Australia: Liechtenstein Foundations on the Radar

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As the United States and European countries try to repatriate undisclosed offshore accounts, the Australian Taxation Office (ATO) is also fighting against international tax evasion, avoidance and crime. Recently, Liechtenstein foundations and people who promote them have become the subject of Project Wickenby investigations. Through Project Wickenby, implemented in 2006, the ATO has commenced almost 2,800 tax audits, resulting in about 900 investigations still in progress (as at February 2011). The scorecard of Project Wickenby is remarkable: more than AU$1 billion in tax liabilities has been raised and 62 people have been charged with tax evasion or other tax crimes. At issue is how a Liechtenstein foundation is characterised from an Australian law perspective.

Unlike a trust, a Liechtenstein foundation is a legal entity with its own legal personality and administered by a foundation board. The founder of the foundation transfers assets to the foundation as property which shall be used according to the foundation's purpose. The purpose and the classes of beneficiaries are determined by the founder. Once the foundation exists as an entity, it is essentially no longer subject to the outside control of the founder but rather is controlled by the board.

In order to avoid assets of Liechtenstein foundations becoming subject to Australian taxation, foundation by-laws include clauses which exclude from beneficiary status beneficiaries who are Australian tax residents. In other words, the beneficiaries must leave Australia to benefit from the foundation's assets.

A central matter is the Australian tax law characterization of the Liechtenstein foundations. Such entities are not known to the law of Australia. The Australian entity they most closely resemble is the trust, because, despite their separate legal personality, the relationship between the foundation board and the beneficiaries appears similar to a fiduciary relationship, and its subject matter is property. The New South Wales Supreme Court has confirmed that a Liechtenstein foundation is similar to a trust under Australian law. However, this decision does not bind the Federal Court of Australia (the usual court for tax disputes), so the position is still uncertain.

The term "trust" is also not defined in the Australian income tax legislation; there is therefore some flexibility in its interpretation. The Commissioner of Taxation would likely argue that "trust" includes Liechtenstein foundations. For example, in an Australian Taxation Office publication "Taxpayer Alert TA 2008/2", the Commissioner of Taxation expresses the view that Australian trust taxation rules may apply to Liechtenstein foundations. However, it is also open to the Commissioner to argue that a foundation is a company for Australian tax purposes and he will probably do so, if it suits his position.

Under the Australian foreign investment fund (FIF) rules (which are shortly to be replaced by a new regime entitled the foreign accumulation fund, or FAF, rules), a FIF is defined to include a foreign trust (except a trust established under a will or similar arrangement in relation to a deceased person). For FIF attribution to take place, a beneficiary must have a "FIF interest", which is, relevantly, an interest in the corpus or income of the foreign trust. The mere object of a discretionary trust, for example, does not have an interest in the trust capital (corpus) or income.

The income of the FIF is attributed to an Australian resident who has a FIF interest. The FIF attribution rules are complex, but their broad effect is that:

- the income earned by the FIF each year, if any, is calculated by one of three methods (one, comparing the market value of the interest at the end of the year to that at the start of the year; two, imposing a deemed rate of return; three, calculation of actual income of the FIF as if it were an Australian taxpayer); and
- this income is then "attributed" to the Australian residents in proportion to their respective interests in the FIF. It is included in the relevant Australian resident's assessable income and should be declared in the Australian resident's tax return.

The Australian taxation system also contains onerous penalty provisions, which can be as high as 90% of the tax shortfall, if the taxpayer is found to have intentionally disregarded the tax laws and then obstructed the Commissioner from uncovering the shortfall. In addition, the interest rate on the unpaid shortfall is the cash rate plus 7%, which compounds and is imposed daily.

Besides the taxation of distributions from a Liechtenstein foundation to an Australian resident, there is also a risk that a Liechtenstein foundation will be characterised as a FIF and that the income earned, but not distributed, by the FIF will be attributed to the Australian taxpayer. Given the law is not settled as to the character of a foundation, the Commissioner is able to review each case separately and decide, whether it assists his case to characterise the foundation as a trust or a company. Therefore, Australian residents who have an interest in a Liechtenstein foundation without having declared it in their tax returns, are well advised to reconsider their tax structures and to consult an experienced internationally acting law firm before the Wickenby task force has started its audit or investigation.

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