

Australian tax reforms webinar

Australian tax reforms: Implications for Australians in the US and US citizens in Australia

Transcript

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- Welcome, everyone, to today's webinar, which is Australian Tax Reforms: Implications for Australians in the US and Americans in Australia.

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Thanks very much for joining us. My name is Daniel Sparks.

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I'm a partner here in the Private Business and Family Advisory Division within Pitcher Partners in Sydney, specialising in US tax and high-net-worth families.

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For individuals and families with financial interests and connections across Australia and the US, navigating these two tax systems is already quite complex.

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Recent Australian tax reforms will now add yet another layer of complexity, and understanding how these Australian and US rules interact is as important as ever.

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Today, we're going to explore what these changes could mean in practice, particularly in relation to capital gains, discretionary trusts, existing structures and investments,

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and some of the cross-border planning considerations to be aware of.

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What I enjoy most about these sessions is the opportunity to showcase the breadth of experience we have in our ever expanding US team.

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To take us through the presentation today, I'm happy to welcome Terry Hoban, a US Tax and Global Mobility Partner here at Pitcher Partners Sydney.

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Terry brings a specialist cross-border perspective to today's discussion and will help unpack what these reforms could mean for people with obligations in both jurisdictions.

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We're also very pleased to have a couple of senior members of our team, Noelle Abella and Brayden Ward, joining us for the discussion,

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bringing their own sort of further insight to the cross-border issues and considerations we'll be exploring.

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So, just a little bit of housekeeping before we start.

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In the interest of a quality internet experience for everyone, can we please ask that you turn your screens and microphones off, or keep them off if you've got them off already?

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I'm going to be fielding any questions you might have. It'd be great to get everyone's questions.

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You can type them into the Chat function or the Q&A function, and we'll answer these.

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So, we'll hold the questions till the end and answer them at the end.

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The webinar's going to be recorded and a copy of the recording and the slides will be made available to you within three business days after the webinar by email, so just keep an eye out in your inbox.

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The webinar's, no doubt, going to raise questions for you or your client-specific circumstances, so please feel free to...

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Feel free to reach out to us by email or phone us on the contact details that will follow. So, our first speaker up is Brayden.

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There's plenty to cover, so I'm going to hand over to Brayden now to get started. - Thanks, Daniel.

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I'll be starting with negative gearing, one of the key budget changes for Australians with residential property.

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So, from a cross-border perspective, these changes bring Australia closer to the way the US is already trading rental losses.

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So, first, I'll look at what's changing in Australia, and then some of the additional issues that arise if you move to the US while keeping an Australian rental property.

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So, from 1 July 2027, if you buy an established residential property,

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your net rental losses can no longer be deducted against your other income. Instead, those losses are quarantined.

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They could be used against other residential property income, including a future capital gain on property, and any unused losses are carried forward.

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There are three key points to note. The first is grandfathering.

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If you already owned the property at 7:30 PM on budget night, which was the 12th of May this year, the existing rules continue to apply.

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The second is that there's a transition period.

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So, if you do buy an established property after budget night, you can continue to negatively gear it under the existing rules up until 30 June 2027.

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Lastly, there are some important exclusions.

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So, the government doesn't want these changes to discourage investment into the housing supply, so qualifying new builds are carved out in the rules

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and can continue to access the existing negative gearing rules.

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From a cross-border perspective, one interesting outcome is that it brings Australia and the US systems more closely into alignment.

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Previously, Australian rental losses could produce your Australian taxable income straight away, but that same loss might be suspended and carried forward on the US side.

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So, you could end up paying less Australian tax, meaning fewer Australian foreign tax credits available while not receiving the benefit of the rental loss on your US return.

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Under the new Australian rules, the rental loss is more likely to be carried forward in both countries through the ability of credits to become...

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The slide on screen compares Australia internationally.

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So, countries, including the UK, Ireland, New Zealand, already restrict the ability to use rental losses against other income.

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And the US also restricts rental losses, which brings me onto the next slide.

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How the US taxes your Australian rental property, if you're a US tax resident with an Australian rental property, there are three key differences to be aware of.

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The first is how the US treats rental losses.

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In simple terms, the US generally puts rental income and losses into their own bucket.

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So, if one rental property makes a loss, that loss can be used to offset other rental property income.

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The important distinction is ordinary investment income is treated separately, so you can't use rental losses against any of your interest or dividends.

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There is a limited exception to this that can allow up to 25,000 USD of rental losses

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to offset other income if you actively participate in the management of the property.

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However, that benefit starts to reduce once your adjusted gross income reaches 100,000 US and it's gone by 150,000 USD.

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Any losses you can't use aren't necessarily gone, they're just carried forward and used against future passive income from the property and release when the property is eventually sold.

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So, conceptually, that's quite similar to Australia's new carry forward rules that they're moving towards.

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The second difference is depreciation.

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Australia and the US calculate depreciation differently, and in many cases, the US actually provides a larger annual deduction when it comes to depreciation.

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There is a trade-off with this, though.

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The depreciation deduction you receive in the US will reduce the tax cost basis of the property for US purposes,

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which will increase the taxable gain when you eventually sell.

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So, the key takeaway there is you may get a bigger deduction whilst you own the property, but that can mean a bigger taxable gain when you eventually sell it.

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The third issue, and it's probably the least intuitive, is the Australian dollar mortgage.

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So, once you become a US taxpayer, the US effectively looks at the Australian dollar loan in US dollar terms.

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So, I'll go through an example of how it gets taxed.

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Say you borrow 500,000 Australian when the AUD and the USD are roughly equivalent.

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From a US perspective, you've borrowed 500K USD as well.

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A few years later, you repay that $500,000 loan in full, but the Australian dollar has weakened and it only costs you 350,000 USD to repay it.

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From an Australian perspective, you've borrowed 500K Australian, and you've repaid that 500K, so nothing's happened.

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But from a US perspective, you've effectively borrowed 500,000 USD and only needed 350,000 USD to repay that debt.

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So, that currency movement has created a taxable US foreign exchange gain of 150,000 USD.

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That often surprises a lot of people because there's no equivalent Australian taxable gain, which means there's no Australian foreign tax credit available to offset the additional US tax.

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If you haven't yet triggered US residency, consideration should be given to potentially refinancing prior to relocation.

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The US measures the gain or loss on your mortgage from the day you took out the loan to the day you repay or refinance.

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A refinance counts as extinguishing the entire loan balance.

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So, if you were to refinance or repay before you move, you're doing it whilst you're outside the US tax system and avoiding a US tax bill on it.

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So, a practical tip is to do the calculations in the sums first, compare the exchange rate from when you originally borrowed,

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or when you originally borrowed or to when you last refinanced to today's exchange rate.

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And if the Australian dollar has fallen since then, there may be a built-in US gain sitting in there that you'd rather reset before you trigger US residency.

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And that brings me onto the next slide, which is planning before you go.

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So, if you do own Australian property and you're heading to the US, there are a few things worth considering before your US residency starts.

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If you break Australian tax residency and sell the property whilst a foreign resident, you lose the main residence exemption on the property.

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The CGT discount is also prorated over your non-resident period and, from 1 July 2027, will be replaced by indexation and a minimum tax.

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Foreign residents also pay 30% tax in Australia from the first dollar of net rent they earn, as there's no tax-free threshold available.

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If you do so, there's also a 15% foreign resident capital gains withholding tax on the sales price at settlement.

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On the US side, there are a few additional complications.

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Your eventual gain is calculated in US dollar terms, so movements in the exchange rate can create a larger US taxable gain.

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Australia and the US also have different tax years, which can create timing issues when it comes to claiming foreign tax credits.

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State tax also adds another layer of complexity.

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Most US states, including California, don't provide foreign tax credit relief for Australian income tax paid, so you can essentially have Australian tax and US state tax on the same gain.

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Separately, a warning to be careful about changing ownership structures before you move, putting the property into a family trust

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or a self-managed super fund can create foreign grantor trust issues and significant additional US tax and reporting issues down the line.

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Finally, your Australian financial accounts will also trigger FBAR reporting once their combined values exceed 10,000 USD at any point during the year.

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So, the practical message from us is to plan before you move, speak to a cross-border advisor, get a property valuation on departure, and keep your cost records.

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Think about repaying or refinancing Australian dollar loans before you go as well. I'll pass over to Noelle to go through capital gains tax.

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- Thank you, Brayden.

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So, over the next 20 minutes, I'll walk you through two of the biggest changes that came through from this year's federal budget.

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So, those included the CGT reforms and the new minimum tax on trusts, and specifically what those mean for US citizens in Australia.

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So, just setting the scene a little bit, obviously these changes were designed with Australian taxpayers in mind,

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but for US citizens in Australia, the issue isn't siloed, and that's predominantly because Americans in Australia still need to file their tax returns year-on-year.

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So, there is, obviously, that flow-on effect. In terms of where we stand and just as a status update,

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obviously the CGT changes are now law, so that's due to come into effect on 1 July 2027, which is next year.

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There is a further tranche that needs to be finalised as well, so that includes things in terms of some of the options around apportionment methods and some of the small business designs.

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So, that's still a watch-this space.

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But, for now, let's start with what's actually changed for CGT purposes.

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So, there are three moving parts to the CGT changes, and I'll just take them left to right as they appear on the screen.

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So, the first one, as Brayden mentioned earlier, is the introduction of indexation from 1 July 2027.

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So, that will impact individuals, trusts, and partnerships, which means that the 50% CGT discount

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is going to be replaced with CPI indexation of the cost base, and that's essentially a term back to the pre-1999 approach.

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So, the aim is ultimately just to tax the real above inflationary gains on any capital assets that are being held.

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You still need to hold the assets for more than 12 months for indexation to apply, and it'll apply to most cost-based elements, except for any holding costs.

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In terms of what hasn't changed, so companies never had the CGT discount, and they still won't.

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Super funds still get to retain their 33% discount.

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And for the most part, the government has said that the main resident exemption isn't going to be affected,

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but the way that the second tranche bill is drafted may end up impacting some individuals who are overseas as of 30 June,

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who could lose part of it, but obviously we expect that this is just a drafting error and will be rectified prior to being finalised.

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For those Americans in Australia who are temporary tax residents or US citizens who are abroad,

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obviously, CGT is something that impacts ordinary residents, so temporary tax residents are still included... Excluded, sorry.

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And unfortunately, pre-CGT assets, so anything that was exempt from CGT in 1985, will be brought into the system.

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So, just putting a US lens on top of all of that, the US has never really recognised the 50% discount, and they won't recognise indexation.

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US tax is still going to be applied on the nominal gain that's realised and calculated in US dollar terms using the historical spot rates.

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So, whilst indexation would shrink the Australian taxable gain, it'll probably have zero effect on the US taxable gain.

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So, these two tax bases will ultimately diverge, which hopefully will come to light in an example we'll share in the following slide.

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The second change that came about from the federal budget was the introduction of the 30% minimum tax on any real capital gains, which were accrued from 1 July 2027.

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So, nothing is really payable until that gain is realised, but it really does bite those clients

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who are deliberately selling down things in lower income years.

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So, for example, after retirement or during a career break, or if you do have a non-working spouse holding specific investments in your family group structure.

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Previously, that was a common strategy that was employed, but that'll no longer work from next year.

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So, obviously, top marginal rate taxpayers are going to remain largely unaffected by the minimum tax itself.

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The biggest change for them would probably just be the loss of that 50% CGT discount.

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The final change that's come about is obviously the transition rules.

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So, as I mentioned, only gains accruing from 1 July 2027 are caught.

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So, any assets that are bought or sold prior to then, there's no change, and the discount would still apply.

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Assets bought after then are fully into the new rules.

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So, for that transitionary period and for assets held as of 30 June 2027,

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the pre-1 July '27 gains keep the 50% discount and the post-1 July '27 growth is indexed and subject to the minimum tax.

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You then have two choices.

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So, the first option being that you can get the market value as of 1 July 2027 as the reset point for your assets,

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as they enter into the new indexation system, but obviously that would require a valuation.

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The second option is to use the apportionment method based on time held, which avoids the valuation, and that's the apportionment method

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is still being legislated under the second trench at the moment.

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I think a key rule of thumb from what we've seen is that if most of the growth in your capital assets has happened prior to 1 July 2027, then a market valuation is likely to be better.

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But if the growth has been even or it's expected to occur later, then the apportionment method may be simpler and comparable, but it's always good to model both.

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I think if you are a US person and just looking at the US angle, obviously there's probably three warnings or three things to keep in mind.

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So, the first one is that the 1 July '27 valuation is purely an Australian tax concept.

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So, there's going to be no step up in the US cost basis for any assets that have historically been held.

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So, the US cost base will still remain at its historical US dollar value on the date of acquisition.

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We probably also wouldn't recommend rushing to sell anything prior to 30 June 2027 just to lock in the discount.

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The transition rules already protect any of that pre-1 July 2027 gain.

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And selling, obviously, accelerates any of the US taxes that you'd end up needing to be paid, as well as the Australian taxes.

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And that could include things like the 3.8 net investment income tax as well. So, even so, we'd recommend...

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Valuations would still be quite important to obtain because it does provide you with a cheap insurance policy

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and it helps you understand both sides as we start to do the analysis for any big transactions and disposals coming up in the future.

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So, what does this all mean in US dollar terms for US citizens? Let's look at an example and first under the current rules.

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So this slide effectively shows why US citizens in Australia have always paid more than their Australian neighbours on capital gains.

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And then the next slide will just show how this gap widens.

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But, sticking with this, if we look at $1 million gain in our example, let's assume we've got an individual

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at the top 47% marginal tax rate in Australia, so obviously that does include Medicare, and they've disposed of something prior to 1 July 2027.

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In the US, they'd pay a top 20% US long-term capital gains tax rate on that disposal.

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And to the extent that the income is above the net investment income threshold, so that's $200,000 US dollars for singles

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and $250,000 for joint filers, then the same gain is going to be obviously taxed in both countries.

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Under the existing rules in Australia, you still get that 50% discount if it's sold at this point in time.

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So, the assessable gain would be $500,000 US dollars and taxable at 47%.

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So, that brings your total Australian tax to around $235,000 Australian dollars.

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And then, in the US, you'd have to pay 20% long-term capital gains tax, so that's $200,000 US dollars before credits.

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As you can see, the Australian tax paid exceeds the US taxes.

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So, the foreign tax credits obviously wipe out all of the US capital gains, so there's effectively no US tax to be paid.

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There's an extra $35,000 of an Australian taxes that can be carried over and used as excess foreign tax credits in the future.

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So, they're not effectively lost, they're just rolled forward, and they can be utilised to offset any other passive investment income in future years.

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The big cost is the net investment income tax, which is applied at 3.8%, and that's purely because those taxes aren't creditable from any foreign tax credits that are available.

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I think what we've seen from some recent cases as well is that the US was quick to shut down, that there would be any treaty relief available.

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And so, that's purely a tax cost of retaining citizenship.

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If you are living in Australia, you'd ultimately still have to pay that 3.8% net investment income tax.

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So, if we compare what the total global tax would be, in this scenario, you'd have $235,000 in Australian taxes paid,

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plus the $38,000 in net investment income tax, which brings your global effective rate to 27.3%.

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I think, as a practical point, just to bear in mind in this example of the things that won't change,

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even after 1 July, is that, obviously, US capital gains are calculated in US dollars and take into account historical spot rates.

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So, even that FX movement can create US gains where there was no Australian gain and vice versa.

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Obviously, the timing of any foreign tax credits needs to be managed, particularly because the Australian fiscal year does not align to the 31 December US tax year.

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So, making sure you pay those taxes in Australia to be able to be credited on the US return is important.

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And then, likewise, just for those individuals who are selling their main residences, as you know, the main residence exemption

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is still available in Australia, but in the US, only up to $500,000 of capital gains can be excluded on a joint return.

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So, no Australian taxes means no credits.

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So, US clients obviously have a US-only tax bill if they do sell their family home.

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So, let's run the same million dollar gain through the new rules.

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So, same client, same million dollar gain, but this time all of the growth happens after 1 July 2027.

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So, I think just a quick note that the effective Australian tax rate on gains moving forward after next year

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would obviously be dependent under indexation and inflation during the holding period. So, this just shows an illustrative example.

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I think when we were looking at treasury's own modelling, if there was a taxpayer who was at that 47% tax bracket,

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their kind of rates end up being around 27 to 30% for property disposals and a little bit lower for shares.

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So, using the 30% here is just a little bit of a sensible illustration for our purposes.

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But, as you can see, that same million dollar gain would widen the amount of tax disparity between both countries.

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So, in Australia, instead of paying a maximum of 23.8%, that gain is now going to be subject to that 30% minimum floor,

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which means that the tax here, at a minimum, would be around $300,000 Australian dollars.

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The US taxes still effectively get wiped out, but there will be that bigger foreign tax credit basket that's carried forward.

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So, there's $100,000 more in excess gains that would largely be unusable in this scenario. The total gains that would...

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Oh, net investment income tax would still be applicable.

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And so the total gains payable worldwide would be around $300,000 plus that $38,000 in net investment income tax,

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which effectively brings up the effective rate to 33.8%.

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So, all in all, that's an extra $65,000 in global tax that would need to be paid on a million dollar gain.

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So, that's around 6.5 percentage points or roughly around 24% more tax.

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So, as you can see, Australia does become the jurisdiction that applies the more dominant tax with net investment income tax obviously being the binding cost.

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So, I guess, how do we try to avoid this?

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I think one of the questions that comes up a lot is: Can we just leave Australia prior to selling?

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And I'll just hand over to Terry to talk a little bit more through that example. - Thanks, Noelle.

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So, since May, when the budget changes were announced, there has been a lot of attention from the media on tax.

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A lot of people have become tax experts.

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There's a lot of clickbaity headlines about people leaving Australia to avoid tax. And the US is a particularly popular destination.

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As a practise, we've seen a significant uptick in clients seeking tax advice around relocation to the US from Australia after the changes.

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So, can you leave Australia and avoid capital gains tax because you don't like the new rules?

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We wanted to break this down and bust some of the myths around this. So, first, it's not just as simple as getting on a plane.

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If you want to avoid Australian tax, you need to try to break Australian tax residency. An Australian tax residency is not always easy to break.

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Ideally, what the ATO wants to see is that you have an intention to be outside of Australia for at least two years, you take your family with you,

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and you sever your ties to Australia, including generally renting out your home or breaking your lease.

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Now, if you do successfully break Australian tax residency, there is an exit tax known as the deemed disposal rules,

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and you are deemed to have sold all of your assets for whatever they're worth on the day that you break Australian tax residency.

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Now, this applies to all capital assets, with the exclusion of Australian real estate. So, essentially, you have a choice when you leave.

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You either pay tax now on the way out based on the current value of the asset, or you elect out of the deemed disposal,

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and you defer that tax until you actually sell the asset later on.

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And in terms of the mechanics of that choice, you make that choice when you file your departure year Australian tax return.

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And because of the extended lodgement due dates for Australian tax returns, that could be anywhere from 12 to 18 months after you actually leave.

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So, sometimes, you do have the benefit of hindsight when making that choice.

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So, imagine you are the founder of a successful start up company, and you're living in Australia, and your shares in that company have gone up in value, have a large unrealized capital gain.

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If you leave Australia and break Australian tax residency, and if you do not elect out of the deemed disposal rules, you're going to have a large tax bill.

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And if that's the case, it's often impractical for you to fund that deemed disposal tax because you don't have the liquidity to.

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You're not actually selling your shares to anyone. It's only a deemed sale.

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So, most founders in that scenario, they would elect out of the deemed disposal,

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which means that they are still stuck with Australian CGT when they eventually sell the asset later on.

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And often, we find that that's actually worse because, later on, when you sell as a non-resident,

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you don't get access to the full 50% CGT discount and the indexation going forward, so you can end up worse off.

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However, the US is the exception to that rule.

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And the reason is because we have a particular tax treaty with the US that's a bit unique.

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And that tax treaty, under Article 13 of the treaty, it contemplates this scenario

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where you have somebody leaving Australia and being subject to the deemed disposal rules. And it actually prevents Australia from this tax overreach.

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So, essentially what the treaty says is if you have an individual who leaves Australia, and breaks Australian tax residency,

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and elects out of the deemed disposal rules, once they become a resident of the US,

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if they sell an asset, the US, as the resident country, has the sole taxing rights to that asset, overriding Australia's right to tax the gain.

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So, essentially, the IRS says, "No, ATO, that's my tax resident. That's my capital gain.

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That's my tax, not your tax." And so that's why in the right circumstances, under the new CGT rules,

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leaving Australia and selling in the US as a US tax resident could provide a better tax outcome. So, this can potentially get you an advantage.

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However, as always, it's not that simple. You also need to consider state level tax.

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So, whilst the federal level tax may be lower going forward than Australia, you still have potential state level tax depending on where you're living in the US.

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So, for example, California has an additional 13 to 14% state tax on top of the federal tax.

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And New York state and city combined is even higher when you get to the top brackets.

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The other important thing is none of this will work if the asset is in a discretionary trust.

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If it's in a discretionary trust, that's a whole different ballgame with different rules.

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And that's a good segue to the next section, where I'll pass back to Noelle to talk about the trust tax changes.

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- All right. Thank you, Terry.

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So, just moving now to the second major change, which is the minimum tax on discretionary trusts.

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I think, why does this matter?

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So, family trusts are everywhere in Australian tax planning, and a lot of US citizens are either appointors, trustees, grantors, or even beneficiaries of trusts.

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So, that sometimes comes without realising the US tax consequences.

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So, again, just to make sure everyone's aware, these changes were proposed.

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They're not yet law, but they were introduced into parliament on the 14th of October this year with a proposed start date of 1 July 2028.

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So, details could still change.

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In terms of the US backdrop, I think the reason why trusts are quite a hot topic

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is Australian discretionary trusts, from a US lens, are typically foreign trusts for those purposes.

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And depending on who's funded it, it could either be a foreign grantor trust or a foreign non-grantor trust

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with Form 3520 and 3520A reporting requirements, potentially exposure to throwback tax rules

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in non-grantor trust situations on accumulated income, and also PFIC issues on any underlying investments of a non-grantor trust.

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So, these new Australian tax rules, and these changes will already sit on top of all of that in the US landscape.

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So, let's look quickly at the three key parts to the trust measures.

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So, again, those are the minimum tax itself at 30%.

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There are option to restructure out and then also the option to fix entitlements and stay put, but neither of these is US tax-neutral.

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So, just looking at the 30% tax from 1 July 2028, so this is a tax that trustees will pay

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at least 30% on the trust's taxable income, and that includes net capital gains.

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Individuals, other non-corporate beneficiaries will still need to include their distributions on their own returns,

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and they get a non-refundable credit for the tax that the trustees paid.

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So, the net effect is if you're distributing to a beneficiary who's either on 30% or more, there's no extra tax.

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But if you are distributing to a lower income spouse, an adult child, a grandparent, income splitting and streaming benefits would effectively be gone.

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And so, those excess credits are also going to be lost.

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There are some exclusions to the 30% tax depending on the type of investment vehicles.

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So, those would be fixed trusts, deceased estates, genuine testamentary trusts, super funds, and then also distributions to charities and deductible gift recipients.

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So, looking at it from a US lens, I think US citizen beneficiaries who are connected to Australian trusts,

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the US question then becomes: Who paid the Australian tax in this scenario?

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So, if the trustee pays the tax and the beneficiary only gets that credit, we then need to look and confirm how foreign tax credits would flow.

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So, our thinking is from a non-grantor trust perspective, it could flow through to the beneficiary to the extent it relates to their share of the taxes paid by the trust.

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But in a grantor trust situation, it would flow through to the grantor.

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So, we'd expect that there would still be some need for analysis in that situation, just to make sure that there isn't any double tax in the family group.

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Under the changes, there's two different reliefs.

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So, the first is restructuring relief, which is effectively a three year rollover, which is available from 1 July 2027 to 30 June 2030.

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And that enables you to roll over and move assets from a discretionary trust into a company or a fixed trust without triggering Australian income tax or CGT.

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Stamped duty is still payable in these situations, and so is transaction costs, so those aren't covered.

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But I think that ambiguous warning for our audience is that, obviously, this is an Australian rollover for Aussie tax purposes, and it's not a US rollover.

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So, restructuring that is tax neutral in Australia could actually become a taxing point or a taxable event

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if you are a US citizen beneficiary or a grantor connected to a foreign trust.

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And, obviously, the destination entity does matter.

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So, an Australian company that's owned by a US person may create CFC issues, which Terry will go through later in the presentation.

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And even if there's no control by a US person, it could also create PFIC issues to the extent it may be transferred into a unit trust

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that's classified as a partnership or even other types of entities as well.

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So, the key takeaway there is just not to be pre-emptive with any restructuring.

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Obviously, it's important to receive cross-border advice prior to doing so, just to make sure each sides of the equation are balanced out.

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The last change that was proposed, which is an alternative to restructuring, is the fixed entitlement election.

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So, this would be available to trusts which exist as of 1 July 2028.

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They can effectively elect to nominate beneficiaries with fixed percentages of income and capital, so the same share of each, and stay outside of the minimum tax rules.

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So, there's no restructuring there, so no stamp duties obviously expected, but the trade off is that you are losing that flexibility

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which was available with discretionary family trusts previously. There are limited changes which are allowed.

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So, for example, death or family breakdown and revocation of the election does trigger tax at the top marginal tax rate in Australia in the year that you choose to make it.

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So, obviously, that needs to be balanced as well, particularly if there are massive transactions and things like that happening within the trust.

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So, again, from a US angle, who you nominate as a beneficiary will matter moving forward.

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So, more so in a non-grantor trust scenario, so many trustees probably steer a lot of the distributions away

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from US citizen beneficiaries, just to manage the US complexities.

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But once a US person is a nominated beneficiary, that flexibility is effectively gone. So, they get their fixed share of income every year.

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But on the flip side, especially in a non-grantor trust scenario, regular current year income distributions

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may actually reduce the build up of accumulated income in the trust.

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So, the exposure to the throwback rules is a little bit lower.

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So, it's obviously important to consider whether US beneficiaries should be nominated at all.

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And if they are just managing any additional reporting from a US perspective, so 3520s and 3520As,

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and then PFIC consequences to the extent that those investments are within the trusts as well.

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So, just flipping to the next slide, the last thing that I wanted to cover in respective trust

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is what many advisors are calling the death of the bucket company.

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So, the bucket company strategy was effectively distributing trust income to a company to cap tax at the corporate tax rate in Australia.

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And that's effectively going to be finished if these new changes are put into law for any distributions that would happen after 1 July 2028.

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So, why this matters, obviously under the new rules, the trustee pays the 30% minimum tax, but a corporate beneficiary gets no credit for it.

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So, looking at the Australian tax landscape at the moment, the company would then, once they get the distribution,

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pay tax on the same income again, and that's double taxation.

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So, the cumulative and effective tax rate on everything, once it goes up the chain, would be roughly 55 to 60% before anything is paid out to a shareholder.

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So, for US citizens, bucket companies were already a problem.

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If an Australian company was owned by a US person, as I mentioned, it could create CFC issues or PFIC issues, if they weren't controlled.

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So, passive income that's retained in a bucket company, it could just end up being taxed anyway

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under the Subpart F or net CFC tested income rules if nothing was effectively paid out.

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There are some mitigation strategies as well, which includes things like the high tax exception and Section 962 elections.

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But I'll let Terry unpack that in the following segment as he starts to talk about how companies will impact US citizens in Australia.

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- Thanks, Noelle. So, if you are a US citizen in Australia and you're considering restructuring out of a trust, what are the options?

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So, the overriding message from the government is that they do not want taxpayers using discretionary trusts or other vehicles that have an element of discretion.

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So, a lot of our clients are considering the use of a private company as a holding structure or a similar structure, such as a unit trust that has fixed economic entitlements to income and capital.

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However, for US citizens in Australia, an Australian private company can create significant additional complexities

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on their US tax filings and lead to some unintended consequences.

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Australian private companies will generally fall within the US-Controlled Foreign Company rules, or CFC rules, if they are majority owned by US citizens or residents.

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Now, the CFC rules are essentially antideferral rules designed to prevent the use of foreign companies to avoid or defer US tax, and they do create these unintended consequences.

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The consequences can include the attribution of income earned at the company level to the US shareholder, even if they haven't received any of it.

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So, typically, with an Australian company, as a shareholder, you wouldn't pay tax until you receive a dividend from the company.

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So, you can benefit from the deferral of tax.

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But this may not be the case if you're a US shareholder under the CFC rules.

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Now, the rules are complicated and ever evolving, but there is an exception under the rules,

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which is important to understand, which is called the high tax exception.

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And this exception basically says that if you have a CFC and your CFC is paying corporate tax

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in a foreign jurisdiction that's 90% or more of the US corporate tax rate of 21%, then the shareholder attribution rules won't apply.

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So, in practice for Australian companies, typically they're paying Australian corporate tax at 25% or 30% on income.

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And so this falls generally within that exception.

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So, this is a good way of mitigating the impact of the CFC rules.

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However, you need to carefully plan to make sure that the effective tax rate of your company is actually going to be at that level

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after considering things like franking credits, carry-forward losses, R&D credits, other kinds of concessions that you have in Australia.

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The other sort of unintended consequences of owning a CFC or a private company in Australia are the additional filings and the complexity involved.

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Because the US assumes that your CFC is for tax avoidance, they want to know everything that is going on with it.

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So, you do have to do some additional forms called Form 5471, along with your individual tax returns,

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which is essentially an informational corporate tax return, which is a disclosure attached to your individual tax return.

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And if you don't do it, there's potentially pretty large penalties.

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The other thing for US citizens looking at restructuring as a result of these rules and considering a company structure is what we call the check-the-box election.

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So, under the US rules, you can essentially choose how an entity will be taxed when you set it up.

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So, for example, even if you set up a company in Australia, you can make an election to the IRS to say that you want that company taxed as a partnership or a sole trader.

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Now, the main reason that you would want to consider doing that is to avoid the CFC rules.

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The added benefit, however, is that if you do make that election and the entity is essentially looked through,

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it also means that the Australian corporate tax that the company is paying can flow through to the individual US shareholder as a credit.

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So, for any US citizens in Australia looking at restructuring under the new rules, the check-the-box election becomes an important consideration.

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Now, what about Australians in the US? What are the implications for the trust tax changes to them?

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So, if you're an Australian in the US and you have an Australian trust, it's already probably not the best structure for you.

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By using an Australian trust, you're essentially tying yourself back to Australian tax and you're potentially paying more tax in Australia

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than you otherwise would have if you just stayed in Australia.

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And the reason for that is because of the loss of the 50% CGT discount for non-residents and various other concessions that are available

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for beneficiaries of trust in Australia that are not available to non-residents. And with the new rules, it's only going to get worse.

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On the US side, the IRS also doesn't like your foreign trust.

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And what I mean by that is the US will assume that your trust is for tax avoidance, and they will usually look through the trust and tax whatever is happening within the trust anyway.

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And similar to the Controlled Foreign Company rules, there's a lot of paperwork you need to do.

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So, Forms 3520, 3520A, these are additional complex and costly forms that need to go in with your US federal tax returns to tell the IRS everything that's going on.

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So, with all that in mind, the trust tax changes, and the incentives and concessions

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that are going to be available over the next couple of years around restructuring, it actually might be a good time for Australians in the US

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or Australians going to the US to really think carefully and consider restructuring out of the trust.

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And it is, in a lot of ways, this opportunity to restructure is going to provide an opportunity that wasn't available in the past to restructure and get things right.

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However, whatever structure you do put in place, you just need to understand how the US is going to tax it.

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Unfortunately, too often, we see advisors doing sort of complicated tax structuring for clients on the Australian side

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without understanding or considering the US tax implications of the structures they're putting in place, and this can lead to some costly mistakes.

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So, with the new complexities with the Australian tax laws, and the trust changes, and CGT, and everything else, it's even more essential that you get that advice upfront.

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Lastly, I just wanted to touch upon a really common issue that we've seen for a lot of Americans in Australia,

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which I think will become more of an issue due to the trust tax changes and the 30% minimum tax that's coming in.

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So, we find that it's really common for US estate lawyers, for clients in the US to suggest that they set up a revocable trust for estate planning purposes.

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So, generally, the reason for that is to avoid the probate process if they pass away in the US.

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So, typically, what would happen is the lawyer in the US would draught the trust deed, you would transfer all of the assets into the trust.

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So, it's really quite simple administratively, you just call up your bank and your brokerage, and you say, "I want to change the name of my account into so-and-so trust," and they just switch it over.

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But for US tax purposes, it's a bit of a non-event because anything that happens in the trust, any income still ends up on your US individual tax returns.

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So, for US tax purposes, it's pretty simple.

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And so, that's why we say that a lot of clients who are in the US as US citizens, they get this advice from their lawyers and they set these structures up.

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However, the issue is the Australian tax side and if they come to Australia.

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Because under Australian tax law, the trust is actually seen as a separate taxpayer to the individual.

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So, you then need to consider the trust's tax residency.

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And if the trustee of the trust has become an Australian tax resident and has immigrated from the US to Australia,

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then the trust will also become a resident trust in Australia, even though it's set up and effectively managed in the US.

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So, by doing that, what you're doing is you're pulling all of the assets in that trust into the Australian tax net.

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And so the ATO will then expect that you're doing trust tax returns, you're doing distribution minutes by 30 June,

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you're paying your 30% minimum tax in Australia going forward.

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It does create a lot of additional complexities and tax on the Australian side.

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It also potentially means that if you then leave Australia and you're the trustee of that trust, or if you change the trustee of that trust, then,

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to someone outside of Australia, that's a potential deemed disposal because you're breaking the trust's Australian tax residency leading to potentially exit tax.

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So, it becomes more of an issue. And separately, even if you can avoid the US trust

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becoming an Australian tax resident, there's a separate set of rules around how Australian beneficiaries

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of foreign trusts are taxed, which are particularly harsh called the Section 99B rules.

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And they basically say that anything that's coming out of a foreign trust will be subject to tax to you in Australia as a beneficiary, unless you meet a certain exception.

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The main exception that we would be looking at is what's called the corpus exception.

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And under that exception, it basically says that you need to demonstrate that whatever you're getting out of the foreign trust

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relates to the amounts that were originally put into the foreign trust in the first place.

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So, common scenario is someone sets up a revocable trust, say 20 years ago,

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they put all their assets into it in the US, these assets accumulate in value, they pass away.

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As part of the estate administration, the trustee of the trust in the US then looks to wind up the trust and distribute those assets.

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Now, if you have an Australian beneficiary of that trust, there is a risk that they pay Australian tax on all of those assets,

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unless they can prove that some of those assets relate to the original assets that were put in, which can be quite difficult if a lot of time has passed.

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If you compare this to a regular inheritance from a deceased estate, where generally no tax is payable,

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it's a very different outcome for the Australian beneficiary.

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So, that's why it's really important not just to be thinking about what you're doing with your tax affairs now,

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but in the future with estate planning, inheritances, anything that's in place in the US, what that's going to mean for you as an Australian tax resident.

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So, that's enough from me.

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I might pass over to Daniel, who's then going to lead our Q&A session. - Yeah, thanks, Terry. And yeah, thanks to everyone there.

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It's great run through of some pretty complex issues there and a lot to think about, I think, in coming out of those budget changes.

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So, we do have a few questions.

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I guess if anyone wants to ask a burning question, we probably have time for a couple more,

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but we will spend a couple minutes just going through questions. So, I guess I might just grab the first one from...

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Given that it's been raised by my client.

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So, can the US net investment income tax generate a credit on the Australian tax return?

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I think this is one that we probably debate a little bit internally because it's not entirely clear, but I think if you do look at how the treaty works

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and how Australia's domestic foreign tax credit rules work, it is difficult to make an argument for the net investment income tax being a credit in Australia.

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I think if it relates to US source income, such as sale of a US property, for example,

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I think there's probably a good argument for it in that case.

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I think if it's purely tax you're paying because you're a US citizen, it's a fair bit harder. I think, in most cases, we probably wouldn't claim that.

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Does anyone else on the panel have anything additional to say about that? - I'd agree.

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(Daniel chuckling) - All right.

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So, we had a question probably best for Terry, I think, given he ran this part of the presentation.

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So, I guess in what circumstances would you say that it makes sense to allow the deemed disposal to occur upon exiting Australia as a resident?

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- Yeah, I mean, it does really depend on the individual circumstances.

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And as I said, like you have that benefit of hindsight sometimes, where you can run the numbers both way and make a decision.

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But one way that we do see how it can benefit clients is if you have a scenario

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where you're going to the US for a fixed time period, so say five years, if you do take that deemed disposal

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on the way out of Australia, there's a reciprocal set of rules for people who are coming into Australia called the deemed acquisition rules.

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And basically, they say that if you have acquired an asset when you're outside of Australia, your starting point for Australian capital gains tax is the value on the day you come back to Australia.

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So, to access that uplift or that step up in basis essentially under the deemed acquisition rules, you do have to take the deemed disposal.

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So, it has worked out well for some clients, where they have a capital asset, they're happy to pay, well, not happy to pay,

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but they're willing to pay the deemed disposal tax on the way out.

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The asset continues to go up in value while they're in the US.

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They then repatriate back to Australia and get an uplift in value, and they essentially get that interim gain out of tax anywhere.

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So, I guess that's one scenario where it can work, but again, everyone's circumstances are quite different.

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- Yeah, and just following on from that, do we think there's any chance the choice to defer would be taken away, at some stage, by the government?

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- I mean, who knows?

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I mean, if you'd asked me a year ago if I thought they would change trusts, I'd probably say, "No," so...

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I don't think I'm the best person to ask about what the government's going to do.

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But I mean, the rules have been around for a while, and I don't think there's been too much focus on them

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56 minutes, 48 seconds

as potentially avenues for tax avoidance or anything like that.

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56 minutes, 51 seconds

So, we haven't any reason to suspect that they would change them. - I think the next one might be good for Noelle.

57:01

57 minutes, 1 second

Does the 30% capital gains tax on sale of an asset from 1 July 2027, does it also apply to the 50% part of the asset?

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57 minutes, 11 seconds

Well, I guess does the 30% minimum tax apply to the discounted gain, as well as the index gain or only maybe index gain?

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57 minutes, 20 seconds

- Oh, I think it would actually apply to the index gain only.

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57 minutes, 25 seconds

So, the way the rules work is that you get to basically preserve the component prior to the changes for the 50% discount.

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It's just anything moving forward thereafter that would have the 30% applied.

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57 minutes, 43 seconds

I'd have to double-check how that all comes out in the wash, because obviously if you're paying lower than 30% at the end of the day,

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you may end up just having to pay that floor tax when you end up reporting it on your US return.

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57 minutes, 57 seconds

But yeah, we probably need to run some modelling numbers just to figure out how that all comes out. - Probably time for just one more, I think.

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58 minutes, 6 seconds

So, we've got a question about the...

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58 minutes, 8 seconds

I guess the election to sort of, quote, unquote, "Fix the trust interests to avoid the minimum tax."

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58 minutes, 15 seconds

So, does fixing the beneficiaries' share change how the IRS classifies the trust?

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58 minutes, 20 seconds

So, ordinary trust versus business entity, grantor versus non-grantor, simple versus complex.

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58 minutes, 28 seconds

Anything to say about that, Noelle? - Yeah, from a US lens, it wouldn't.

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So, the existing rules would still, from a US perspective, just look at the funding of the trust and ownership.

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58 minutes, 41 seconds

So, those don't really change.

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I think what the balance will then be is if, for example, you've got a US person who's made contributions to a trust or is the owner, it would effectively be treated as grantor.

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So, in that situation, all the income would be accessible to that US person.

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59 minutes

You might then have a mismatch in terms of if distributions then go out to another US beneficiary within the family group, but they aren't the grantor, how do you balance the credits and things like that?

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59 minutes, 10 seconds

So, you just got to kind of carefully plan who you're going to fix those entitlements to if you make the election moving forward,

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59 minutes, 17 seconds

just so that you avoid any double tax over the whole family group, I think. Yeah. - Great.

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Well, I think we're sort of almost up for the time allowed, so we might end it there.

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There are a couple more questions we can probably follow up directly with the people involved, but thanks to everyone for their time today.

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So, as we mentioned earlier, a recording will be sent out within three business days, and our contact details will be included with that if you have any direct questions.

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And so, thanks for your attendance and have a great day. Bye. - Thanks everyone. - Thank you, everyone. - Thanks everyone.