Structural choices for expanding into the US – an issue-driven analysis

By Buck Xiao, CTA, Director, and
Anna Bullimore, Senior Analyst,
Hall Chadwick Melbourne

Australian and US tax laws and the interaction between them are of galactic complexity. This article firstly identifies four archetype structures that can be adopted by a successful Australian enterprise for the concurrent operation of business in both countries, and then proceeds to discuss the relevant issues pertinent to each structure. This provides a coherent framework to elaborate on otherwise diversified or desultory taxation rules in both countries and the interaction between them, thereby achieving greater practical value. Further, a financial model is proposed to quantify the tax implications of each archetype structure in terms of the effective tax rate. This can be further developed to measure tax on both nominal and present value terms, which can ideally inform the decision by an Australian enterprise considering expanding into the US. In the authors' view, the tax principles derived from the discussion herein and the financial model should serve as a launch pad for further exploration of the tax issues arising from the concurrent operation of business in both countries.

Introduction

After having achieved success in the domestic market, it is natural for Australian enterprises to consider expanding into the US – the world's largest economy. However, this also means they will have to deal with convoluted US tax laws, and their interactions with Australian tax laws.

The foremost issue for those Australian enterprises is determining what structure should be chosen to conduct the US operation in conjunction with the existing Australian structure. This article discusses issues arising from the concurrent operation of popular Australian and US business structures, bringing in the analysis of relevant Australian, US and tax treaty rules. This will hopefully assist to inform the structural choices an enterprise can make for operating their business in both Australia and the US.

This article will not discuss the "Global Anti-Base Erosion" (GloBE) rules (pillar two) for the following two reasons: firstly, the purpose of this article is to discuss the relevant Australian and US tax legislations, articles of the treaty and interactions between them in order to provide practical advice to Australian enterprises that have concurrent operations in Australia and US. This purpose is practically unachievable, as legislation implementing pillar two has yet to be introduced.[1] Secondly, the target audience of this article is the medium-sized Australian multinational, which has global revenue below the threshold (€750m)[2] for pillar two to apply.

This article first discusses popular business structures in both Australia and the US, with four archetype combined Australian/US business structures listed below. Relevant taxation issues in respect of each archetype structure will then be elaborated on.

This article contains many illustrations, the facts of which have been distilled so that they are pertinent to the issues intended to be discussed. Therefore, they do not cover other tax implications including anti-avoidance rules, which can arise from particular factual situations of a particular illustration as described herein. A discussion of all potential issues would greatly overstretch the length of this article.

There are four sets of legislation and regulations that will be referred to throughout this article. They are set out below with their abbreviations:

- *Internal Revenue Code of 1986* (US) (IRC): "§" will be used as the provision prefix;
- Treasury Regulations promulgated under the IRC (Treas Reg): "§" will be also used as the provision prefix;
- *Income Tax Assessment Act 1997* (Cth) (ITAA97): "s" will be used as the provision prefix; and
- *Income Tax Assessment Act 1936* (Cth) (ITAA36): "s" will be also used as the provision prefix.

Business structures in Australia and the US

From a fiscal perspective, structures adopted in Australia and the US by an enterprise to conduct business operations can be classified as being either opaque or transparent. Fiscal opacity means the entity, instead of its owners, is liable for tax in respect of income[3] derived, while fiscal transparency means the owners, as opposed to the entity, are responsible for the income derived by the entity. It does not matter whether the owners are liable for tax, because the said income is distributed to the owners, wholly or partially, by an exercise of power, or automatically, by operation of the law. Fiscal opacity and fiscal transparency are the key concepts underpinning the discussion throughout this article.

In Australia, an enterprise often carries on its business through a company or trust structure. A company in Australia is fiscally opaque. Under the Australian imputation system (Pt 3-6 ITAA97), a shareholder is liable for the tax on a distribution made by a company; but the shareholders' tax liability in respect of the company distribution is reduced by the tax paid by the company.

Under trust taxation rules (Div 6 ITAA36, Subdivs 115-C and 207-B ITAA97), a trust may be liable for tax in respect of income accumulated in the trust; however, it can shift its tax liability to beneficiaries, by making distributions of income to them. However, a trust is unable to distribute a loss, as the relevant provisions do not provide a mechanism for this. Consequently, to the extent a distribution is made by it, a trust can be regarded as being fiscally transparent. In this case, there is only single layer of taxation as, unlike with a company, the income is not taxed in the hands of the trust and then again in the hands of the beneficiary.

For US tax purposes, under the Treas Reg, a business entity can be either a corporation or a partnership (§301.7701-2 Treas Reg). Contrary to the popular practice in Australia of using a trust to conduct a business, in the US, with very few exceptions, a trust is simply an arrangement to protect or conserve property for its beneficiaries (§301.7701-4(a) Treas Reg). If a trust is created for the purpose of carrying on a profit-making business, it will generally be regarded as a business entity, which, by election (§301.7701-4(b) Treas Reg), can be either a corporation or a partnership (see the discussion below).

There are two types of corporations in the US, which are colloquially named after the relevant subchapter of the IRC that contains the taxation rules of each — ie a C-Corp is subject to the tax rules of subchapter C, and an S-Corp is subject to subchapter S.

An S-Corp is fiscally transparent, ie its profits will be passed through and taxed in the hands of the shareholder, with the S-Corp itself not subject to tax. On the contrary, a C-Corp is fiscally opaque. An S-Corp cannot have a foreign shareholder (§1361(b)(1)) IRC) and therefore is not a suitable vehicle for an Australian enterprise to conduct business in the US. As such, S-Corps will not be discussed further, and a corporation referred to hereinafter is a C-Corp.

A partnership is fiscally transparent. Under the taxation rules contained in subchapter K of the IRC, a partnership can distribute items of income or loss (eg gains, loss, deduction and credits) to its partners, thereby passing tax to the partners (§702 IRC). Those partnership tax rules in the US go much further than their Australian counterpart, which only enable partnerships to make a distribution of net income or loss (s 92 ITAA36).

The most dazzling feature of the US entity classification regime is contained in §301.7701-3 Treas Reg, ie the check-the-box regulation (CTB reg). Other than a corporation incorporated under US federal or state law, or a specifically listed non-US entities (§301.7701-2(b)(8) Treas Reg), such as limited public company in Australia, virtually all other business entities can freely choose to be either a partnership/disregarded entity or a corporation. They can also generally change their mind later, by lodging form 8832. A disregarded entity is a single-owner entity that is disregarded for US tax purposes, thereby being deemed as part of that owner. It is quite possible that an Australian subsidiary company of a US group could change from being a partnership for US purposes to a corporation several years later, without the knowledge of the management of the Australian subsidiary company. As Professor Yin[4] points out, the CTB reg "reflects a policy determination generally to disregard business organization form and characteristics for income tax purposes".

Another phenomenon of the development of business structures in the US was the rise of limited liability companies (LLCs), which quickly became the darling of the tax world.[5] As former Internal Revenue Service (IRS) Commissioner Donald C. Alexander declared:[6]

> "No rational, reasonably well-informed tax professional would deliberately choose Subchapter S status over an LLC when there is a choice, and 99 percent of the time there is a choice … The LLC is clearly the choice of the future if you are dealing with rational people, and most of the time we are dealing with rational people."

Based on the foregoing discussion, the permutation of Australian holding structures and US operating structures are as follows in Table 1.

It should be noted that the US entity is in the form of an LLC, a Sub US is a corporation by election and an LLC US is a disregarded entity in most situations. In certain situations, to facilitate the discussion of a particular issue, an LLC US will instead be a partnership. It will be specified where this is the case.

The subsequent discussion of Australian and US taxes is to be structured according to the above four archetype structures, with following additional assumptions:

Table 1. Archetype structures for Australian enterprises to expand into the US

	Archetype structure	Australian structure	Entity type	US structure	Entity type
1	AusCo/Sub US	AusCo	Australian company	Sub US	US corporation
2	AusCo/LLC US	AusCo	Australian company	LLC US	Disregarded entity
3	Aus Trust/Sub US	Aus Trust	Australian trust	Sub US	US corporation
4	Aus Trust/LLC US	Aus Trust	Australian trust	LLC US	Disregarded entity

- Aus Trust is a discretionary trust;
- the relevant enterprises carry on the relevant business through or at a permanent establishment (PE) in the US;
- the structure does not own passive investments;
- the structure does not own real property in the US. These types of investments in the US by a non-US entity are subject to a special regime contained §897 IRC, which is not discussed in this article;
- the term "business" as used in Australia has the same meaning as the phrase "trade or business" customarily used in the US;
- the terms shares, stock and membership interest have the same meaning;
- current prevailing tax rates in the US and Australia, as at the date of this article, are used in all examples and illustrations; and
- all individual beneficiaries (defined below) are Australian residents.

The financial model "Effective tax rate of US profits" in Appendix 1 (effective tax rate model), sets out the effective tax rates when US profits are eventually distributed to the economic owner who will ultimately bear the burden of tax, for each archetype structure. Those economic owners are typically individuals (individual beneficiary), but can be other entity types, such as government and charities, which also do not make further distribution to another entity. For simplicity, this article proceeds on the basis that the individual beneficiaries are the owners of each of archetype structure.[7]

The authors venture to suggest that this financial model incorporates the two most fundamental and countervailing factors to be taken into consideration for international tax planning, being:

- the tax deferral benefits; vs
- the single tax benefit.

When an enterprise expands into the US, it is inevitable that its profits will be subject to both US and Australian taxation. The single tax benefit means that the individual beneficiary is only subject to one layer of taxation (single tax), thus achieving a lower overall effective tax rate. A tax deferral benefit, on the other hand, means that, although the individual beneficiary may bear a higher nominal tax rate, due to the multiple layers of tax imposed on the US profits caused by the presence of fiscally opaque entities in the structure, the net present value of the tax can be lower when judged in the hands of the individual beneficiary. These two concepts will be elaborated on below.

Archetype 4, the Aus Trust/LLC US column of the table in Appendix 1, shows the single tax benefit. The combination of a LLC US and Aus Trust, both of which are fiscally transparent, achieves an effective tax rate equal to the marginal tax rate of the individual beneficiary, being 47% based on the assumed facts. The three other archetypes involve at least one fiscally opaque structure that can retain profits taxed at a lower rate, thereby achieving a better overall result in some situations in terms of net present value, despite the higher ultimate effective tax rate.

Archetype 1 – AusCo/Sub US

The US currently has corporate tax rate of 21%, which is lower than the Australian corporate tax rate. In fact, the US corporate tax rate can become even more attractive under a special regime – foreign-derived intangible income (FDII) under §250 IRC, being as low as at 13.125%.

However, looking at the corporate tax rate alone can be misleading, because an individual beneficiary will be subject to further tax on the eventual distribution made by a corporation. Obviously, the benefit of the low US corporate tax rate may potentially be diminished for mature enterprises if they make regular distributions to their individual beneficiaries. That is because the profits made by a corporation cannot be retained long enough to achieve tax deferral benefits – ie in this situation, single tax benefits should be the more important consideration.

For example, we understand that Macquarie Bank has substantial operations in the US. Based on its dividend statement issued on 1 July 2022, for every $100 distribution, the unfranked dividend is about $60. Assuming this unfranked dividend was from its subsidiaries in the US, the tax rate on this amount could be over 60%, as shown in in the archetype 1 – AusCo/Sub US column of the effective tax rate model table in Appendix 1.[8]

At its mature stage where the enterprise generates substantial cash, which is distributed to the individual beneficiaries, the appeal of single tax benefits cannot be underestimated – see the discussion below regarding the tax planning undertaken by Blackstone Group LP in order to be listed as a partnership instead of as corporation in the US.

However, for an enterprise in its growth phase, the US corporate tax rate can be ideal, as there can be a considerable lapse of time between the generation of profits and eventual distribution to its shareholders. The tax saving from the lower US corporate tax rate can be reinvested for the growth of the business, such that the returns generated may well exceed the additional tax paid at the time when the distribution of profits occur – ie in this situation, tax deferral benefits outweigh the single tax benefits.

The participation exemption regime

The most pertinent feature of the Australian tax system in regard to this archetype structure is the Australian participation exemption regime, which exempts an Australian company (AusCo) from tax on income and capital gains that arise in respect of business operations outside Australia. This participation exemption regime is implemented by three separate provisions (collectively, the participation exemption measures):

- Subdiv 768-A ITAA97 – which exempts non-portfolio dividends (participation dividend exemption);
- Subdiv 768-G ITAA97 – which reduces capital gains and losses arising from CGT events in relation to non-portfolio

interests in active foreign companies (CGT participation exemption); and

- S 23AH ITAA36 — which exempts foreign branch income of Australian companies (branch exemption).

These rules were put in place by the *New International Tax Arrangements (Participation Exemption and Other Measures) Act 2004* (Participation Exemption Act), which implemented the relevant recommendations made by the Board of Taxation's report*, International taxation – a report to the Treasurer*, as detailed in para 4.6 of the revised explanatory memorandum (EM) to the said Act. We will defer our detailed discussion of the branch exemption to the next section, in respect of archetype 2 AusCo/LLC US.

There are two exceptions to the participation exemption measures. Firstly, the controlled foreign company (CFC) rules[9] attribute tainted sales income (s 386 and s 447 ITAA36), or tainted services income (s 386 and s 448 ITAA36), back to Australian shareholders (ie the AusCo). Secondly, and analogically, the branch exemption does not apply to tainted sales income or tainted services income (s 23AH(7) and (14) ITAA36). In broad terms, tainted sales income is income arising from transacting goods between a CFC (ie Sub US) and their Australian associates (s 447 ITAA36); tainted services income (s 448 ITAA36) is income arising from a provision of services to Australian customers by a CFC.

From the above discussion, it is discernible that the purpose of the participation exemption measures is to improve the international competitiveness of Australian companies with offshore operations, as they will not be held back by the additional tax needed to be paid in Australia.[10] On the other hand, the tainted sales and tainted services income rules prevent Australian enterprises from offshoring their Australian business.[11]

However, in the case of listed countries, which includes the US,[12] the income attributable under the Australian CFC rules is further limited (s 385 ITAA36), comprising only designated concession income (DCI). In the case of the US, there are only two items of DCI,[13] meaning the Australian CFC rules only operate in very rare situations. Similarly, under the branch exemption rules, all income of US branches is exempt, except for DCI. This effectively means that, under this archetype structure, the Australian CFC rules do not apply to tainted sales and service income[14]. In practical terms, the Australian international tax regime, as applicable to this archetype structure and archetype 2 AusCo/LLC US (to be discussed next), is territorial.

According to the EM to the Participation Exemption Act, this favourable treatment was provided because the US had a tax system that was comparable to Australia.[15] This assumption has been anachronistic since the enactment of the *Tax Cuts and Jobs Act* in 2017, which reduced the US corporate tax rate to 21% and introduced FDII.

In the authors' view, the CGT participation exemption is curiously generous. At para 1.7, the EM justifies the exemption in the following terms:

> "Australian companies are currently subject to tax on capital gains arising from the disposal of shares in foreign companies. This includes disposals of shares in foreign companies with underlying active businesses. Conversely, where the underlying active business assets of the foreign company are sold, any gain arising on that sale may escape attribution under the accruals regimes and be repatriated to Australia free from Australian tax if it is distributed through a non-portfolio dividend."

The above statement was broadly correct from an Australian perspective. It can be added that the sale, or repatriation of gains from sale, of the business of a foreign branch were also, and still are, not taxable in Australia (s 23 ITAA36). However, they are treated very differently in the US, as follows:

- the capital gains from the sale of shares in Sub US are not subject to income tax and withholding tax; however
- the sale of the business by Sub US is of course taxable in the US; further, withholding tax will be levied on the repatriation of the gains on the sale, in the form of a dividend (§881(a) IRC); and
- so is the sale of the business by a US branch (ie LLC US) under §882 IRC, and in fact, the assets used in a US business are subject to US tax within 10 years after the cessation of such business (§882 and §864(c)(7) IRC). Further, there can be applicable branch profit tax (§884 IRC), as discussed below.

Therefore, in the authors' view, the different treatments in the US as outlined in the preceding paragraph vitiate the policy argument for introducing the CGT participation exemption, as discernable from the paragraph of the EM cited above, which was to achieve neutrality between a sale of shares in a Sub US with underlying active businesses and a sale and repatriation of profits from a sale of business either operated by Sub US or through a branch of AusCo.

Definition of a dividend

Section 768-5 ITAA97 (which replaced 23AJ ITAA36[16]), the operative provision of the participation dividend exemption, exempts foreign equity distributions that pass the 10% participation test, ie a non-portfolio dividend.[17] Consequently, under this archetype structure, dividends paid by Sub US are exempted in Australia. On the other hand, Sub US is subject to withholding tax on dividends paid[18] at the prima facie rate of 30% in the US. This is reduced to 5% by art 10(2)(a), and further to nil if the AusCo is listed (art 10(3)) of the Australian–US tax treaty (Aus/US treaty).

It should be expected that the definitions for Australian and US tax purposes are not coterminous. This character mismatch may have tax consequences, which should be taken into consideration in terms of structure choice.

From a US perspective, "dividend" is defined, in §316 IRC, as any distribution of property made by a corporation to its shareholders from its earnings and profits, as described in §312. The term "earnings and profits" is largely an economic concept utilised by the tax law "to approximate a corporation's power to make distributions which are more than just a return of investment".[19]"

To the extent that a distribution made by a Sub US exceeds the current and accumulated earnings and profits, §301(c)(2) IRC treats it as a return of capital, which is applied against (reduces) an AusCo's adjusted basis in the Sub US. Where the distribution exceeds the stock basis of an AusCo, §301(c)(3) IRC treats the excess as gain from the sale or exchange of the stock, which gives rise to a capital gain.[20] Typically, capital gains are not subject to §881 and §1442 IRC.[21] However, the dividend can nevertheless be exempted under the participation dividend exemption, as a dividend as defined in Australia is different, probably including any distribution made by a Sub US, whether in money or other property, as long as it is not debited against an amount standing to the credit of the share capital account of the company (s 6(1) ITAA36).

In the US, the IRC, in some circumstances, provides that the distribution of profits made by a Sub US is not divided, thereby being taxable under §301 IRC. For example, distributions in redemption of stock under §302(b) IRC, in some circumstance, can produce capital gains, rather than dividends.

Illustration 1

AusCo has 75% of shares in Sub US, which have a nominal issue price. Sub US operates a profitable business with accumulated "earnings and profits" of $300, which is equal to the accumulated profits. The business has a market value of $400. AusCo redeemed its shares for $300 cash, which was debited to the accumulated profits.

In the US, the $300 is capital gains, because the distribution is a substantially disproportionate redemption of stock (§302(a) and (b)(2)) or is in complete redemption of all of the stock of Sub US owned by AusCo (§302(a) and (b)(2)). As AusCo is not a US resident, these capital gains are not subject to US tax.[22]

From an Australian perspective, the distribution is nevertheless a dividend either under s 6(1) or a deemed dividend under s 159GZZZP ITAA36[23] if the redemption is regarded as a buyback in Australia, as it is not debited to paid-up share capital. Consequently, the dividend can nevertheless be tax free under s 768-5 ITAA97.

Under this archetype structure, as illustrated in the archetype 1 – AusCo/Sub US column of the effective tax rate model table in Appendix 1, the dividend withholding tax rate is 5%. However, because of the participation dividend exemption, its benefit as a tax offset is lost (s 770-10 ITAA97), which is an extra tax cost (deadweight tax) under this archetype structure. The difference in view on the concept of dividends, as taken by Australia and the US, may provide circumstances where this deadweight tax can be avoided.

It should be noted that the participation dividend exemption only applies to "dividends" — its protection does not extend to other types of income, for example, capital gains.

Illustration 2

After a long history of profitable operations, Sub US sold its US business. After having met all of its US tax obligations, it went into voluntary liquidation, and distributed $100 to AusCo, which represented the capital gains made on the sale of the business.

Where both parent and subsidiary are US domestic entities, the complete liquidation of a subsidiary into a parent is not taxable. Section 332 IRC disregards the gain or loss made by a parent on receiving the assets distributed by its subsidiary, and §337 IRC effectively provides roll-over relief to the subsidiary upon transferring its assets to the parent.

However, because AusCo is a foreign corporation from a US perspective, the operation of §332 is modified by §367(e)(2) IRC, which generally requires gains and losses to be recognised by Sub US under §336 IRC, instead of being exempted under §337 (§1.367(e)-2(b)(1)(ii)(A) Treas Reg). However, in this illustration, no gains are to be realised, as Sub US has no appreciated asset but cash at bank.

Section 367(e)(2) does not, however, limit the benefit of §332 for the AusCo that receives distributions on liquidation. Thus, §332 should allow AusCo to pay no US taxes on the receipt of the assets of Sub US in a §332 liquidation,[24] which means that the 5% withholding tax applicable to dividends can be avoided.

From the Australian perspective, the taxation rules of company liquidation are contained in s 47 ITAA36, which deems that amounts distributed by the liquidator represent "income" derived by the Sub US as a dividend (s 47(1)). Section 47(1A) ITAA36 extends income, as referred to in s 47(1), to the amount (including taxable capital gains) included in the assessable income. As the $100 was from the sale of a business, it is non-assessable capital gains under s 885-10 ITAA97, thereby not subject to s 47. As s 47 is not applicable, the $100 is capital proceeds on the cancellation of shares in Sub US, which gives rise to capital gain CGT event C1 under s 104-20 ITAA97. Further, in the present case, the CGT participation exemption does not apply, as the Sub US did not carry on a business at the time when the capital gains event occurred (s 768-505(2) ITAA97).

The FDII and designated concession income rules

Under the FDII regime as contained in §250 IRC, Sub US can access a concessional rate as low as 13.125% in respect of its export income, including on exports to Australia. As discussed above, the Australian CFC rules, practically, do not apply to a US CFC such as Sub US. This means that Sub US can access the low tax rate in respect of its income generated from Australian-bound goods and services, which would be tainted sales or service income. If the Sub US was a resident of an unlisted country, the income would be attributed to AusCo, and the benefit lost.

Illustration 3

The group, of which AusCo is the head company, has highly valuable marketing intangibles (brand, and sophisticated marketing and distribution systems, etc), a substantial part of which is owned by Sub US. Sub US is responsible for packaging and rebranding products sourced from Mexico, which are sold to AusCo for selling to customers in Australia.

The actual calculation of FDII is quite complicated. In a simplified version, the FDII of Sub US is the Australian net sales income/total net sales income (total net sales income – 10% written-down value (WDV) of plant and equipment). The last portion of the formula produces the deemed intangible income (§250(b)(2) IRC), which is effectively the net sale income minus a 10% (arbitrarily chosen) deemed return on investment in the tangible assets. The FDII is that portion of deemed intangible income attributable to the net Australian sales income. This formula avoids the conceivable hair-splitting exercise needed to calculate the income attributable to intangible assets used in an export sale. For those who are interested in the detail, see §1.250 to §1.250(b)-6 Treas Reg.[25]

Given today's economy is dominated by digitalised and service-oriented businesses, a high percentage of income will be from intangibles, which can be located anywhere in the world. This maximises the opportunity to access the concession offered by the FDII regime, using a well-designed transfer pricing mechanism.

The Sub US can repatriate the profits, in the form of a dividend, Australian tax-free to the AusCo under the participation dividend exemption regime, but subject to withholding tax in the US (5% under art 10(2)(a) of the Aus/US treaty, or nil where AusCo is listed under art 10(3)).

In respect of the Australian CFC rules, if the Sub US was instead based in Mexico, sales from it to Australia would be tainted sales income (TSI) under s 447 ITAA36, which would be subject to tax in the hands of AusCo under s 456 ITAA36, as it is an attributable taxpayer. The Australian sales income of the Sub US would not come within the exceptions to TSI under the substantial alteration test (s 447(1)(a)(iii)). Importantly, the value added by the Sub US is ignored under s 447(4)(c) for assessing the exceptions from tainted sales income, such as value added by intangibles.

The effective 13.125% tax rate under FDII is only marginally higher than the infamous Irish 12% corporate tax rate. High-tech companies (such as Apple) may not bother to set up subsidiaries in Ireland anymore because of the introduction of the FDII regime. Goulder[26] reported that there has been a recent spike in claimed FDII benefits, which may include some Australian multinationals. As at December 2021, five US tech giants (Amazon, Apple, Facebook, Google and Microsoft) reported a 300% increase in claimed FDII benefits.

The Biden administration initially proposed repealing FDII. However, as Goulder pointed out, achieving that is wishful thinking at this point, short of a successful World Trade Organization challenge, which would be years away.

The above discussion proposes that the combination of FDII and designated concession income can be used by Australian multinationals to emasculate the effectiveness of the Australian CFC rules. It seems that the designated concession income rules should be urgently reviewed, as least in the context of the US, given their anachronistic nature.

Based on the foregoing discussion, in general terms, archetype 1 structure AusCo/Sub US has the following features:

- the income of Sub US will be only taxed in the US. Losses will also only be deductible in the US;
- in most circumstances, the profits of Sub US can be repatriated in the form of dividends to AusCo free of Australian tax, but subject to US withholding tax. However, the idiosyncrasies of the Australian and US tax laws may produce less expected outcomes, which can be either a boon or a bane, and will ultimately be reflected in the ultimate effective tax rate in the effective tax rate model in Appendix 1;
- although the Sub US's dividends are not taxable, they can only be paid out as unfranked dividends to individual beneficiaries. Further, withholding tax cannot be claimed as an offset in Australia, because the dividend is not assessable in Australia; and
- Sub US can sell or provide services back to Australian associates without falling foul of the CFC rules, which facilitate its access to the low rate offered by the FDII regime.

Archetype 2 – AusCo/LLC US

An alternative way for AusCo to foray into the US is through a branch operation. As mentioned above, since the promulgation of the CTB reg, LLCs have gained popularity as a structure for conducting business in the US, and can be registered under all fifty states' LLC legislation.[27] It is, at least in the authors' experience, almost ineluctable that a branch operation is conducted through an LLC, which is a disregarded entity. The effective tax rate of this archetype structure is shown in the archetype 2 – AusCo/LLC US column of the table in Appendix 1. In this instance, AusCo pays branch profits tax, instead of dividend withholding tax as in the archetype 1 structure. They have the same effective tax rate.

A disregarded entity is disregarded as an entity separate from its owner (§301.7701-3 Treas Reg), ie it is fiscally invisible. The analogy in Australia perhaps is a subsidiary of a tax consolidated group, which is regarded as part of the head company under the single entity rules (s 701-1 ITAA97). Consequently, while LLC US is a fully fledged corporation from a commercial perspective, for US tax purposes, it is AusCo that is regarded as carrying on business in the US.

In the US, AusCo is subject to US tax, as a foreign corporation, on its taxable income that is effectively connected (ECI) with the conduct of a trade or business within the US under §882 IRC (ECI regime). It should be noted that, if there is more than one shareholder in LLC US, it is classified as a partnership, instead of a disregarded entity (§301.7701-3(a) Treas Reg). In that instance, AusCo is liable to pay tax on its share of ECI of LLC US (§875 IRC), and is subject to withholding tax at 21% under §1446 IRC. Further, on disposal of its interest in LLC US, AusCo is liable for tax on the portion of gains attributable to the ECI under §864(c)(8), which is subject to withholding tax under §1446(f) IRC. Those withholding taxes are creditable against the primary tax in US.

The foreign hybrid rules and branch exemption

From an Australian tax perspective, under Div 830 ITAA97 (the foreign hybrid rules), an LLC US is a foreign hybrid company (s 830-15(1) ITAA97), which is treated as partnership (s 830-20 ITAA97). AusCo, as a shareholder in LLC US, is treated as partner in a partnership under s 830-25 ITAA97.

In respect of this archetype structure, under the branch exemption, income derived and capital gains arising from the disposal of assets (including whole or part of the business) by LLC, at or through its US PE, is exempted in Australia in the hand of AusCo, unless it is DCI.

However, there is an important technical point that needs to be considered, being whether the US business is carried on by AusCo or LLC US. This issue is addressed by ID 2011/35, in which the Commissioner proposes that AusCo, as a partner, does not carry on the LLC's business in the US, so the US income is not exempted under the main operative provision – s 23AH(2) ITAA36. Nevertheless, it provides that AusCo's indirect interest (ie the partner's interest) in income derived by LLC US is exempted through the application of s 23AH(10) ITAA36. ID 2011/35 makes the point that, under the foreign hybrid rules, the US business is still carried on by LLC US, not by AusCo, recognising that the LLC is a separate entity to AusCo in Australia, not a disregarded entity as in the US.

A partnership with only one partner

Any doubt as to whether an LLC US with only one member can be a partnership is dispelled by ID 2010/77, which provides an affirmative answer to this question.

Consequently, an LLC US is treated as a disregarded entity in the US, but a partnership in Australia. In Australia, a partnership is a separate entity as listed in s 960-100 ITAA97. As foreshadowed above, there is a subtle but significant distinction between the two; ie a disregarded entity is fiscally invisible, while a partnership is fiscally visible. The differences will be material in many instances, for example:

- A payment (such as technical services fee) from LLC US to AusCo will be taxable to it, with no corresponding deduction available in the US, being disregarded as it is an internal payment within the same entity. A payment in a reverse transaction is not taxable in hands of LLC US for the same reason; but it is prima facie deductible under s 8-1 ITAA36 in Australia. This deduction is then denied by Subdiv 832-D ITAA97 (Hybrid payer mismatch).
- A payment, loan or debt forgiveness by AusCo to LLC US can be deemed as dividend under Div 7A of Pt III ITAA36. Any doubt as to whether Div 7A can operate between AusCo and a wholly owned partnership (ie LLC US) is diminished by the Full Federal Court decision in *D Marks Partnership (by its General Partner Quintaste Pty Ltd) v FCT*,[28] where the Full Federal Court endorsed the AAT's decision that a loan made to a tax law partnership came within s 109D ITAA36. Further, the branch exemption can only apply to non-Australian sourced income, which a deemed dividend is unlikely to have.
- The CGT participation exemption may apply if AusCo directly holds share in a US subsidiary that carries on active business in the US, but will not apply if the said share of the subsidiary are held by LLC US (TD 2008/23).
- In respect of the transfer pricing rules, it seems that the operating provision would be Subdiv 815-B ITAA97, which applies to transactions between separate entities (instead of Subdiv 815-C, which applies to attribute profits between head offices and PEs), in conjunction with art 9 of the Aus/US tax treaty. However, it seems that AusCo would be subject to US tax under the US ECI regime, which imposes tax on the income of a branch (ie LLC US) of a non-US company (ie AusCo), or art 7 of the Aus/US treaty. Further, in respect of the application of art 7, the US prefers the authorised OECD approaches for the attribution of profits to LLC US (AOA),[29] while Australia prefers the relevant business activity approach.[30] It is conceivable that this difference may give rise to challenges or delays for AusCo to resolve any transfer price disputes through the mutual agreement procedure (MAP).

Branch profits tax

In the authors' view, the burning sting of this archetype structure is the operation of §884 IRC, which may impose two fictional taxes – branch profits tax[31] and tax on excess interest (to be discussed the next sub-heading "Branch interest tax"). These cannot be claimed by AusCo as an offset in Australia and therefore are deadweight tax.

The policy under branch profits tax (BPT) is easily comprehended. If LLC US was the Sub US of the archetype structure 1, the profits paid from the US in the form of a dividend is subject to withholding tax under §1442 IRC. However, in the case of LLC US, which is a branch, there would be no withholding tax on repatriated US profits to AusCo, as it is an internal transaction within the same entity. The US Congress created a BPT regime in §884 IRC to harmonise the treatment of foreign subsidiaries and branches.[32]

The BPT rules are complicated, and are better explained by reference to illustrations.

Illustration 4

LLC US made profits of $100 from its business in the US, and AusCo paid $21 US tax. LLC US invested $79 in a portfolio of shares.

The $79 is "effectively connected earnings and profits" (ECEP) under §1.884-1(f) Treas Reg, which becomes the "dividend equivalent amount" (DEA) (§1.884-1(b)(1)), after adjusting for the changes in net US equity at close over two successive years (§1.884-1(c)). The portfolio of shares is not accounted for in determining the net US equity and therefore the change in net US equity is nil, and the DEA is $79, on which BPT will be levied in the hand of AusCo. This will be at prima facie 30% (§1.884-1(a)), but reduced to 5% under art 10(2)(a) of the Aus/US treaty.

Illustration 5

The same facts as the previous Illustration 4, except the $79 is invested in an asset used in their business to produce ECI in the US.

The asset is a US asset (§1.884-1(d)(1)), as it produces ECI. The net US equity is equal to the US asset minus the US liability. As the US liability is nil, the net US equity is $79. Thus, there is an increase in net US equity from nil to $79, which reduces the DEA to nil.

Illustration 6

Following on from the scenario in illustration 5, in the next year, LLC US makes no profit. It sold the asset for $79 at its cost, and invested in a portfolio of shares.

There is a decrease in net US equity, which produces a DEA of $79.

From the above three illustrations, it can be discerned that BPT arises either because:

- profits of LLC US are not invested by AusCo in the business operated by LLC US; or
- an asset used in the US business is disinvested in a future year.

In order to avoid the BPT, AusCo has to continuously expand its US business. It cannot take advantage of the low rate of US corporate tax to invest extra profit into non-US assets; nor, except in limited circumstances[33], can AusCo stop reinvesting in its existing US business in order to start a new line business or switch to a new business.

Illustration 7

AusCo subscribes to $79 of shares in LLC US and uses it to purchase a US asset within the meaning of §1.884-1(d). In the next year, the business generates after-tax profits of $79. LLC US repatriates $79 to AusCo. The DEA is $79, as ECEP is $79, and there is no change in the net US equity (ie the amount of US assets remains the same).

This illustration demonstrates that BPT embodies the profit first rule. The $79 was not traced to the $79 subscription for the shares in LLC US. This has important implications, AusCo cannot repatriate its capital contribution until its US profits are fully subject to BPT.

It should be noted that, prima facie, the BPT rate is 30% (1884(a) IRC), which is reduced by art 10 of the Aus/US treaty. Section 1.884-1(g)(4)(B) Treas Reg provides the BPT rate is 15%, but this seems outdated. The rate should be 5% under art 10(2)(a) of the treaty.

As the LLC US profits are exempted under s 23AH ITAA36, the 5% BPT is deadweight tax – an extra cost, which neither produces a deduction nor a foreign tax offset in Australia.

In summary, in respect of BPT, under this archetype structure:

- AusCo is to subject to BPT, unless it continuously expands its US business. BPT is deadweight tax; and
- the repatriation of capital contributions cannot occur until the US profits are fully subject to BPT.

Branch interest tax (BIT)

Under archetype structure 1 AusCo/Sub US, Sub US is liable for interest withholding tax on the interest it pays to a non-US lender in the US (§881(a)(1) IRC), such as an Australian bank, as the source of such interest is in the US (§861(a)(1) IRC). However, if AusCo borrows from an Australian bank to fund the operations of LLC US, the interest is paid by AusCo (a foreign entity from a US perspective) to a foreign lender (the Australian bank), and there is no withholding tax, as the source of interest is not in the US (§862(a)(1) IRC). BIT was created to tax branch interest in likeness to a subsidiary (§884(f) IRC), the operation of which will be explained through an illustration.

Illustration 8

AusCo borrows $50 (at an interest rate 6%) from a Hong Kong bank, together with $20 raised from its paid-up capital (ie total $70), to fund the operation of LLC US. This borrowing is properly recorded in the books of LLC US – ie it is a "U.S. booked liability" (1.882-5(d)(2) Treas Reg). AusCo borrows another $30 from an Australian bank (at interest rate 10%) to fund its Australian operation.

The first step is to calculate US-connected liabilities (1.882-5(c) Treas Reg), which will determine the interest expenditure to be allocated to LLC US. US-connected liabilities are the product of the value of US assets the AusCo world-wide debts/asset ratio (ie $7080/100 = $56) (1.882-5(c) Treas Reg). US assets are essentially those used in producing ECI (§1.884-1(d) Treas Reg).

As the US-booked liabilities of $50 is less than the $56 of US-connected liabilities, the interest expenditure allocated to LLC US is broken down into two components:

- interest paid on booked liabilities, ie $50 6% = $3, which is termed as branch interest ((1.882-5(d)(i)); plus

- interest deemed to be paid, which is the product of the excess of US-connected liabilities over US booked liabilities interest rate of non-US-booked liabilities (1.882-5(d)(i) Treas Reg) (ie (56 – 50)10% = $0.6), which is termed as excess interest.

In the case where the US-booked liabilities were less than the US-connected liabilities, the interest expenditure allocated to the LLC branch would have been scaled down according to 1.882-5(d)(4) Treas Reg.

The interest expenditure paid, or deemed to be paid, by LLC US may be deductible, but can also be disallowed, deferred or capitalised (§1.882-5(a)(2) Treas Reg); for example, interest may be deferred under 163(j) IRC — the earnings stripping rule (equivalent to thin capitalisation in Australia). This seems to be the goal of the allocation of interest to a US branch under §1.882-5 Treas Reg.

For BIT purposes, branch interest is deemed to be paid by a US domestic corporation under §844(f)(1)(A) IRC, thereby being subject to withholding tax under 1442 IRC, if paid to a non-US resident, as in this illustration. The withholding tax rate is determined by either the country of the home office (ie Australia) or the foreign lender (ie Hong Kong, with which the US does not have double tax agreement) (1.884-4(b)(8) Treas Reg). This seems to be a loophole that should be closed, as can be discerned from the discussion regarding Illustration 8.

The excess interest is deemed to be *received* by AusCo from a US domestic corporation, after having been deemed to be *paid* by AusCo, as mentioned above (1.884-4(a)(ii) Treas Reg). This is a very unusual way to impose tax. There are several interesting features of the excess interest:

- the excess interest represents two fictional offsetting income and expenditure amounts. The income is taxable; the expenditure can be deductible but also can be disallowed, deferred or capitalized;
- the excess interest is assessed on the gross amount under 881(a) IRC. Section 881(a) imposes tax on items of passive income, the tax liabilities of which are often subject to withholding tax under 1442 IRC. However, excess interest is not subject to withholding tax, nor can it access most of exemptions under 881. The most notable one is the portfolio interest exemption under 881(c) IRC, which effectively exempts an entity from US tax on interest arising on debts issued by a non-US person (except for bank) who have less than a 10% shareholding in the home office (ie AusCo in the present case);
- the tax rate can be reduced to 10% under art 10 of the Aus/US treaty, which can have either a positive of negative outcome. In the case where LLC US is in a loss situation, the BIT on excess interest can nevertheless be payable, as it is imposed on the gross amount. On the other hand, where, for example, the excess interest is $100, which is fully deductible against other income of LLC US, the effective tax on excess interest is 10%, instead of 21%;
- as excess interest is the functional equivalent of interest paid on AusCo's debt funding with respect to LLC US[34] — eg where AusCo's only operation is the business conducted by LLC US, which is funded by the borrowing of the LLC branch in its own right, there would be no excess interest.[35] In that case, the LLC branch would only have branch interest. Alternatively, the excess interest can be avoided by having an associated entity undertake the borrowing and subscribing to shares in AusCo for the funding of LLC US, thereby reducing its debt/asset ratio;[36] and
- where the whole operation of LLC US was funded by AusCo's borrowings (eg through the subscription of membership interests in the LLC branch), the LLC branch would have only excess interest. It appears that the excess interest rules impose, curiously, a quasi-thin capitalisation on AusCo — a non-US resident entity.

The tax on branch interest seems benign, being an analogy to interest withholding tax paid to a lender by a US domestic corporation. However, excess interest is harmful. Australia takes no notice of all these complicated deeming operations that create excess interest and tax thereon, which is deadweight tax. If incorporated into the archetype 2 – AusCo/LLC US column of the effective tax rate model table, this deadweight tax will increase the effective tax rate.

In summary, the BPT and BIT are major pitfalls associated with this archetype structure, which in the authors' experiences, are ubiquitously adopted to operate a US branch. Further, the structural character mismatch of LLCs in Australia versus the US may be operationally and technically difficult to manage.

AusCo may consider reclassifying LLC US to Sub US (to be discussed below under "Archetype 4 – Aus Trust/LLC US"), where a similar reclassification issue is explained.

Archetype 3 – Aus Trust/Sub US

The defining feature of this archetype structure is that it is fiscally opaque in the US, but transparent in Australia. That means that once the profits are distributed out of Sub US, they will be immediately taxed in the hands of the individual beneficiaries, with US withholding tax available as an offset. However, because Aus Trust is a trust (not a corporation), the withholding tax on dividends is 15% (art 10(2)(b)). This compels an immediate distribution to the individual beneficiary — the effective tax rate of which is shown in the archetype 3 – Aus Trust/Sub US column of the table in Appendix 1. If the dividend is distributed to a corporate beneficiary, the participation dividend exemption does not usually apply.[37] The corporate beneficiary will pay Australian tax with US withholding tax (15%) as an offset, which is higher than the tax (5%) paid by AusCo in archetype structure 1. Further, the portion of profits that is exempted can only be paid out as an unfranked dividend, as the US tax paid does not generate franking credits. Therefore, distributions to a corporate beneficiary from Aus Trust should generally be avoided.

Compared to the two-tier company structure as in archetype structure 1, this archetype is simpler to operate. However, if the Aus Trust has operations in Australia, which can benefit from cash generated by the US operation, this structure does not offer the lower withholding tax rate of 5% (or even zero) – art 10(2)(a) and (3) of the Aus/US treaty.

Excessive earnings tax and personal holding company tax

The lower US tax corporate rate creates a bias in favour of retaining profits in the US for further business expansion and investment. In this regard, attention needs to be paid to two antique rules designed to combat improper accumulation:

- the accumulated earnings tax (AET) imposed by §531 IRC on the accumulated taxable income (as defined in §535 IRC) of corporations that accumulate their earnings in order to avoid the taxing of their shareholders (ie Aus Trust), even if those shareholders are non-US resident;[38] and
- the penalty tax imposed by §541 IRC on personal holding companies (PHC).

AET taxes earnings and profits that have been accumulated beyond the reasonably anticipated[39] needs of the business, for the purposing of avoiding tax on dividends. The fact that the corporation is a mere holding or investment company is prima facie evidence of the purpose to avoid income tax for its shareholders (§533(b) IRC). The tax is not self-assessed (as the PHC tax is supposed to be), ie it arises only on a deficiency assessment.

When applicable, the tax is levied at the rate of 20% of the accumulated taxable income, which is the current year's taxable income with various adjustments. If applicable, §531 tax imposes a severe triple tax effect on Sub US: first at the regular corporate tax rate (21%); then at the §531 rate (20%) on the after-tax income of Sub US; and, finally, at 15% as withholding tax on the after-tax net distribution in the form of a dividend to Aus Trust.

Under the PHC rules, §541 IRC imposes tax at a special 20% penalty rate on undistributed personal holding company income of a PHC, which can apply to a foreign shareholder such as Aus Trust.[40] To constitute a PHC, the Sub US must meet both an income test and a stock ownership test. That is, at least 60% of its adjusted ordinary gross income must be PHC income (primarily passive investment income plus personal service income in the case of incorporated talents §543 IRC), and more than 50% of its stock (by value) must be owned – directly or indirectly, actually or *constructively* – by five or fewer individuals.

The constructive ownership rules are contained §544 IRC, and are more inclusive than other attribution rules in IRC, under which:

- stock owned by corporations, partnerships, estates or trusts is attributed proportionately to the shareholders, partners or beneficiaries of these entities; and
- an individual is considered as owning the stock owned by his brothers, sisters, spouse, ancestors and lineal descendants.

The PHC rules most likely operate if Sub US has converted to a passive investment vehicle. PHCs are not subject to the AET(§531 IRC).

Consequently, these two rules may prevent Aus Trust from taking advantage of the lower US corporate rate by using Sub US as a vehicle for holding passive investments, alongside operating the business in US.

Rules against treaty shopping

The US withholding tax rate is prima facie 30% (§1441 and §1442 IRC), reduced to the rate prescribed by the relevant articles of the Aus/US treaty, which have been mentioned herein. The reduction in withholding tax rate raises concerns regarding the rules against treaty shopping, discussed here, but also relevant to all situations where treaty benefits are sought.

As a matter of normal trust practice in Australia, the trustee of Aus Trust is most likely to have the power to make distributions to a wide range of beneficiaries, including those who are neither Australian nor US residents for tax purposes. Australia does not tax Aus Trust on a dividend from Sub US where it is distributed to beneficiaries who are non-Australian residents, as the dividend is not sourced in Australia (s 97(1)(a)(ii) ITAA36). It is conceivable that Aus Trust may be used as a device to reduce US withholding by residents of those countries that do not have a tax treaty with the US. In this regard, there are three anti-treaty shopping rules that should be taken into consideration to secure the reduced US withholding tax rate.

In the authors' view, to alleviate the treaty shopping concerns, the deed of Aus Trust should be drafted in such a way as to rectify this problem. The trust deeds should contain a clause, referred to as the overriding clause. That overriding clause ensures the distribution of capital or income that can only be made to a beneficiary who is a resident of Australia or the US for AUS/US treaty purposes. In the authors' view, this should address the treaty shopping issues that can arise under the following three provisions contained in the Aus/US treaty and IRC/Treas Reg.

Firstly, under art 4(iv) of the Aus/US treaty, a trust (such as Aus Trust) will not be regarded as a resident of Australia, thereby being denied the treaty benefits, *except* to the extent that the income is subject to Australian tax on the taxable income of a resident, either in the hands of that trust or in the hands of a beneficiary.

The overriding clause should operate to ensure that dividend income is taxed in Australia, thereby bringing about the operation of the "exception" limb and securing Aus Trust's entitlement to the reduction in the withholding tax rate on dividends derived in the US.

Secondly, under art 16 (Limitation on benefits) of the Aus/US treaty, Aus Trust has to be a qualified person, within meaning of art 16(2), in order to be entitled to benefits provided by the treaty. In the authors' view, the inclusion of the overriding clause in the trust deed will facilitate Aus Trust being regarded as a qualified person under para (g) of art 16(2), which provides a two-part test – the so-called "ownership test" and the "base erosion test". Both prongs of the test must be satisfied for the resident to be entitled to benefits under para (g) of art 16(2).

In respect of the ownership prong of the test: subpara (i) of para (g) requires that 50% or more of the aggregated voting power and value of a trust be owned, directly or indirectly, in at least half the days of the person's taxable income year, by a qualified person. In Australia, a discretionary trust, as such as Aus Trust, will never, *literally*, meet the ownership prong test, as a beneficiary will not, neither individually nor collectively, have a beneficial interest in a discretionary trust,[41] without statutory intervention.[42] However, the technical explanation issued by US Treasury Department accompanying the protocol amending the Aus/US treaty in 2001 provides the following guideline:

> "… the beneficial interests in a trust will be considered to be owned by its beneficiaries in proportion to each beneficiary's actuarial interest in the trust. The interest of a remainder beneficiary will be equal to 100 percent less the aggregate percentages held by income beneficiaries. A beneficiary's interest in a trust will not be considered to be owned by a person entitled to benefits under the other provisions of paragraph (2) if it is not possible to determine the beneficiary's actuarial interest. Consequently, if it is not possible to determine the actuarial interest of any beneficiaries in a trust, the ownership test under clause (i) cannot be satisfied, *unless all possible beneficiaries are persons entitled to benefits under the other sub-paragraphs of paragraph (2).*" (emphasis added)

The overriding clause should operate to ensure that all possible beneficiaries of the said Aus Trust are qualified persons under art 16(2), thereby enabling that trust to meet the ownership test.

The base erosion test requires that no more than 50% of the gross income of the trust is paid out as deductible expenditure, for Australian tax purposes, to non-residents of either the US or Australia. Therefore, where Aus Trust purchases goods and services from a third country other than the US or Australia, it should be vigilant in avoiding this base erosion prong, thereby jeopardising its treaty entitlement in regard to a reduction in the US dividend withholding tax rate. This is a practical matter that Aus Trust has to manage.

Thirdly, due consideration should also be given to §1.894-1 Treas Reg (Income affected by treaty), which may operate to deny a treaty benefit if Aus Trust is deemed a fiscally transparent entity. This regulation seems unlikely to apply for the following two reasons:

- The Aus Trust is not fiscally transparent. According to para (d)(3)(ii) of the aforementioned Treas Reg, a trust is regarded as "fiscally transparent" if the character and source of an item of income derived by that Aus Trust is carried over to its beneficiary, under *Australian* tax laws. The High Court of Australia in the *Bamford* case[43] (as explained by the full Federal Court in the *Greenhatch* case[44]) provided that the character of the income of a trust may not necessarily correspond to the character of that income distributed to a beneficiary. This is encapsulated in the following statement from the decision impact statement published by the Commissioner of Taxation (Australia):[45]

  > "In particular, absent specific statutory rules that lead to a different result (such as can now be found in Subdivision 115-C of the ITAA 1997), the character for trust law purposes of the income to which the beneficiary was made presently entitled *does not inform* the character of the share of the net income assessed to the beneficiary under section 97 of the ITAA 1936 for tax law purposes. Put differently, streaming of amounts for trust law purposes by reference to the character of those amounts will only be effective for tax law purposes where that result is facilitated by specific statutory rules." (emphasis added)

- Further, even if Aus Trust was a fiscally transparent entity, all persons who will potentially derive the US dividends are Australian residents, thanks to the inclusion of the overriding clause in the trust deed. This ensures the availability of the reduction in the dividend withholding tax rate. On this matter, §1.894-1(d)(1) Treas Reg states:

  > "The tax imposed by sections 871(a), 881(a), 1443, 1461, and 4948(a) on an item of income received by an entity, wherever organized, that is fiscally transparent under the laws of the United States and/or any other jurisdiction with respect to an item of income shall be eligible for reduction under the terms of an income tax treaty to which the United States is a party only if the item of income *is derived by a resident of the applicable treaty jurisdiction.*" (emphasis added)

Reclassify LLC US as Sub US

The most salient feature of the CTB reg is its incredible flexibility. As Rosenbloom points out "because the check-the-box regime is so easy for taxpayers to use, the invitation to arbitrage is especially compelling".[46] Yet, Australia imports this feature through its foreign hybrid rules, demonstrated in the following illustration.

Illustration 9

Sub US, an LLC electing as being a corporation, has carried on a considerably profitable business in the US, paying tax between 13.5% to 21%. It eventually sells the business – the capital gain arising thereon was taxed at 21%. The Sub US now has only cash at bank of $100, which is ready to be repatriated to Aus Trust. If it is distributed as a dividend, the tax consequence has been set out in the archetype 3 – Aus Trust/Sub US column of the effective tax rate model table (Appendix 1). The Sub US then unchecks the box so that it becomes a disregarded entity of Aus Trust.

In the US, Sub US is deemed to distribute all of its assets and liabilities to its single owner (ie the Aus Trust) in a complete liquidation of itself (§301.7701-3(g)(1)(iii) Treas Reg). The deemed liquidation triggers a deemed sale by Sub US of the all assets at market value under §336 IRC, and can give rise to substantial capital gains, however, these are nil in this illustration. Further, the amount (ie $100) received by Aus Trust in a distribution of complete liquidation is treated as a full payment in exchange for the shares in Sub US. This gives rise to a capital gain of $100, not a dividend (§331(a) and (b) IRC), which is not taxable to Aus Trust in the US.[47]

From the Australian perspective, the deemed liquidation in the US is invisible. Section 830-80 ITAA97 resets the Aus Trust tax cost, which seems to be the $100 (ss 830-90 and 830-95 ITAA97). Further, s 830-110 operates to ensure that there are no capital gains on the change in the status of Aus Trust's interests in Sub US — ie from shares in a corporation to a partnership interest in a one-partner partnership. Furthermore, there is no tax implication arising in respect of the assets of Sub US on change of status,[48] which is a paper exercise, triggering no CGT event or other taxing point in Australia. Even if there was a taxing point during the change, it would occur when Sub US was a corporation, which is fiscally opaque. There is no mechanism to attribute the capital gains realised by Sub US to Aus Trust after the reclassification, which is converting a company to a foreign hybrid for Australian tax purposes.

There is no Australian tax on the repatriation of $100 to Aus Trust, nor on its distribution from the trust to the eventual individual beneficiary. Further, it is at least arguable that there is a $100 capital loss on the wind up of LLC US, as the shares in LLC US are a CGT asset. Section 108-5(2)(d) ITAA97 specifies that a CGT asset includes an interest in a partnership (ie the shares in LLC US), other than an interest in an asset of a partnership.

In summary, a feature of this archetype structure is a higher withholding tax (15%) on dividends paid by Sub US, which compels Aus Trust to distribute the dividends through to individual beneficiaries. Aus Trust should carefully manage the anti-treaty shopping rules to secure the reduction in withholding tax, which is also pertinent to any archetype structure where a treaty benefit is sought. Further, it seems that the foreign hybrid rules are not equipped to deal with the incredible flexibility of the CTB reg. This may produce opportunities for tax planning and tax avoidance, which can have a downward impact on the effective tax rate under the archetype 2 column of the effective tax rate model table.

Archetype 4 – Aus Trust/LLC US

This archetype structure is designed to be fully fiscally transparent, which means:

- individual beneficiaries will bear the tax implication immediately whenever the income and losses arise. There are no tax deferral benefits; and
- the US tax paid can be utilised to offset the Australian tax liability of the individual beneficiary, thereby achieving single tax benefits (see the archetype 4 – Aus Trust/LLC US column of the effective tax rate model table in Appendix 1).

The central operating provisions under this structure are the foreign hybrid rules, which follow the entity classification under CTB reg in the US, treating the LLC US as a partnership for Australian tax purposes.

In Australia, a taxpayer is only able to claim foreign tax offsets if that person has paid the said foreign tax (s 770-10 ITAA97), being US tax in this instance. However, a taxpayer will be treated as having paid foreign income tax on an amount included in their assessable income where the foreign income tax has effectively been paid by someone else on their behalf, whether under an arrangement with the taxpayer, or under the law.[49] Accordingly:

- where the US income is retained, the Australian trust is able to claim the US tax as a tax offset against its Australian tax, as it pays tax on the income of LLC US under §882; and
- where the US income is distributed to the individual beneficiaries, they can claim the US tax as a tax offset against their Australian tax, because Aus Trust pays US tax on their behalf.

The tax offset can be claimed subject to a cap,[50] which is the amount of Australian tax that would have been paid on the foreign source income, without taking the foreign tax offset into consideration. That means, if the US tax paid is higher than the amount of Australian tax to be paid, the excess of the US tax over the Australian tax will be lost. In essence, the effect of the cap is to tax the US income at the higher of the US tax rate and the Australian tax rate. As the Australian tax rate is higher than the US tax rate, generally speaking, the US tax can be fully utilised to reduce Australian tax liabilities.

In the US, while a partnership is fiscally transparent, publicly traded partnerships are treated as corporations for tax purposes, as required by §7704 IRC. However, as described in an interesting article by Cauble,[51] when it listed on the New York Stock Exchange in 2007, Blackstone Group LP, a member of the Blackstone Group (one of the largest global private equity firms), utilised a complex tax structure in order to be treated as a partnership, instead of a corporation, and, in the process, saved US$150m annually. As Cauble reported, other private equity groups, including Fortress, KKR and Carlyle, were publicly traded and benefited from a similar approach.[52]

Although the transactions undertaken by the Blackstone Group and other private equity groups are historical, they nevertheless demonstrate the tremendous appeal of single taxation to enterprises at a mature stage, generating considerable cash profits, and needing to be distributed to their individual beneficiaries.

However, a fully transparent structure provides considerable, sometimes overwhelming, complexities, as a matter of both substantive law and procedure, because:

- Australia requires LLC US (a US entity) to draw up tax accounts according to its laws, in order to ascertain the liabilities of its shareholder (eg the Aus Trust); and
- the US may trace through both LLC US and Aus Trust (which are regarded as fiscally transparent) in order to ascertain the US liabilities of their direct and indirect owners (eg Aus Trust and the individual beneficiaries, as case may be – see the discussion below).

A trust for US tax purpose

Section 301.7701-4(b) Treas Reg makes it abundantly clear that a trust can be a business trust if it is "created by the beneficiaries simply as a device to carry on a profit-making business". A business trust is business entity, which can only be either in the form of a partnership or a corporation (ie it is not a trust for US tax law purposes).

It would be generally undesirable if Aus Trust were classified as a business trust for the following reasons:

- if it is classified a partnership, which is the default position, Aus Trust would be fiscally transparent, meaning that each beneficiary would be exposed to the complicated US tax system. Further, their US tax liabilities would then be determined on the basis of how the beneficiary is classified under US tax law (ie whether as a trust, corporation or an individual, etc). This gives rise to considerable procedural complexities; and
- if Aus Trust is classified as a corporation for US tax purposes, LLC US can be subject to BPT and BPI as discussed above; however, Aus Trust would not be able to access the branch exemption, as it is not a company in Australia.

The Aus Trust[53] can be regarded as a trust for US tax purposes, if it is an "ordinary trust" under §301.7701-4(a) Treas Reg. This section provides that an arrangement will be treated as a "trust" where:

> "the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit."

This means that whether a trust will be initially considered an ordinary trust or a business trust will depend on whether it is imbued with both:

- an objective to carry on a business and divide its gains (business purpose); *and*
- associates in a joint enterprise for the conduct of business for profit (associates test).

The business purpose can likely be negated by carefully drafting the trust deed, where:

- the trustee merely has the power to hold investments (eg the shares in LLC US), and further is not authorised to carry on a business; and
- the predominant function of the trustee is just to collect and distribute:[54]
  - any income distributions from investments (eg LLC US); and
  - the proceeds of the ultimate sale of investments (eg shares in LLC).

According to Bishop,[55] in order for a trust to fail the associates test, a trust:

- should not be created by the beneficiaries; and
- the instrument should specifically prohibit the beneficiaries from exercising any trustee powers (but a removal power should be acceptable).

The test is conjunctive, ie even a trust with a demonstrated business purpose will not be classified as a business trust unless it also has associates, and vice versa. However, it is prudent to pass both tests. In the authors' view, for a trust to pass the associates test, in the context of a family business, the controller (eg the patriarch and matriarch) should be excluded from the definition of a beneficiary, which enables the controller to control the trust through trusteeship or as director of trustee company, without falling foul of the associates test.

One issue that is not clear is whether the business carried on by LLC US can affect Aus Trust's status as a trust for US tax purposes. The risk seems higher where LLC US is a disregarded entity, essentially being part of Aus Trust, so business carried on by LLC US is regarded being part of Aus Trust, thereby imbuing it with a business purpose. However, if LLC US is a partnership for US tax purposes (the partners can be related entities[56]), the risk would be considerably lower. The relevant provisions in the IRC regarding the taxation of a partnership reflects two contradictory approaches[57] – the entity approach (ie partnership is a separate entity) versus the aggregate approach – where a partnership is simply an aggregation of individuals, each of whom should be treated as the owner of a direct undivided interest in the partnerships assets and operations.[58] However, in the authors' view, the aggregate approach does not go further to alter the structural character of Aus Trust – ie to imbue it with a business purpose, just because LLC US carries on a business.

Non-grantor/complex trust

If an Australian trust is classified as a "trust" for US tax purposes, it is further desirable that the Australian trust should be considered as both a:

- "non-grantor trust"; and
- further, a "complex trust".

If the grantor trust regime was applicable, the grantor would be responsible for the tax on the income of Aus Trust, disregarding how the trust distribution is made.

This could mean that the income of Aus Trust would be taxed in the hands of the beneficiary for Australian law purposes, but in the hands of the grantor for US tax purposes. Consequently, the US tax paid by the grantor may not be claimed as a tax offset in the hands of the beneficiary who is subject to tax in Australia, as they are different taxpayers.

If Aus Trust is a simple trust (ie not a complex trust), it may expose its beneficiaries to US withholding tax, as the trust, being a simple trust, is not considered as the beneficial owner of the income (§1.1441-5(e)(3) Treas Reg).

If Aus Trust is classified as a non-grantor complex trust in the US, it will be taxed in the same fashion as an individual,[59] file its own separate income tax return and pay tax on its undistributed net income, and there will be no requirement to withhold tax from distributions made to its beneficiary (§1.441-5(e) Treas Reg). This may ensure that, subject to the important qualifications below, Aus Trust is the only entity that has an interaction with the US tax system, thereby avoiding the situation where its beneficiaries have to ascertain their US tax liabilities based on their individual circumstances.[60]

For Aus Trust to be regarded as a non-grantor trust, the deed should contain a clause ensuring that a citizen or resident of the US, or a US domestic corporation (collectively, US tax residents) are excluded from being beneficiaries. This avails the operation of §672(f) IRC, which provides that the grantor trust rules *only apply* to the extent that such an application results in an amount (if any) being currently taken into account (directly or through one or more entities) in computing the income of a US tax resident. The grantor trust rules therefore do not operate where Aus Trust does not, and cannot have any beneficiaries who are US tax residents, except in the case where §672(f)(2) IRC applies. The exception in §672(f)(2) provides that, inter alia, the grantor trust rules operate where the non-US grantor has the sole power to re-vest absolutely in the grantor title to the trust property without the approval or consent of any other person, or with the consent of a related or subordinate party who is subservient to the grantor.

A grantor includes any person to the extent that such a person either creates a trust, or directly or indirectly makes a gratuitous transfer of property to a trust. Section 1.671-2(e)(1) Treas Reg does not include a nominee settlor (such as a legal secretary often appearing as the settlor in an Australian deed). A gratuitous transfer is any transfer other than a transfer for fair market value (§1.671-2(e)(1) Treas Reg) that catches an interest-free loan at call, often used to fund a discretionary trust. In the Australian family business context, the grantor is often the patriarch or the matriarch of the family (the controller).

A power to re-vest includes a power of revocation, a power to withdraw or a power as trustee to distribute property to himself or herself. In Australia, a trust deed often bestows powers upon the trustee to distribute property (typically by the exercise of the power of appointment or advance), which would be regarded as a power to re-vest. As the controller is likely to hold an office of trust (such as trustee, director of trustee company or appointor), that person should be excluded from being a beneficiary, precluding the controller from re-vesting the trust property to himself/herself, but nevertheless being able to benefit other family members. This exclusion of controllers from being beneficiaries is the same in respect of the associates test for determining whether a trust is a business trust or not, as discussed above.

The term "complex trust" refers to a non-grantor trust other than a simple trust (§1.1441-5(b)(2)(iii) Treas Reg). A simple trust is a trust where:[61]

> "the governing instruments of which:
>
> (a) Requires that the trust distribute all of its income currently for the taxable year [ie cannot accumulate income], and
>
> (b) Does not provide that any amounts may be paid, permanently set aside, or used in the taxable year for the charitable, etc., purposes specified in section 642(c) [IRC],"

Consequently, in order for Aus Trust to be regarded as a complex trust, there should be clauses in its deed to provide for the ability to donate to a charity, and to enable the trustee to accumulate income. These are normally standard terms of a discretionary trust in Australia.

Australian trust penalty tax and the US look-through rules

In Australia, if a trust retains income for accumulation, the income will be taxed at a flat rate equal to the top marginal rate under s 99A ITAA36. This normally compels the trust to make distributions out to its beneficiaries, in order to avoid this penalty tax.

In the US, distributions made by a trust constitutes a deduction to the trust, thereby reducing its taxable income. Deductible amounts are taxed to the beneficiaries, who must treat them as having the same character as they do to the trust (§652(b) and §662(b) IRC).

Consequently, in the present case, where Aus Trust makes a distribution, the US income will be shifted to the individual beneficiaries. It can be expected that the US will trace through Aus Trust to tax the individual to ensure that the proper US tax is paid. This look-through rule is contained in §875(2) IRC, which treats an individual beneficiary as being engaged in the US trade or business conducted by Aus Trust,[62] thereby being a taxable US entity and subject to tax on the ECI of LLC US.[63]

In the US, the trust tax rate is not materially different from the individual tax rate (§1 IRC), which is progressive with a top marginal rate of 37%. Therefore, from a US tax perspective, it is preferable that the Aus Trust retains income so that it is only a taxable entity in the US.

The look-through rules contained §875(2) IRC and the Australia trust penalty tax imposed by s 99A ITAA36 pose a challenge for Aus Trust to manage trust distributions. The authors suggest that the distributions should be made along the following principles:

- where the individual beneficiaries are at a high marginal tax rate, the Aus Trust should retain profit and pay the Australian tax with US tax as an offset, which would shield the individual beneficiaries from exposure to the US tax system; and
- where the individual beneficiaries are at low marginal tax rate, the Aus Trust can consider making a distribution to the individual beneficiaries, who will file tax returns in both the US and Australia.

The complexity of the hybrid entity rules

As foreshadowed above, the key provisions in Australia that underpin the operation of this fully transparent structure are the foreign hybrid rules, under which LLC US is treated as a partnership for Australian tax purposes.

A salient feature of foreign hybrid rules is that LLC US (a US entity) is compelled to draw up tax accounts in order to ascertain the net income of Aus Trust under s 92 ITAA36. On the other hand, naturally, the US requires Aus Trust to pay US tax, based on the income of LLC US. That is, Aus Trust and LLC US are simultaneously subject to two sets of taxation rules, which, unsurprisingly, give rise to considerable, sometimes overwhelming, complexities at three levels.

Firstly, at the overall level, LLC US is required to account each and every transaction, according to both Australia and US tax rules. The two set of rules are vastly different, with considerable variance in the treatment of particular items, and the eventual tax outcomes. Prima facie, the accounts have to be drawn up in both Australian and US dollars. In this regard, it is essential for LLC US to make an election to US dollars as their functional currency under Subdiv 960-D ITAA97, in order to prevent the translating and calculating of foreign currency gains and losses on each and every transaction, which are dominated in US dollars.

Secondly, at the operational level of LLC US, in Australia, the main operating provision is Div 5 ITAA36, under which the net income and losses of the partnership are allocated to partners according to their individual interest in respect of the partnership (s 92 ITAA36). In the US, the main operative provision is subchapter K of chapter 1 of the IRC,[64] under which a partnership can cherry-pick items of the partnership's taxable income, gain, loss, deduction, and credit to be distributed (§702 IRC) to minimise the tax of a partner.

In order to curtail the freedom granted by §702 to prevent a partnership from manipulating the tax outcome through distribution, numerous rules were introduced later in subchapter K, supplemented by the Treas Reg promulgated thereunder. As a US commentator pointed out "in order to keep tax planners from wholly abusing the partnership's privileged status, while not denying them all remaining flexibility, Congress and Treasury [fashioned] a statutory and regulatory apparatus which [is] one of the most inaccessible and burdensome features of the entire tax system".[65]

Unfortunately, the complexity of US partnerships has been introduced into the Australian system through the foreign hybrid rules. The interaction of the two sets of rules could conceivably engender infinite known unknowns, and worse, unknown unknowns. We will provide only one example here.

Illustration 10 – US distribution without an Australian equivalent

Aus Trust, an Australian financier, and E, an Australian entrepreneur, form an LLC US to purchase a US business through an initial contribution of capital of $1,350 and $150, respectively. They agree that income is to be distributed to E but the amortisation be allocated to Aus Trust, together with all cash, until their capital accounts are equal; then share 50/50 of every item. For US tax purposes, in the first year, the partnership has a gross income and cash of $90, and an amortisation of goodwill of $100 for both US tax and accounting purposes. The capital account of Aus Trust is reduced from $1,350 to $1,160 by the $90 cash distribution and $100 amortisation,[66] and E's capital account is $240 (ie $150 plus $90 income).[67]

From the US perspective, the above distribution is valid for tax purposes, if the LLC agreement complies with §1.704-1(b)(2) Treas Reg "substantial economic effect". It effectively says that the allocation would be valid if it reflects in the partnership capital accounts, representing the economic claim by the partners against the partnership at liquidation of the partnership. As this illustration demonstrates, the distribution of $100 amortisation and cash erodes Aus Trust's capital account. This reduction in economic entitlement outweighs the tax benefits associated with amortisation, making it valid.

From an Australian perspective, LLC US's accounting profit is a loss of $10 and the net income is $90, as the amortisation of goodwill is deductible only in the US, not in Australia. It is not clear how to ascertain Aus Trust and E's individual interest in the $90 net income under s 92 ITAA36. It seems very complicated to examine an LLC agreement and the local laws in respect of the LLC, which could be incorporated in any of the fifty states of the US, in order to discern the individual interest of Aus Trust and E in the net income and partnership losses under s 92 ITAA36, which can be at different percentages. This exercise is probably futile, as the LLC agreement is most unlikely to have been drawn up without Australian tax concepts in mind.

Thirdly, at the partners' level, there are disparities as to how the transaction in respect of the interest in the partnership should be treated in the two countries, for example, the tax treatment of disposal of a partners' interests in the partnership.

Illustration 11

Aus Trust and E hold 50% interest in LLC US, which operates a business. Aus Trust sells its interest in LLC US at its market value for $1,000, representing 50% of the value of the following assets:

Assets	US tax cost	US profits	Aus tax cost	Aus profits	Market value
Trading stock	$120	$80	$160	$40	$200
Depreciating assets	$140	$100	$180	$60	$240
Land in US	$300	$260	$300	$260	$560
Total	**$560**	**$440**	**$640**	**$360**	**$1,000**

From the US perspective, the disposal of the partnership interest is a gain or loss from the sale or exchange of a capital asset,[68] except for the portion of the gain attributable to assets subject to §751(a), including, inter alia, trading stock, which is treated as ordinary income. Therefore, Aus Trust realises gains of $440 overall, which is divided into:

- ordinary (revenue) gains of $80, which is subject to the ordinary trust tax rate; and
- capital gains of $360, which is subject to a concessional tax rate (normally at 20%).

From the Australian perspective, LLC US[69] is deemed to realise *100%* of the profits from trading stock ($40 × = $80) and depreciating assets ($60 × = $120), assuming the roll-over relief under s 40-340(3) and s 70-100(4) are not elected to apply, which will be distributed to Aus Trust and E according to their individual interest. Aus Trust also realises capital gains on the trading stock and deprecating assets, but they are exempted under ss 118-24 and 118-25 ITAA97. Aus Trust realises capital gains on the $260 of land according to s 106-5 ITAA97, which can be discounted by 50% so that there are $130 taxable gains and $130 non-assessable gains.

The taxable revenue gains and capital gains by Aus Trust and E can be summarised in Table 2.

Some observations can be made in respect of US tax available as offsets against the Australian tax liability under Div 770 ITAA97:

- only Aus Trust can claim tax offsets; E cannot claim offsets as E does not pay any US tax;
- the amount taxable in the US is greater than the amount taxable in Australia, so Aus Trust can only claim a partial US tax offset; and
- under s 770-10,[70] only US tax paid in respect of an amount included in the assessable income of Aus Trust can be accounted to the tax offset. As the amount taxed in the US and Australia have differences in character and in quantum, it is not clear what part of the ordinary gains or capital gains in the US should be regarded as being included in the assessable income of Aus Trust. This has an impact on the quantum of US tax able to be claimed as foreign tax offsets in Australia.

Table 2. US and Australian tax consequences summary

	US		Australia	
Entity	**Revenue**	**Capital**	**Revenue**	**Capital**
E	$–	$–	$100	$–
Aus Trust	$80	$360	$100	$130

The above two illustrations are fairly basic and common scenarios. If the interaction of the two sets of rules has the tendency to collapse in such simple situations, it is probably not equipped to cope with much more complicated scenarios. Emeritus Professor Lokken said, commenting on the complexity of US partnership tax rules, "The cumulative result of all of this legislative and administrative activity is a system of such complexity that full compliance is only theoretically possible".[71] His comment is also very apposite here.

Reclassify LLC US to Sub US

The foregoing discussion has focused on a profitable enterprise at a mature stage. However, the transparent structure can be useful in situations where the Australian operation is profitable while the US is in losses. In this situation, the full transparency rules allow the US loss to be brought back to Australia to utilise against the profits in Australia, which cannot be done under archetype structure 2 – AusCo/LLC US, due to the operation of the branch exemption.

However, after having become profitable, the enterprise may wish to restructure to an archetype 3 – Aus Trust/Sub US, which can be further restructured into archetype 1 – AusCo/Sub US, through either Div 615 or Subdiv 124-M ITAA97.

From the US perspective, the exercise is simply a "check the box", by filing form 8832, so that the LLC becomes a corporation for US tax purpose, with Aus Trust converting its interest in a partnership and disregarded entity to shares in a corporation. Section 301.7701-3(g)(1) Treas Reg deems:

- where the LLC is a partnership, it contributes all of its assets and liabilities to itself as a corporation, in exchange for a share in that corporation, and immediately thereafter, the LLC, as a partnership, liquidates, by distributing the share of the corporation to its partners (ie Aus Trust and other shareholders in the LLC); and
- where the LLC is a disregarded entity, Aus Trust contributes all of the assets and liabilities of the LLC to itself, as a corporation, in exchange for shares in the LLC.

In both scenarios, there should be roll-over relief available,[72] so there is no US tax. Further, from an Australia perspective:

- s 830-85 ITAA97 resets the tax cost for assets of Sub US, which should have no practical relevance in the future, as Sub US is a US CFC, to which the Australian CFC rules do not have practical implications, as discussed above;
- the paper exercise convention should not give arise to other Australian tax implications in respect of the assets of Sub US, as is also discussed above; and
- curiously, nothing in the foreign hybrid rules (or indeed anywhere else in ITAA36 and ITAA97) provide what an Aus Trust's cost base is for the share (actual or deemed) in Sub US that it is now treated as a holding,[73] after the disappearance of its partnership interest.

After reclassification, Sub US, being fiscally opaque, is no longer subject to Australian tax – only being taxed as a US corporation at a favourable rate. Further, the shares in Sub US are no longer subject to US tax, unlike on the disposal of an interest in LLC US, either as a partnership or disregarded entity – a portion of gains, referable to assets used in producing ECI, are taxable in the US.[74]

The favourable US treatment of the shares in Sub US, after reclassification, gave rise to concerns about whether the non-recognition provisions such as §351 IRC could apply to the reclassification of an LLC from a partnership/disregarded entity to a corporation. This issue has been resolved by the later published §1.864(c)(8)-1(b)(2)(ii) Treas Reg, which provides a positive answer.

The discussion here is largely applicable to the reclassification of LLC US into Sub US under archetype 2, to avoid BPT and BIT implication.

In summary, while this archetype structure is very desirable for an enterprise generating considerable cash profits to be distributed to its individual beneficiaries, it has to be traded off against the considerable complexity of its operation. Further, this structure may be useful for an enterprise to equalise Australian profits with US losses, which could then be converted to another archetype structure comprising a fiscally opaque entity in the US, after it has turned a profit.

Conclusion

After having surveyed popular business structures in the US and Australia, this article has identified four archetype structures often adopted to conduct business in both the US and Australia, which serve as anchors to discuss the various US and Australian tax issues pertinent to them. This article also put forward an effective tax rate model, which can be used or further developed to quantify the tax implications of the issues discussed. The authors wish that the principles derived from the discussion herein and the model can serve as a platform for readers to explore deeper and more complicated US and Australian tax issues emerging from the operation of a business in both countries.

Buck Xiao, CTA
Director
Hall Chadwick Melbourne

Anna Bullimore
Senior Analyst
Hall Chadwick Melbourne

References

1 Australian Treasury issued the consultation paper *Global agreement on corporate taxation: Addressing the tax challenges arising from the digitalisation of the economy* (consultation paper) in October 2022, and the consultation process has been completed.
2 See consultation paper, p 10.
3 Unless otherwise specified, "income" is used as a generic term that encompasses profits, gains and losses, as the particular context dictates.
4 G Yin, "The future taxation of private business firms", (1999) 4 *Fla. Tax Rev.* 141 at 149.
5 R Mann, "Subchapter S: Vive le difference!", (2014) 18 *Chap. L. Rev.* 65 at Introduction.
6 Quoted by A Hamilton, "S Corporations 'Most Popular Choice of Entity,' IRS Finds", (2000) 88 *Tax Notes* 157 at 157.
7 As typical Australian practice, there will often be trusts interposed between the archetype structures and the individual beneficiaries. This should not affect the analysis herein.
8 Of course, this is purely an illustration, as the background of Macquarie Bank and the pattern of its dividends are suitable for this purpose.
9 Pt X ITAA36.
10 Para 4.2 of the EM to the Participation Exemption Act.
11 Para 4.7 of the EM to the Participation Exemption Act.
12 Reg 19 of the *Income Tax Assessment (1936 Act) Regulation 2015* (Cth).
13 Reg 17 of the *Income Tax Assessment (1936 Act) Regulation 2015.*
14 In fact, it goes further – the CFC rules do not apply to most passive investment income in the case of US entities.
15 Paras 2.101 and 2.103 of the EM to the Participation Exemption Act.
16 *Tax and Superannuation Laws Amendment (2014 Measures No. 4) Act 2014* (Cth).
17 Ss 768-10 and 960-120 ITAA97– see the EM to the *Tax and Superannuation Laws Amendment (2014 Measures No. 4) Act 2014*, ch 2 – Foreign dividends.
18 §881(a)(1) and §1442 IRC.
19 B Bittker and J Eustice (online), *Federal income taxation of corporations and shareholders*, Thomson Reuters/Tax and Accounting, para 8.04[2].
20 Ibid at para 8.02.
21 R Doernberg and M Herzfeld, *International taxation in a nutshell*, 11th edition, West Academic, 2018, p 103.
22 Ibid.
23 It seems that the redemption could be regarded as a buyback under s 159GZZZP ITAA36. Whether the dividend is under s 6(1) or s 159GZZZP is not material for this illustration.
24 J Kuntz and R Peroni (online), *US international taxation*, Thomson Reuters/Tax and Accounting, para C3.12[3].
25 Available at www.ecfr.gov/current/title-26/chapter-I/subchapter-A/part-1?toc=1.
26 R Goulder, "Taking the fun out of FDII", (2022) 106 *Tax Notes International.*
27 R Mann, "Subchapter S: Vive le difference!", (2014) 18 *Chap. L. Rev.* 65 at 67.
28 [2016] FCAFC 86 at [164].
29 OECD, *United States: transfer pricing country profile*, lasted update: 9 June 2022. Available at www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-united-states.pdf. Accessed 12 September 2022.
30 OECD, *Australia: transfer pricing country profile*, lasted update: 9 June 2022. Available at www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-australia.pdf. Accessed 12 September 2022.
31 Branch profits tax does not apply to a publicly traded company, a subsidiary of a publicly traded company or a company granted treaty benefits by the competent authorities (art 10(8) of the Aus/US treaty).
32 See HR Conf. Rep. No. 841, 99th Cong., 2d Sess. 646–650 (1986); Staff of Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1986 (JCS-10-87) at 1035–1047 (May 4, 1987).
33 §1.884-2T Treas Reg.
34 Notice 89-80 (IRS NOT), 1989-30 I.R.B. 10, 1989-2 C.B. 394, 1989 WL 587553, Internal Revenue Service (I.R.S.), *Branch tax: branch-level interest tax; effect of treaty provisions on the tax on excess interest; qualified residents.*
35 For illustration purposes, §1.884-4(b)(5) is ignored. This section converts excess interest into branch interest if US assets constitute 80% of AusCo's assets.
36 §1.882-5(a)(3) Treas Reg.
37 Para 62 of TD 2017/22.
38 R Kuntz and J Peroni (online), *US international taxation*, Thomson Reuters/Tax and Accounting, para C3.04[2].
39 §537(a)(1) IRC.

40 R Kuntz and J Peroni (online), *US international taxation*, Thomson Reuters/Tax and Accounting, para C3.04[3][a].

41 *Gartside v Inland Revenue Commissioners* [1967] UKHL 6.

42 For example, s 165-207 ITAA97 enables a discretionary trust to make an election to be treated as a single notional person for the continuity of ownership test, for the purpose of utilising a loss in a company in which the said discretionary trust owns shares.

43 [2010] HCA 10.

44 [2012] FCAFC 84.

45 Decision impact statement, *Greenhatch v Commissioner of Taxation of the Commonwealth of Australia*, ATO.

46 D Rosenbloom, "The David R. Tillinghast Lecture: International Tax Arbitrage And The International Tax System", (2000) 53 *Tax Law Review* 137.

47 J Kuntz and R Peroni, *U.S. International Taxation* (online), Thomson Reuters/Tax and Accounting, 2022, para C3.11[3].

48 ID 2010/210, in which the Commissioner has accepted that CGT event A1 does not happen in respect of partnership assets when a partnership becomes a limited partnership and therefore a deemed company under Div 5A ITAA36.

49 S 770-130(1) ITAA97 and s 6B ITAA36.

50 S 770-75 ITAA97.

51 E Cauble, "Was Blackstone's initial public offering too good to be true? A case study in closing loopholes in the partnership tax allocation rules" (2013) 14 *Fla. Tax Rev.* 153, section I.

52 Ibid.

53 The Aus Trust is a discretionary trust as assumed in this article. In the case of an Australian unit trust, an expedient avenue to achieve that purpose is for the Australian unit trust to be classified as "investment trust" under §301.7701-4(c) Treas Reg. An investment trust is one that is established to facilitate an investment that could have been done directly by the investors.

54 *A A Lewis & Co v Commissioner* 301 US 385 (1937), *Wyman Building Trust v Commissioner 45 B.T.A. 155* (1941).

55 C Bishop (2003), "Trusts, taxes and business: dealing with 'check-the-box' regulations", (2003) 13 Business *Law Today* 23 at 4.

56 M McMahon, Jr. (2012) "Now you see it, now you don't: the comings and goings of disregarded entities", 65(2) *The Tax Lawyer* 259 at para II.A.

57 *Grecian Magnesite Mining, Industrial & Shipping Co.* 149 T.C. No. 3 (2017), p 9.

58 W McKee, R Nelson and W Whitmire (online), *Federal taxation of partnerships and partners*, Thomson Reuters/Tax and Accounting, para 1.02.

59 §641(b) IRC.

60 This consideration becomes important where a large investment unit trust with numerous unit holders.

61 §1.651(a)-1 Treas Reg.

62 See Revenue Ruling 85-60, 1985-1 CB 187 (US) where, under §875(1) and §875(2), a non-resident alien, who was beneficiary of foreign trust (from US perspective) that was partner of US domestic partnership, was deemed engaged in the partnership's US trade or business.

63 B Bittke and L Lokken (online), *Federal taxation of income, estates and gifts*, Thomson Reuters/Tax and Accounting, para 67.6.2.

64 Subchapter K becomes applicable if the LLC has more than one shareholder.

65 See CJ Berger, "W(h)ither partnership taxation?" (1991) 47 *Tax L. Rev.* 105 at 108.

66 §705(a)(2) IRC.

67 §705(a)(1) IRC.

68 §741 and §864(c)(8) IRC; §1.864(c)(8)-1 Treas Reg; §897(g) IRC; §1.897-7 Treas Reg.

69 PBR 1012595772097 – issue 1, question 2; and issue 2, question 6.

70 *Burton v FCT* [2019] FCAFC 141.

71 L Lokken, "Taxation of private business firms: imagining a future without subchapter K", (1999) 4 *Florida Tax Review* 249 at 252.

72 Revenue Ruling 84-111: Transfers; controlled corporations; partnership interests for stock; M McMahon, Jr. (2012) "Now you see it, now you don't: the comings and goings of disregarded entities", 65(2) *The Tax Lawyer* 259 at para II.C.1.

73 A Hirst and J Pinson (2011), "Foreign hybrids – where are we now?", New South Wales Division, The Tax Institute.

74 §864(c)(8) IRC.

Appendix 1

Effective tax rate of US profits

Assumptions related to US service fees

US profit	$100.00	US trust tax rate	37.00%
US corporate tax rate	21.00%	Australian company tax rate	30.00%
Withholding tax rate/branch profits tax rate	5.00%	Australian individual beneficiary tax rate	47.00%
Withholding tax rate – trust	15.00%		

	Archetype 1	Archetype 2	Archetype 3	Archetype 4
	AusCo/Sub US	**AusCo/LLC US**	**Aus Trust/Sub US**	**Aus Trust/LLC US**
US profits	**100.00**	**100.00**	**100.00**	**100.00**
US corporate tax	(21.00)	(21.00)	(21.00)	
US withholding tax/branch profits tax	(3.95)	(3.95)	(11.85)	(37.00)
Overall tax paid in the US	(24.95)	(24.95)	(32.85)	(37.00)
Net profit after US tax	**75.05**	**75.05**	**67.15**	**63.00**
	(Tax deferral point)		**(Tax deferral point)**	
Net profits repatriated to AusCo or Aus Trust	**75.05**	**75.05**	**67.15**	**63.00**
US tax offsets				
Australian taxable income				
Prima facie Australian tax				
US tax offsets				
Australian tax				
Net profit distributed	**75.05**	**75.05**	**67.15**	**63.00**

	Archetype 1	Archetype 2	Archetype 3	Archetype 4
	AusCo/Sub US	AusCo/LLC US	Aus Trust/Sub US	Aus Trust/LLC US
	(Tax deferral point)	(Tax deferral point)		
Profits distributed	75.05	75.05	67.15	63.00
US tax offsets			11.85	37.00
Total assessable income	75.05	75.05	79.00	100.00
Prima facie Australian tax	(35.27)	(35.27)	(37.13)	(47.00)
Tax credits			11.85	37.00
Tax payable by ultimate beneficiaries	**(35.27)**	**(35.27)**	**(25.28)**	**(10.00)**
Reconciliation				
Net profits received by individual beneficiaries	39.78	39.78	41.87	53.00
Overall US tax paid	24.95	24.95	32.85	37.00
Overall taxes paid in Australia	35.27	35.27	25.28	10.00
Reconcile back to profits before US and Australian taxes	100.00	100.00	100.00	100.00
Overall tax rate	**60.22%**	**60.22%**	**58.13%**	**47.00%**

Note:

This model is designed to also deal with more comprehensive and complicated scenarios.

The empty cells may become relevant in those scenarios. For example, if the Australian CFC rules become applicable, the branch exemption does not apply, due to the presence of Australian source income and the Aus Trust has to retain income, thereby being taxed, etc.