributed to the trust before considering whether the income is assessable and before deductions are taken into account.[1054] In order to prevent trust losses being passed on to beneficiaries, a special rule stipulates that a person who derives beneficiary income 'is denied a deduction for expenditure or loss that a trustee incurs in deriving the income' and that, for the purpose of determining a trustee's deductions, beneficiary income is treated as if it were trustee income.[1055]

The same simple example as in previous sections will serve to illustrate what happens. A trust has $200 of local DIR income and $120 of related expenses which are prima facie deductible. The balance, $80, goes by vesting or appointment to a non-resident beneficiary. The amount to which the beneficiary is entitled is the measure of his or her 'beneficiary income'. The remaining $120 of gross income is 'trustee income' taxable to the trust, and the full $120 of expenses are deductible to the trust. If the trustees are

[1053] The consequences may be illustrated as follows. If non-resident trustees conduct a qualifying New Zealand business, NRWT will not apply at the point of trust-level derivation of New Zealand–sourced income unless that income is already attributed to a non-resident beneficiary. If the income is later attributed to a non-resident beneficiary without a qualifying New Zealand business, NRWT applies and the trustees must withhold. Conversely, if non-resident trustees without a qualifying business derive such income which later becomes attributable to a non-resident beneficiary who does have such a business, it will initially attract NRWT but will ultimately be assessable to the beneficiary in the ordinary way and with credit for withholding.

[1054] See Flowchart B2 in ITA NZ subpart BC. The 'income derived by a trustee of a trust' in s HC 5 is 'income' referred to in s BD 1(1). Assessable income is a subset of income (s BD 1(5)). Deductions only come to account at a later stage. They are subtracted from assessable income for the relevant year in order to calculate 'net income' (s BC 4).

[1055] ITA NZ s DV 9. If the trust has net losses after excision of beneficiary income, those losses may be carried forward within the trust: ITA NZ s IA 2; Ammundsen, n 49, ch 11.

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non-resident,[1056] NRWT applies to the $120 gross income without deduction; the result is similar to what one would expect if the beneficiary had invested directly.[1057] If they are resident, however, NRWT does not apply to trustee income, the gross trustee income is wiped out by deductions, and the only resulting tax liability is that which falls upon the beneficiary income. If that income attracts final NRWT, the relevant NRWT rate is applied to $80, not $200. Compared to a direct investment, the non-resident beneficiary is better off if the income in question bears meaningful final NRWT, which is most likely to be the case with respect to dividends or copyright royalties.

A.4 Foreign Tax Credit: Identity of Taxpayer

This section addresses exceptions to the identity-of-taxpayer requirement for unilateral double tax relief by foreign tax credit in Australia and the United States. The findings support discussion relating to those countries in Section 3.3.3.

A.4.1 Australia

Australia's extended taxpayer identity rule has two limbs, neither of which is specific or limited to trusts. The starting point is to identify an amount of tax-law income attributed, from an Australian perspective, to the taxpayer claiming credit, referred to as a 'taxed amount'.[1058] The first limb applies where foreign tax is paid in respect of the taxed amount 'by another entity under an arrangement with you or under the law relating to the foreign income tax'.[1059] The second limb applies where foreign tax is 'paid in respect of the taxed amount' to the extent that '(a) the taxed amount is taken' because of another rule that traces beneficiary-attributed income to underlying trust income[1060] 'to be attributable to another amount of income of a particular kind or source', (b) the foreign tax has been paid in respect of that other

[1056] The ultimate incidence of NRWT on trustee income depends on the separate personal or corporate non-residence of the trustees. See further Brabazon, *Ariadne*, n 235, §5.1.4 and passim.

[1057] Leaving aside treaty issues that may arise if the beneficiary and the trust are resident in different countries.

[1058] ITAA 1997 s 770-130(1), referring to an amount 'included in your ordinary income or statutory income'. The requirement for local taxation in addition to attribution comes from s 770-10(1), which requires inclusion in assessable income.

[1059] ITAA 1997 s 770-130(2).

[1060] ITAA 1936 s 6B (discussed further at n 908). Tracing under s 6B does not follow any specific rules, such as Div 6 proportionate attribution or Div 11A tracing under s 128A (3), but depends on whether 'an amount of income derived by' the beneficiary 'can be

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amount, and '(c) the taxed amount is less than it would have been if that tax had not been paid'.[1061]

The conventional understanding is that the first limb applies where foreign tax is imposed on and paid by the trust directly, and that the second limb applies where foreign tax is imposed on or paid by somebody else, such as a person who pays income to the trust under withholding, or another trust in which the first trust is a beneficiary.[1062]

Little practical difficulty arises, so long as the foreign tax is paid by the trust or is deducted on its way to the trust by withholding or by taxation of a remoter trust that Australian tax law recognizes as transparent. But what happens if the foreign tax is imposed on a grantor? In a simple case where the foreign country taxes the grantor directly on the same trust income that Australia attributes to its resident beneficiary, the first limb criteria are satisfied, regardless of whether the amount received by the trust is diminished by grantor taxation.

Should it be necessary to resort to the second limb, the analysis is more complicated because of para (c), quoted earlier. It is difficult to imagine any circumstance in which the 'taxed amount' attributed to the Australian beneficiary is reduced by foreign taxation at all. If para (c) is allowed to mean what it says, it will never be satisfied, even in cases (not involving a grantor) that are conventionally accepted as creditable. The better view seems to be that it refers to the foreign tax being taken out of the beneficiary's trust-law entitlement.[1063]

attributed directly or indirectly to' an underlying item of income. Presumably trust-law allocation will be recognized as a proper basis for s 6B tracing.

[1061] ITAA 1997 s 770-130(3).

[1062] See Explanatory Memorandum, Tax Laws Amendment (2007 Measures No 4) Bill 2007 (Cth) [1.100], [1.108], [1.110], cited by Thomson Reuters, *Checkpoint, Australian Income Tax 1997 Commentary* (online) (at 27 December 2017) §770-1400, §770-1420. This represents a continuation of views expressed in TR 2007/4 *Income tax: entitlement to foreign tax credits under Division 18 of Part III of the Income Tax Assessment Act 1936 when foreign income is included in the net income of a trust estate* [25]–[27] with respect to the effect of ITAA 1936 s 6AB(3) and (4) before the 2007 rewrite of the foreign tax credit rules and, more remotely, in Explanatory Memorandum, Taxation Laws Amendment (Foreign Tax Credits) Bill 1986 (Cth) Part II, heading 'Section 6AB: Foreign Income and Foreign Tax'. (The 2007 ruling was published in draft as TR 2007/D3 *Income tax: entitlement to foreign tax credits under Division 18 of Part III of the Income Tax Assessment Act 1936 when foreign income is included in the net income of a trust estate* a few months before the 2007 Explanatory Memorandum.)

[1063] The history of the statute provides little assistance. The predecessor provision, ITAA 1936 s 6AB(4)(c), was not identically structured but was also difficult to interpret. It required the 'amount of foreign income' that was 'derived' by the beneficiary to be less, 'because of the payment of [the foreign] tax', than it would otherwise have been. It seems that the 2007 rewrite of the foreign tax credit rules was not the sole source of the

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The legislative history and parliamentary materials suggest, by silence, that the capacity for grantor taxation to generate foreign tax credits has not been considered. This is so, notwithstanding Australia's close economic and interpersonal ties with the United States and the United Kingdom – jurisdictions which impose significant general and outbound grantor taxation and do so under significantly different models, particularly with respect to whether grantor taxation may be recouped from the trust.

A.4.2 United States

A US beneficiary is entitled to claim foreign tax credit for 'the amount of his proportionate share of the taxes . . . of the . . . trust paid or accrued during the taxable year to a foreign country' as if the beneficiary had stood in the position of the trust vis-à-vis that taxation.[1064] The view is taken that foreign tax is recognized for a beneficiary to the extent that it is paid or accrued on income that is attributed to that beneficiary under the applicable trust taxation

interpretive quandary in s 770-130(3)(c). It is more promising to consider how the present wording might be interpreted to produce a rationally coherent outcome.

To read 'taxed amount' as if it referred to the amount actually subjected to Australian taxation is no solution, if for no other reason than that Australia does not use the deduction method to relieve beneficiaries from double taxation. It makes more sense to focus on the effect of foreign tax on the real economic benefit actually received by the beneficiary. The economic benefit that a beneficiary receives from the legal and economic facts that give rise to the attribution to the beneficiary of a 'taxed amount' may be affected by foreign taxation to the extent that the trustees debit that taxation to the beneficiary's account and distribute only the net residue (gross trust-law entitlement minus tax). That seems more likely to be what the Treasury drafting staff had in mind. If so, the drafting has miscarried by confusing economic or trust-law benefits with tax-law income and attribution. A corresponding or corrected meaning could be achieved if the reference in para (c) to 'the taxed amount' being less than it would have been in the absence of the foreign taxation were instead a reference to '*your economic benefit corresponding to the inclusion in your ordinary income or statutory income of* the taxed amount' being less than in the counterfactual. Whether this interpretation is permissible (see *Taylor* v *The Owners SP 11564* (2014) 253 CLR 531, 47–49; *Newcastle City Council* v *GIO General Ltd* (1997) 191 CLR 85, 113, 116 per McHugh J) remains to be decided. In the absence of an alternative that is both intelligible and workable, the proposed meaning will be assumed for the purposes of further analysis. It may be conceded that the result is still not free of anomaly: if foreign tax is creditable under s 770-130(3)(b) without impact on the beneficiary's trust-law entitlements (as would be the case, e.g., if the foreign country imposes US-style grantor taxation without indemnity from the trust), no corresponding question arises concerning the actual impact of foreign tax on the claimant beneficiary. But at least some meaningful operation is preserved for the second limb.

[1064] IRC s 901(b)(5) first sentence.

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rules.[1065] Taxes borne by the trust, whether by assessment or by withholding from a remoter entity, are treated on parity with taxes similarly borne by the beneficiary, to the extent of beneficiary attribution through the usual DNI accounting mechanism.

A second rule contemplates the granting of credit for foreign taxes paid by a grantor of a foreign trust provided that, if the foreign taxing country hypothetically applied US tax rules, it would have taxed the grantor.[1066] It does not grant the credit directly; it does so only '[u]nder rules or regulations prescribed by the Secretary [of the Treasury]'. As no such rules or regulations have ever been promulgated, it appears that the rule has never become legally operative, contrary to the expectation of Congress.[1067] As things stand, the United States only extends the identity of taxpayer principle for foreign taxation of the trust.

[1065] See Zaritsky, Lane and Danforth, n 295 (at 27 December 2017) 2.11[3].

[1066] IRC s 901(b)(5) second sentence.

[1067] See *Conference Report on Small Business Jobs Protection Act of 1996*, HR Report 104-737 (1 August 1996) 333: 'In a case where a foreign person (that would be treated as the owner of a trust but for the above rule) actually pays tax on the income of the trust to a foreign country, it is anticipated that Treasury regulations will provide that, for foreign tax credit purposes, US beneficiaries that are subject to US income tax on the same income will be treated as having paid the foreign taxes that are paid by the foreign grantor.' This is also a clear summary of how the new rule was intended to work. It may have been part of the political price for securing the amendment of IRC s 672(f) denying most inbound grantor attribution (n 101 and corresponding text); both amendments derive from the *Small Business Job Protection Act of 1996*, Pub L 104–188, 110 Stat 1909 s 1904. See also Bruce, n 25, 194–195. In broad terms, Congress anticipated that credit would be available to a US beneficiary for grantor taxation imposed by the residence country of a grantor who, under US tax rules hypothetically applied by the foreign taxing country, would attract grantor attribution. Congress may also be taken to have contemplated foreign source-based grantor taxation under circumstances of remote factual probability where the grantor, not being resident in the foreign taxing country or the United States, would notionally fall within s 672(f)(3). The anticipation of Congress remains unfulfilled.

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