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Non-resident testamentary trusts

Robert Gordon *and* ***Aaron Zoanetti*** *POINTON PARTNERS*

With globalisation, it is increasingly common for Australian-based families to have children go overseas to live for a period and, in some cases, for those children to permanently make their homes outside Australia.

If this is a likely reality for a family, then the Australian resident testator may consider creating a non-resident testamentary trust for the benefit of the child residing outside Australia.[1]

This article discusses the key benefits of creating a non-resident testamentary trust, predominantly from a taxation perspective, but the asset protection perspective may be equally important.

Resident testamentary trust

Resident testamentary trusts are relatively well known for their ability to provide worthwhile asset protection from beneficiaries' creditors,[2] and to provide graduated tax rates to beneficiaries who are minors[3] (which is not available through *inter vivos* trusts).

Australian resident trusts are taxed on their worldwide income, whereas non-resident trusts are only taxed in Australia on their Australian source income.

If a resident testamentary trust is set up for the benefit of a non-resident family member, and its income is Australian sourced, the non-resident family member will bear Australian tax on it.[4]

In general, an Australian resident trust with foreign source income and presently entitled non-resident beneficiaries is tax "transparent", ie, neither the trustee nor those beneficiaries are taxed in Australia, but in some common circumstances, there are problems with:

- streaming particular types of income to particular beneficiaries;[5] and
- trustees being subject to tax at the top marginal rate on notional income.[6]

So, if there are to be non-resident beneficiaries, and the income will not necessarily be Australian source, it might be better to start with a non-resident trust. This is especially so where the settled property will be cash, which can be invested overseas.[7]

Non-resident testamentary trust

Generally, income and gains of a non-resident trust will be taxed to an Australian resident transferor with respect to that trust (Div 6AAA of ITAA 1936). These anti-tax-deferral provisions do not apply to a non-resident testamentary trust which meets the requirements of s 102AAL of Div 6AAA.

If a non-resident testamentary trust is set up for the benefit of the non-resident children, some of the Australian source income derived by the trustee may only be subject to Australian withholding tax (interest, royalties, unfranked dividends, managed investment trust distributions) which are at lower rates than marginal rates, or not subject to Australian withholding tax at all (fully franked dividends).

While, at first blush, it might seem appropriate for the non-resident testamentary trust to have trustees in the country of residence of the beneficiaries, if that is a high tax country (especially one without a dividend imputation system, such as the United States), the total tax payable on all of the trust income may be quite high, even though only some of the income was distributed to a beneficiary.

If the amount to be settled is significant, so that the income needs of the beneficiaries might be quite small in relation to the trust's capital, it might make more sense to appoint trustees in a tax haven and to invest the trust capital in offshore markets which will not tax the income in the hands of the tax haven trustee. This will allow the trust capital to "snowball", as it will not be subject to year-on-year high taxation.

Further, if family members are likely to remain in overseas countries that have inheritance taxes (the United Kingdom,[8] most Western European countries and the United States), it may be far more advantageous for inheritance tax planning that the testamentary trust not be resident in their country of residence/deemed domicile/domicile, so that the capital of the trust will not be subject to that tax on the demise of the beneficiary.[9]

If a testamentary trust had not been used, and cash bequests were made to beneficiaries in inheritance tax countries who used the bequests to buy assets there, then even if the beneficiaries resume Australian domicile, if they die leaving the assets in the inheritance tax country, their estate will have an inheritance tax liability on those assets.

If the beneficiaries must buy assets in inheritance tax countries, they would still be better to borrow from a testamentary trust based in a tax haven, and the trust take security over the asset, so the net estate liable to inheritance tax is reduced by that debt.

Basing the trust in a tax haven will generally produce better tax results, and better protect the assets of the trust from attack from creditors (potentially including Family Court orders).[10]

How to make a testamentary trust non-resident?

A trust is a resident of Australia if it has a resident trustee, or its central management and control (CM&C) is in Australia, in either case, at any time during an Australian year of income.[11] A non-resident trust is one that is not a resident trust.[12]

The concept of CM&C is usually relevant to corporate tax residence, for example to determine the residence of a corporate trustee. When the current definition of resident trust was inserted, it seemed unnatural to use CM&C, as to that date it had not been considered to be relevant to trusts, and it has not yet been considered by an Australian court in relation to trusts.

However, a recent Supreme Court of Canada case, *Fundy Settlement v Canada*[13] (commonly referred to as the *Garron* case), applied the concept. In that case, a Barbados trustee did not save the *inter vivos* trust formed in Barbados from being a resident of Canada, as the court held the CM&C was in Canada with the trust's settlor. *Garron* has not yet been considered in Australia.

In relation to a non-resident testamentary trust, as the settlor is dead, and assuming the beneficiaries are non-residents, it will only be if the trustee acts on instructions from an Australian resident appointor/protector, rather than to properly exercise its duties as trustee, that there might be a question of CM&C being in Australia.

Who should be trustee of the non-resident testamentary trust?

When a will is being prepared, it is usual to approach individuals who might be nominated to be executors and trustees to see if they are likely to accept appointment. Such individuals are usually family members or trusted professional advisers.

Family members will act gratuitously, but professional advisers will generally want a clause in the will to allow them to charge professional fees for their professional work (and, often, non-professional time expended) on the estate. An Australian licensed trustee company will charge significant fees for so acting, both as a percentage of assets in the estate and as a percentage of the income of the estate and various other charges, such as hourly rates for additional work or time. Non-resident licensed trustee companies are no different.

Whereas Australian licensed trustee companies are heavily regulated, the regulation of such companies overseas is variable. The fees are also subject to huge variation from jurisdiction to jurisdiction.

Can the decision be left to the executors under the will?

While invalid delegation of testamentary power is unlikely to pose a problem to leave it to the executor to choose the non-resident trustee, there is a serious issue with s 102AAL of ITAA 1936. The cautious view is that the particular non-resident trustees should be nominated in the will so as to obtain the benefit of s 102AAL, so that the executors making the transfer to the non-resident testamentary trust will not be taxable in Australia under the transferor trust provisions of Div 6AAA.[14]

Issues arise from having to nominate a particular non-resident trustee in the will, for example if the testator is still relatively young, so that the trust will not "spring" for maybe 30 years. Is nominating a particular trust company or its successor in title enough? Should cascading trustees be appointed? What if it turns out that their fees are exorbitant, or the tax or trust law of the chosen jurisdiction is unsuitable when the death occurs?

However, these issues may be able to be managed on each review of the terms of the will, which should take place every five or less years, in any event.[15]

Conclusion

If a willmaker has or is likely to have children (or other beneficiaries under a will) who are not or will not be Australian tax residents at the time of their death (and their estate is of substance), then they should consider establishing a non-resident testamentary trust. Tax haven testamentary trusts, in particular, can provide effective taxation and asset protection outcomes compared to resident testamentary trusts, or testamentary trusts resident in the country of the beneficiaries' residence.

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Footnotes

1. A testamentary trust is created on the death of the testator by the terms of the will. This differs from an *inter vivos* trust, which is formed during the life of the settlor. Previously, in Australia, for stamp duty reasons, and due to s 102 of Div 6 of the Income Tax Assessment Act 1936 (Cth) (ITAA 1936), a nominal settler first settled a small sum on trust, to which the client then made a large gift or loan: see *Truesdale v Federal Cmr of Taxation* (1970) 120 CLR 353; 44 ALJR 296; 70 ATC 4056; BC7000220. The stamp duty reason is generally no longer valid, as the various Duties Acts do not subject cash to *ad valorum* duty. In other foreign jurisdictions, any person who makes a gift to the trust is referred to as a settlor.
2. Although trusts effectively controlled by beneficiaries have been subject to more attack in Australia in recent times: *Kennon v Spry; Spry v Kennon* (2008) 238 CLR 366; 251 ALR 257; [2008] HCA 56; BC200810608; *Re Australian Securities and Investments Commission (ASIC); Richstar Enterprises Pty Ltd v Carey (No 6)* (2006) 153 FCR 509; 233 ALR 475; [2006] FCA 814; BC200604846.
3. Section 102AG(2)(d) of Div 6AA, ITAA 1936.
4. Section 98(3), ITAA 1936. The non-resident beneficiary may get a credit for the Australian tax in their country of residence.
5. Following the High Court decision in *Commissioner of Taxation v Bamford; Bamford v Cmr of Taxation* (2010) 240 CLR 481; 264 ALR 436; [2010] HCA 10; BC201001703 ("Bamford"), and amendments thereafter, only capital gains and franked dividends can be streamed to particular beneficiaries. While dividends, royalties and interest will only be subject to withholding tax in the hands of non-resident beneficiaries, the result of Bamford (as applied in *Commissioner of Taxation v Greenhatch* (2012) 203 FCR 134; [2012] FCAFC 84; BC201203896) is that a distribution to resident and non-resident beneficiaries including foreign income will be "blended", rather than streamed. This is also argued for in the stalled draft tax ruling TR 2012/D1.
6. Although ATO ID 2005/200, which has been withdrawn (on the basis that the Foreign Investment Fund (FIF) provisions to which it expressly referred are now repealed), is to the effect that attributed foreign income from a controlled foreign corporation (Pt X, ITAA 1936) or transferor trust (Div 6AAA, ITAA 1936) is not "income" to which a non-resident can be presently entitled (as it is a notional amount rather than a distributable amount).
7. If the trust started out as resident and became non-resident, it would be deemed to have disposed all of its "non-taxable Australian property" for CGT purposes, at market value.
8. Beneficiaries who are not domiciled in the UK are not subject to tax on foreign source investment income (including foreign income trust distributions) not remitted into the UK until they have been resident in the UK for seven out of the last nine years, where after £30,000 flat tax must be paid to continue to obtain the benefit of non-remittance, increasing to £50,000 if resident for 12 out of the last 14 years. Thus, by remitting the funds into a foreign bank account, the beneficiary may be able to spend that income while out of the UK.
9. This will usually require that the beneficiaries be "mere discretionary objects" of the trust — that is, that it be a discretionary trust, with a memorandum of wishes left to the trustee so as to guide the exercise of the discretion.
10. See R Gordon and E Waring "Asset protection trusts in tax havens" (2013) 15(1) *Retirement & Estate Planning Bulletin* 182.
11. Section 95(2) of Div 6, ITAA 1936.
12. Above, n 11, s 95(3) of Div 6.
13. *Fundy Settlement v Canada* 2012 SCC 14; [2012] 1 SCR 520.
14. Section 102AAL provides: "A reference in this Division to a transfer of property or services to a trust estate does not include a reference to a transfer made by the trustee of the estate of a deceased person under … the terms of the deceased person's will or codicil or an order of a court that varied or modified the provisions of the deceased person's will or codicil … unless … the transfer was made in or as the result of the exercise (by the trustee or any other person) of a power of appointment or any other discretion …"
15. As a last resort, if the nominated trust company proves to be a problem, the court can be approached to vary the terms of the will so as to continue to obtain the benefit of s 102AAL.