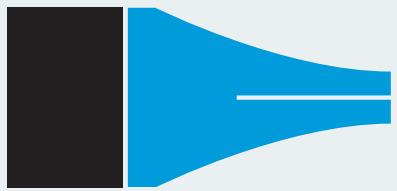


Foreign trusts and foreigner duty surcharge

by Phil Broderick, CTA, Sladen Legal



The wide reach of a recent change to the Victorian Duties Act in relation to "foreign trusts" has the potential to catch many discretionary trusts.

Introduction

From 1 July 2015, if the trustee of a foreign trust acquires Victorian residential property, that trustee is liable for a duty surcharge of 3%¹ on top of the normal ad valorem duty. This can result in a duty rate of up to 8.5%. This article will examine when a trust will be a foreign trust and what changes can be made to trusts to ensure that they are not foreign trusts under the *Duties Act 2000* (Vic).

The foreigner duty surcharge can apply to all trusts whether they are fixed trusts, bare trusts, unit trusts, discretionary trusts or hybrid trusts. This article focuses on the application of the foreigner duty surcharge as it applies to discretionary trusts.

All references to legislation in this article are to the *Duties Act 2000* (Vic).

When is the foreigner duty surcharge triggered?

The foreigner duty surcharge is triggered in three situations:

- where residential property is transferred to a "foreign purchaser";²
- where non-residential property is acquired by a foreign purchaser and that purchaser forms an intention to affix a building on the land that is designed and constructed for residential purposes and may lawfully be used as a residence;³ and
- where there is a relevant acquisition in a landholder that holds a land-related interest in residential property.^{4,5}

Even where the method of acquisition grants the purchaser a concession on ad valorem duty, the foreigner duty surcharge still applies in full.⁶ For example, an off-the-plan purchase entitles the purchaser to a concessional rate of duty. However, the foreigner duty surcharge

will not be discounted, instead the 3% will be payable on the full value of the property.⁷ On the other hand, if the method of acquisition grants the purchaser an exemption from duty, then the foreigner duty surcharge will also not apply.

Who is a foreign purchaser?

A foreign purchaser is:⁸

- a foreign natural person;
- a foreign corporation; or
- the trustee of a foreign trust.

Those terms are in turn defined as:⁸

"**foreign natural person** means a natural person who is not any of the following —

- (a) an Australian citizen within the meaning of the Australian Citizenship Act 2007 of the Commonwealth;
- (b) the holder of a permanent visa within the meaning of section 30(1) of the Migration Act 1958 of the Commonwealth;
- (c) a New Zealand citizen who is the holder of a special category visa within the meaning of section 32(1) of the Migration Act 1958 of the Commonwealth;

foreign corporation means —

- (a) a corporation that is incorporated outside Australia; or
- (b) a corporation in which one of the following persons has a controlling interest —
 - (i) a foreign natural person;
 - (ii) another foreign corporation;
 - (iii) the trustee of a foreign trust;

foreign trust means a trust in which one of the following persons has a substantial interest in the trust estate—

- (a) a foreign corporation;
- (b) a foreign natural person;
- (c) another person that holds the substantial interest as trustee of another foreign trust;"

Controlling interest over a company

In order to determine whether a foreign natural person, foreign corporation or trustee of a foreign trust have a controlling interest in a foreign corporation, the test under s 3A must be examined. Effectively, this section requires that a foreign person and their associated persons hold more than 50% of the voting power (directly or indirectly) or shares in the company.

The Victorian Commissioner of Taxation also has the power to determine that a person has a controlling interest in a company where they have the capacity to determine or influence (directly or indirectly) the outcome of decisions about the company's financial and operating policies.⁹

Substantial interest in a trust

In order to determine whether a foreign natural person, foreign corporation or trustee of a foreign trust have a substantial interest in a trust estate, the test under s 3B must be considered. Section 3B provides that a person has a substantial interest in the trust if the person and their associated persons have a beneficial interest of more than 50% of the capital of the estate.

Importantly, if the terms of the trust grant a power or discretion to the trustee of the trust to make a distribution of capital of the estate to a person, then such a person is taken to have a beneficial interest in the maximum percentage of capital that the trustee is empowered to distribute to that person.¹⁰ Most discretionary trusts empower the trustee to distribute all of the capital of the trust to any of the beneficiaries. For such trusts, this would mean that foreign natural persons, foreign corporations or trustees of foreign trusts would be deemed to have a beneficial

interest of 100% of the capital of the trust and consequently the trust would be considered a foreign trust.

The Commissioner also has the power to determine that a person has a substantial interest in a trust where such a person has the capacity to determine or influence (directly or indirectly) the outcome of decisions about the administration and conduct of the trust.¹¹

What is an “associated person”?

The term “associated person” is drafted very widely in s 3 to include (among others) related persons, partners in partnerships and certain companies and trusts.

How can a discretionary trust be structured to ensure that it is not a foreign trust?

As a result of the provisions outlined above, to ensure that a trust is not a foreign trust:

- no foreign natural person, foreign corporation or trustee of a foreign trust either alone or with their associated persons must hold a beneficial interest of more than 50% of the capital of the estate; or
- the trustee of the trust must not be empowered to distribute more than 50% of the capital of the trust to such persons.

For discretionary trusts in which the trustee has the power to distribute capital to any of the beneficiaries at its discretion, such discretion must be limited so that no more than 50% of the capital of the trust can be distributed to a foreign natural person, foreign corporation or trustee of a foreign trust. Importantly, such restrictions must also be extended to such persons and their associated persons.

This can be difficult for discretionary trusts established for the benefit of families which have members who are foreign natural persons. The difficulty arises because of the broadness of the definition of “related person” and “relative”, which are included in the definition of “associated persons”. For instance, a relative includes all lineal descendants and ancestors of a person and their spouse, as well as siblings and their spouses and nieces and nephews and uncles and aunties.

For example, let’s consider a discretionary trust whose primary beneficiary is an individual who has an uncle who is a foreign natural person. Under that trust, each beneficiary can receive distributions

of capital. That trust would be a foreign trust as one of its beneficiaries (the uncle) is a foreign natural person who can receive 100% of the capital. That would be the case despite the fact that it is never intended that the uncle would ever receive a benefit from the trust.

Let’s say the uncle’s right to capital was limited to 1%. The trust would still be a foreign trust as the uncle and his associates (including the primary beneficiary) can receive more than 50% of the capital of the trust.

Therefore, one way of achieving certainty that the trust is not a foreign trust would be to limit the amount of capital that the trustee can distribute to foreign natural persons, foreign corporations and the trustees of a foreign trust and each of their associates to 50%.

However, for trusts in which the principal beneficiaries have close relatives who are foreign natural persons, this may result in no one within the family being able to benefit from the trust’s capital in excess of 50%. For example, let’s consider a trust whose primary beneficiary is an Australian resident but whose parents are foreign natural persons. If the foreign natural persons and their associates’ rights to capital were limited to 50%, then there would be no one in the primary beneficiary’s nuclear family (including the primary beneficiary) who could receive more than 50% of the capital of the trust.

An alternative option, in such a situation, would be to exclude as beneficiaries of the trust all foreign natural persons, foreign corporations and trustees of a foreign trust. It is not entirely certain that this will solve the problem as associated persons of such persons may still be able to receive distributions. However, in the author’s view, this should not be so as the definition of “foreign trust” requires that foreign persons and their associated persons must have the right to 50% or more of the capital of the trust. Under this alternative option, while the associated person can receive capital distributions, the foreigner cannot receive any. In the author’s view, a foreigner must have the right to receive some capital for the associate’s right to capital to be aggregated with the foreigner.

What is capital?

The definition of “foreign trusts” refers only to the rights of foreigners to capital of the trust. Therefore, a trust that prevents foreigners from receiving capital but allows

distributions of income to foreigners should not cause the trust to be a foreign trust.

This raises the question as to what is capital. Capital is not defined for the purposes of the foreigner duty surcharge. It therefore takes its ordinary meaning. This would include capital gains that may, for tax purposes, be treated as income. However, it is not clear as to whether it would include income that is determined by the trustee to be capital.¹²

How can an existing discretionary trust be amended to ensure that it is not a foreign trust?

The same issues that apply for creating trusts that are not foreign trusts apply for altering existing trusts to ensure that they are not foreign trusts.

However, an additional matter that must be considered in a variation situation is the possibility of potential issues in amending the deed. These include whether the trust deed grants the trustee sufficient power to make such amendments and whether such amendments would cause a resettlement of the trust.¹³

The Commissioner may determine that a person has a substantial interest in a trust

As outlined above, in addition to persons who actually have a substantial interest in the trust, the Commissioner may determine that certain persons have a substantial interest in the trust where such persons have the capacity to determine the administration and conduct of the trust, taking into account:

- (1) the practical influence the person can exert in addition to any rights the person can enforce; and
- (2) any practice or behaviour affecting the trustee’s administration and conduct of the trust (even if that practice or pattern of behaviour involves the breach of an agreement or a breach of trust).¹⁴

This power is in effect an anti-avoidance rule that allows the Commissioner to determine that a trust is effectively controlled by a foreign person even where they have a legal entitlement to capital of the trust of 50% or less.

Power to exempt a foreign company or the trustee of a foreign trust

The Treasurer of Victoria¹⁵ and the Commissioner¹⁶ may exempt companies

or the trustees of trusts that are foreign corporations or foreign trusts from the foreigner duty surcharge regime. To date, to the author's knowledge, the only such exemptions that will be granted are to foreign companies or the trustees of foreign trusts that can show that they are involved in development activities that add to the supply of housing stock in Victoria.¹⁷

Conclusion

For any trustee of a trust that is considering purchasing residential land in Victoria, the new foreigner duty surcharge regime must be considered. Given the broadness of the new provisions, many trustees of discretionary trusts will be surprised that they will be deemed to be a foreign trust just because the trustee has the ability to distribute capital to some distant relative of the primary beneficiaries (being someone who the trustee never intends to benefit).

Therefore, if setting up trusts, or using existing trusts, for a residential property acquisition, consideration should be given to establishing or amending the trust in a manner that ensures that it is not inadvertently caught by the foreigner duty surcharge.

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References

- 1 In this article, the surcharge is referred to as the foreigner duty surcharge.
- 2 S 28A.
- 3 S 18A.
- 4 S 70(2).
- 5 Interestingly, there is no equivalent of change of use, per s 18A, for the landholder regime.
- 6 S 19A.
- 7 S 43.
- 8 S 3.
- 9 S 3C.
- 10 S 3B(2).
- 11 S 3D.
- 12 For example, the Federal Commissioner of Taxation appears to take the view that such a reclassification does not necessarily result in income becoming capital (see TR 2012/D1). This is despite the courts appearing to support such a reclassification (see *FCT v Bamford* [2010] HCA 10 and *FCT v Greenhatch* [2012] FCAFC 84).
- 13 *FCT v Clark* [2011] FCAFC 5 and TD 2012/21.
- 14 S 3D.
- 15 S 3E.
- 16 S 3F.
- 17 Victoria Government Gazette no. G 33, 20 August 2015, p 1804.

OBITUARY

Vale Rodney Rosenblum, AM

It is sad to report that Rodney died on 5 December 2015, aged 81 years, having suffered from heart problems for the greater part of his life.

Educated at Sydney High, he went on to graduate as a lawyer from the University of Sydney. Having served his articles in his uncle's law practice, he later formed his own law firm which quickly became known as one of the leading tax law specialists in Australia.

As a tax lawyer, Rodney was known to be meticulous in furnishing tax advice and he was universally respected in his profession. The former Second

Commissioner of Taxation, Patrick Lanigan, was glad to see his daughter further her career in Rodney's firm, under his caring and watchful eye.

Rodney's achievements included serving as President of the Great Synagogue, as well as being awarded a Member of the Order of Australia. He also was known for sharing his tax expertise with other professionals in several tax discussion groups. One such group was The Gunn Club, of which he was a member from 1971 for some three decades, during which time he presented many erudite papers on tax law and practice.

Rodney enjoyed overseas travel, particularly with his wife Sylvia visiting Europe for classical music festivals. Always with a cheeky sense of humour, a great intellect, a wine connoisseur, generous to many charities, and with a strong commitment to family, Rodney lived life to the full.

We have lost a wonderful man and a true friend. He will be sadly missed and our thoughts are with Sylvia and children, Adam and Ginni.

Graeme L Herring, FTI