IT 2680 - Income tax: withholding tax liability of non-resident beneficiaries of Australian trusts

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Australian Taxation Office

Taxation Ruling
Income tax: withholding tax liability of non-resident beneficiaries of Australian trusts

other Rulings on this topic

IT 319 IT 328 IT 329

IT 2344 IT 2466

IT 2622 CITCM 858

Income Tax Rulings do not have the force of law. Each decision made by the Australian Taxation Office is made on the merits of each individual case having regard to any relevant Ruling.

contents para

What this Ruling is about 1
Ruling 5
Date of effect 13
Explanations 15
Withholding tax on trust distributions 15
Present entitlement to trust income 21
Trusts with no net income or with losses for income tax purposes 25
Unit trust distributions 27
Obligation to deduct withholding tax 30
Trust income not subject to withholding tax 31
Examples 33

What this Ruling is about

1. Persons who are not residents of Australia for income tax purposes, broadly speaking, are subject to withholding tax on the dividend and interest income they derive from Australia (Division 11A of Part III of the *Income Tax Assessment Act 1936*). Withholding tax, which is deducted at the time a payment is made to a non-resident, represents the non-resident's final liability to Australian income tax.

2. Subsection 128A(3) treats a non-resident beneficiary who is presently entitled to a dividend or to interest included in the income of a trust estate as deriving the dividend or interest when the present entitlement arises.

3. This Ruling considers:

(a) whether a trustee, or any other person liable to pay money to a non-resident, is obliged to deduct withholding tax when trust income, which includes a dividend or interest, is derived by a non-resident beneficiary of an Australian trust estate and the beneficiary is thereby liable to pay the withholding tax; and

(b) whether subsection 128A(3) applies to deem a non-resident beneficiary to have derived dividend or interest income even if the trust estate had no net income, or had incurred a loss, for income tax purposes, in the year of income concerned.

4. The Ruling applies to amounts distributed to non-resident beneficiaries of Australian trust estates, including non-resident unitholders in Australian unit trusts (other than public unit trusts which are taxed as companies under Division 6B or 6C of Part III). It does not apply to income of a beneficiary exempted from withholding tax under subsection 128B(3).

Ruling

5. A non-resident beneficiary is liable for withholding tax when the beneficiary derives a dividend or interest included in the income of an Australian trust estate. The time at which the beneficiary derives the dividend or interest income is when the beneficiary becomes presently entitled to it. The terms of a trust may dictate that a beneficiary becomes presently entitled to certain income before the end of an income year.

6. Present entitlement to a share of the income of a trust estate can be conferred on a beneficiary even though the trustee does not actually distribute the relevant income to the beneficiary (for example, if distribution is delayed until a minor comes of age and in the meantime a trustee accumulates trust income to which the minor is presently entitled, and see also Taxation Rulings IT 328 and IT 329).

7. Subsection 128A(3) applies (and, as a result, the beneficiary is liable for withholding tax) even if the trust estate has no net income or has incurred a loss, for income tax purposes, for the year of income.

8. A trustee, or any other person who is liable to pay money to a non-resident, who is paid dividend or interest income to which the non-resident is presently entitled is obliged by section 221YL or sections 128C, 254 and 255 to deduct withholding tax and pay the tax to the Commissioner.

9. Withholding tax must be deducted forthwith, and paid to the Commissioner within 21 days after the end of the month in which the income was derived or, in special circumstances, such further period as the Commissioner allows.

10. The basis on which withholding tax payable by a non-resident beneficiary is calculated is determined by the present entitlement of the beneficiary to income of the trust estate. The income to which a beneficiary is presently entitled is in turn determined by the terms of the trust.

11. Under a fixed trust, a presently entitled beneficiary generally has a right to demand payment of a share of distributable, as distinct from gross, income of the trust (*FC of T v. Totledge Pty Ltd* (1982) 40 ALR 385 at 395; 82 ATC 4168 at 4175; (1982) 12 ATR 830 at 838-9). Distributable income consists of the gross income reduced by the expenses of the trust. Under a discretionary trust, a beneficiary's entitlement results from the trustee's exercise of a discretion to distribute some or all of the distributable income of the trust (section 101).

12. In the case of a bare trust, the distinction between gross income and distributable income is removed. Although a non-resident beneficiary may be liable for commission or other expenses in connection with trust income, these are not expenses of the trust and therefore are not taken into account in calculating the withholding tax liability.

Date of effect

13. This Ruling sets out the current practice of the Australian Taxation Office (ATO).

14. It applies (subject to any limitations imposed by statute) for years of income commencing both before and after the date on which it is issued, except if a contrary opinion has previously been given in writing by the ATO either to the trustee or manager of the trust or to a beneficiary. In this event, the Ruling applies to distributions from the relevant trust estate made after 12 December 1991, and the advance opinion or private ruling which differs from this Ruling is withdrawn from that date.

Explanations

Withholding tax on trust distributions

15. Broadly speaking, withholding tax is imposed on:

(a) dividends (except to the extent they are franked - paragraph 128B(3)(ga)) paid by an Australian resident company (subsections 128B(1) and (4)); and

(b) interest derived by a non-resident to the extent that the interest has an Australian source (subsections 128B(2) and (5) to (9)).

16. By subsection 128A(3), a non-resident beneficiary who is presently entitled to a dividend or to interest included in the income of a trust estate is deemed to have derived the dividend or interest when the beneficiary became presently entitled to that income.

17. It is implicit in the wording of subsection 128A(3) that dividend income and interest income derived by a trustee of a trust estate retain their character as income of those types when a beneficiary becomes presently entitled to a share of the income of the trust estate.

18. If the trust deed allows, a trustee may distribute income by type to particular beneficiaries. The trustee may, for example, choose to distribute interest income derived by a trust estate to a particular non-resident beneficiary if the accounts of the trust estate separately identify and segregate the income to enable this.

19. If:

- the trust deed is silent about distributing income by type to particular beneficiaries; or
- different types of trust income are pooled and are not separately accounted for,

as a general rule, a share of each type of income distributed should be allocated ratably to each beneficiary.

20. If it can be shown that an amount of trust income of a particular type (e.g., dividends) distributed to a beneficiary was actually paid to the beneficiary before a different class of trust income (e.g., interest) was derived by the trustee, a ratable allocation is not necessary. The type of income actually distributed to the beneficiary (i.e., dividend) retains the same character it had when it was derived by the trustee. This is so even if the trust deed is silent about distributing income by type to particular beneficiaries.

Present entitlement to trust income

21. The meaning of the expression 'presently entitled' in subsection 128A(3) is not defined in the statute but its meaning is well settled by decisions of the courts.

22. A beneficiary of a trust becomes presently entitled to income from the trust if all of the following requirements are met:

- the relevant income is legally available for distribution; and
- the beneficiary has an absolutely vested beneficial interest in possession in the whole of the relevant income; and
- the beneficiary would succeed in an action to recover the income from the trustees ignoring for this point the existence of any legal disability from giving a valid discharge to the trustees (e.g., by being a minor).

(See the High Court of Australia decision in *Taylor v. FC of T* (1970) 110 CLR 444 at 452; 70 ATC 4026 at 4030; (1970) 1 ATR 582 at 586. Taxation Ruling IT 319 further explains the concept of present entitlement. Taxation Ruling IT 2622 provides guidelines on the present entitlement of beneficiaries to income from a deceased estate.)

23. The conclusion that a beneficiary is presently entitled to a share of the income of a trust estate if, but only if:

(a) the beneficiary has an interest in the income which is both vested in interest and vested in possession; and

(b) the beneficiary has a present legal right to demand and receive payment of the income, whether or not the precise entitlement can be ascertained before the end of the relevant year of income and whether or not the trustee has the funds available for immediate payment

was agreed to by the parties before the Full High Court in *Harmer v. FC of T* 91 ATC 5000 at 5004; (1991) 22 ATR 726 at 729, 730.

24. The requirement of present entitlement to a share of the income of the trust estate refers to a present vested right to demand and receive payment of the whole or part of what has been received by the trustee as income and, retaining that character in the trustee's hands, is legally available to be distributed to those entitled to it as beneficiaries under the trusts. (See the Full Court of the Federal Court of Australia decision in *FC of T v. Totledge Pty Ltd* (1982) 40 ALR 385 at 394; 82 ATC 4168 at 4175; (1982) 12 ATR 830 at 838.)

Trusts with no net income or with losses for income tax purposes

25. Under the general trust provisions in the income tax law, a beneficiary's or trustee's assessable income includes the beneficiary's 'share of the net income of the trust estate' (sections 97 and 98). Subsection 128A(3), on the other hand, deems a beneficiary to derive a dividend or interest when the beneficiary becomes presently entitled to the income, without any regard to whether the trust estate has a net income for income tax purposes.

26 A trust estate may have income available for distribution even though it has no net income, or has incurred a loss, for income tax purposes. This is because differences arise in calculating net income for income tax purposes and calculating income distributable under trust law.

Unit trust distributions

27. Unitholders in a unit trust generally have a beneficial interest in the entirety of trust property which is managed on their behalf by the trustee and manager in accordance with the terms of the trust deed (*Smith v. Anderson* (1880) 15 Ch D 247). The nature of their beneficial interests, including their entitlement to trust income, is also determined by the terms of the trust deed.

28. Trust deeds governing public unit trusts generally provide for the periodic distribution of income, e.g. quarterly or half-yearly.

Income distributable to unitholders is calculated after charging expenses against trust income derived in the relevant period. Unitholders generally become presently entitled to the distributable income at the end of the relevant period even though actual payment is made several days or weeks later.

29. Although a non-resident unitholder becomes liable to pay withholding tax from the time of present entitlement, the obligation on the trustee, or trust manager, to deduct withholding tax arises at the time the distribution payment is made (section 221YL), or is deemed to have been made, for example, when income is reinvested (paragraph 221YK(3)(a)).

Obligation to deduct withholding tax

30. A trustee in Australia is obliged to deduct withholding tax from interest or unfranked dividend income derived by a non-resident beneficiary if the beneficiary is recorded as having an address outside Australia. Withholding tax must be deducted at, or before, the time the income is paid, credited, accumulated or otherwise dealt with on behalf of, or as directed by , the non-resident. The tax must be paid to the Commissioner within 21 days from the end of the month in which the tax is deducted. A person in Australia, e.g., a person acting in a fiduciary capacity, who receives interest or dividend income on behalf of a non-resident must deduct withholding tax at the time the income is received.

Trust income not subject to withholding tax

31. Trust income which includes interest or unfranked dividend income is not subject to withholding tax if there is no beneficiary presently entitled to that income. In this case, the trustee is subject to tax on the net trust income (sections 99, 99A). There is no withholding tax liability if that income is later distributed to non-resident beneficiaries (para.128B(3)(d)).

32. Taxation Rulings IT 2344 and IT 2466 deal with trust tax avoidance schemes with non-resident beneficiaries. Under the schemes, purported distributions are made to non-resident beneficiaries who, if they exist, are never intended to receive the benefit of the purported distributions. These Rulings provide guidelines for determining how the relevant trust income is assessed to tax. In these scheme cases, it is necessary to refund or credit the amount of any withholding tax paid on interest under the scheme if it is established that no liability for the withholding tax existed.

Examples

33. The following examples illustrate the way in which the principles explained above are applied. It must, however, be recognised that the entitlement of beneficiaries to trust income and the powers and duties of trustees depend on the terms of the particular trust concerned. Withholding tax liability is determined accordingly.

Example 1

34. The facts relevant to this example are as follows:

- XYZ Property Trust is an Australian unit trust with 5000 units issued.
- A non-resident unitholder, Phoren N. Vesta, holds 250 units in the trust, i.e., 5% of the total issued units.
- Distributions of income, calculated according to trust law, are made to unitholders at six month intervals.
- For the six month period ended 30 June 1991, there was total distributable income of $100 000, which consisted of $60 000 of net rental income (i.e., 60% of the total) and interest income of $40 000 (i.e., 40% of the total).
- For the year ended 30 June 1991, the trust estate incurred a loss for income tax purposes.
- Under the trust deed, Phoren N. Vesta is presently entitled to $5000, being her 5% share of the distributable income of the trust estate for the relevant period.

35. Phoren N. Vesta's withholding tax liability for the $5000 distribution paid to her on 31 August 1991 is $200 . This is calculated by applying the interest withholding tax rate (10%) to the interest income proportionally included in the distribution (i.e. 40% of $5000).

36. The trustee (or trust manager) is obliged to deduct $200 before making the payment to Phoren N. Vesta, and to remit the deducted amount to the ATO by 21 September 1991.

37. The part of the distribution that represents rental income (i.e. 60% of $5000) does not attract Australian income tax. This is because there was no net trust income (for income tax purposes) subject to distribution, and because rental income is not subject to withholding tax.

Example 2

38. The facts relevant to this example are as follows:

- Georgian Estates Trust is an Australian unit trust with 10 000 units issued.
- Distributions of income, calculated according to trust law, are made to unitholders at six month intervals.
- The trust deed provides that unitholders are entitled at the end of each income accrual period to share, in proportion to their respective unitholdings at that time, the net income of the trust ascertained in accordance with subsection 95(1) of the *Income Tax Assessment Act 1936*.
- The trust deed also provides the trustee with a discretion to distribute such additional amount as does not exceed the amount held in distributable reserves at the end of the income accrual period.
- Phoren N. Vesta also holds 500 units in this trust.
- For the six month period ended 31 December 1990 net income was calculated as follows:

	NET RENTAL $	INTEREST $	TOTAL $
for income tax purposes	(20 000)	30 000	10 000
for trust accounting purposes	20 000	30 000	50 000

The trustee exercised the discretion to transfer $10 000 to the distribution account. This increased the amount to be distributed on 31 January 1991 to $20 000, and resulted in $10 000 being appropriated to the Accumulated Rental Income Reserve.

- For the six month period ended 30 June 1991 net income was calculated as follows:

	NET RENTAL $	INTEREST $	TOTAL $
for income tax purposes	(20 000)	5 000	(15 000)
for trust accounting purposes	(10 000)	5 000	(5 000)

The trustee exercised the discretion to transfer $10 000 to the distribution account. This resulted in a distribution of $5 000 on 31 August 1991.

39. Although the Georgian Estates Trust incurred a net loss for income tax purposes for the year ended 30 June 1991, this fact does not affect the withholding tax liability of non-resident unitholders.

40. Phoren N. Vesta's share of the amounts distributed consists of $1000 (for the period ended 31 December 1990) and $250 (for the period ended 30 June 1991). In each case, the distribution consisted entirely of interest income.

41. Phoren N. Vesta's withholding tax liability in respect of these distributions is therefore as follows:

31 January 1991 distribution	10% of $1000	=	$100
31 August 1991 distribution	10% of $250	=	$25.

42. The trustee (or trust manager) is obliged to deduct the withholding tax before making the payments to Phoren N. Vesta, and to remit the deducted amounts to the ATO by 21 February 1991 and 21 September 1991 respectively.

Example 3

43. The facts relevant to this example are as follows:

- Ziggurat Buildings & Mortgages Trust is an Australian unit trust with 100 000 units issued.
- Distributions of income, calculated according to trust law, are made to unitholders annually.
- Phoren N. Vesta also holds 5 000 units in this trust.
- For the year ended 30 June 1991 the following income was derived and deductions incurred:

	RENTAL $	INTEREST $	TOTAL $
Gross income	250 000	100 000	350 000
Interest expense[1]	100 000	-	100 000
Borrowing expenses[2]	20 000	-	20 000
Administrative expenses[3]	50 000	20 000	70 000
Trustee expenses[4]	4 000	2 000	6 000
Legal expenses[5]	16 000	16 000	32 000
Net accounting income	60 000	62 000	122 000
Div. 10D allowance	80 000		80 000
Net income [subs.95(1)]	(20 000)	62 000	42 000

Notes

1 Interest expense was incurred in relation to a borrowing arrangement which financed the acquisition of the rental property.

2 Borrowing expenses also were directly incurred in financing the acquisition of the rental property.

3 The cost of reimbursement of administrative expenses incurred by the manager of the trust has been allocated between rental and interest income in proportion to the gross amount of each type of income.

4 Trustee's fees are charged according to the value of assets under management. They have been allocated between rental and interest income in proportion to the value of the assets from which each type of income was derived.

5 Legal expenses were incurred in relation to an advertising campaign. The expenses are allocated in proportion to the net amount of each type of income. (The error due to rounding is not material in this case.)

44. Phoren N. Vesta's share of the amount distributed in respect of income for the year ended 30 June 1991 totals $6 100. It consists of $3000 rental income and $3100 interest income.

45. Phoren N. Vesta's withholding tax liability in respect of the distribution is $310 . This is calculated by applying the interest withholding tax rate (10%) to the interest income proportionally included in the distribution.

46. The part of the distribution that represents rental income does not attract Australian income tax. This is because the beneficiary's share of net trust income (for income tax purposes) consists entirely of income subject to withholding tax and is therefore excluded from assessable income (section 128D).

Example 4

47. Investment Trust Limited ["ITL"] conducts an investment management service on behalf of non-resident clients. Phoren N. Vesta, who is a resident of a country with which Australia has concluded a comprehensive agreement for the avoidance of double taxation, is one of those clients.

48. In accordance with the investment management agreement ITL is registered as the holder of each investment, as nominee for its non-resident client. The client is, therefore, absolutely entitled to the income derived from the investments. Income from the investments is placed in an investment account operated by ITL on behalf of the client. The agreement also provides for the retention by ITL from the investment account of amounts by way of commission and transaction charges. These are debited to the account at the end of each month.

49. During the year ended 30 June 1992 investments held by ITL on behalf of Phoren N. Vesta produced the following income:

(i)	17 July 1991	Partly franked (60%) dividend	$4000
(ii)	30 Sept.1991	Fully franked dividend	$3500
(iii)	1 Mar. 1992	Gain on disposal of discounted security	$7000

50. Phoren N. Vesta's liability to withholding tax is calculated as follows:

(i) Dividend withholding tax on the unfranked component.
15% (i.e., the treaty rate) of 40% of $4000 = $240

(ii) Fully franked dividend income is exempt from withholding tax (paragraph 128B(3)(ga))

(iii) Interest withholding tax rate on the gain.
10% of $7000 = $700.

51. In relation to the partly franked dividend, ITL was obliged to deduct the $240 on receipt of the dividend (subsection 221YL(2)) and to pay that amount to the ATO by 21 August 1991 (subsection 221YN(1)).

52. In relation to the gain on the disposal of the discounted security (which was not a qualifying security as defined by subsection 159GP(1)), ITL was obliged to deduct the $700 on receipt of the proceeds and to pay that amount to the ATO by 21 April 1992.

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- ITAA 221YK(3); ITAA 221YL;
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case references
- Harmer v. FC of T (1991) 22 ATR 726; 91 ATC 5000
- Smith v. Anderson (1880) 15 Ch D 247
- Taylor v. FC of T (1970) 110 CLR 444; 70 ATC 4026; (1970) 1 ATR 582
- FC of T v. Totledge Pty Ltd (1982) 40 ALR 385; 82 ATC 4168; (1982) 12 ATR 830