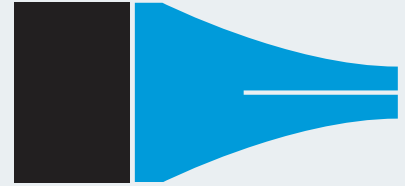


CGT issues when creating and dealing with UPEs

by Sam Campbell, ATI, Sladen Legal



The creation and dealing with UPEs by trusts raises many tax issues, including CGT issues, which should always be carefully considered before embarking on a proposed transaction.

Introduction

Until recently, unpaid present entitlements (UPEs) have been a rarely considered aspect of trusts, especially in relation to tax considerations post their creation. However, in the last few years, the position of the Australian Taxation Office (ATO) on the application of Div 7A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) to UPEs to corporate beneficiaries¹ has brought UPEs into focus. In more recent times, the ATO has released draft determinations, a determination and a ruling on the interaction of UPEs with a number of tax provisions, including the bad debt rules and the small business tax concessions.²

In addition to the issues raised by the ATO, there are a number of other tax matters concerning UPEs. In particular, capital gains tax (CGT) must be considered when creating and dealing with UPEs. As will be seen in this article, the CGT consequences of dealing with UPEs can be a vexed issue and, as such, any dealings with UPEs should only occur after a careful consideration of any intended tax consequences of the proposed transaction.

Creation of UPEs

A UPE is created on the trustee of a trust making a determination, pursuant to the terms of the relevant trust deed, to appoint (distribute) income or capital to a beneficiary of the trust. Most usually on the creation of a UPE, the beneficiary in whose favour it has been created will have an immediate right to call on the trustee of the trust, in which the UPE then exists, to pay the UPE in part or in full.

A UPE, being a right held by a beneficiary of a trust to call for immediate payment of a specific amount, will be enforceable in equity and is proprietary in nature. Accordingly, a UPE is a CGT asset.³

When a beneficiary becomes presently entitled to a share of income of a trust estate, a UPE comes into existence, at which point CGT event D1 occurs.⁴

Payment of UPEs

Most commonly, a UPE is satisfied or discharged by payment by the trustee. The satisfaction or discharge of a UPE by payment will trigger CGT event C2. For CGT event C2 to occur, all that is necessary is that the ownership of the asset by the taxpayer is at an end. It would seem, therefore, that, on the discharge of a chose in action (such as a UPE) by payment, CGT event C2 will occur.

In private rulings, the Commissioner of Taxation has expressed the view that it is appropriate to look through the legal rights incidentally created pursuant to the UPE and either discharged or satisfied when the legal rights so created are facilitating what is the “real” transaction, being the distribution of income from a trust to a beneficiary.⁵ The Commissioner finds support for this view in the Full Federal Court decision of *Dulux Holdings*.⁶ In that case, the court found a discharge of a chose in action by performance of a contract was not a disposal “under a contract” for the purpose of the then s 160U ITAA36. In relation to a UPE, on its creation, CGT event D1 occurs. When the UPE is discharged, satisfied or ends, CGT event C2 occurs.

The look-through approach validated by the Commissioner would look through the legal rights incidentally created or discharged by the discharge/satisfaction/ending of the UPE to the real transaction, being the distribution of income from the trust to the beneficiary.⁷

Conversion of UPEs into loans

It is also not uncommon for a UPE to be effectively disposed of by converting the UPE to a loan by agreement between the beneficiary entitled to the UPE and the trustee of the trust in which it has been created. It is a fundamental premise for a loan to be made that there must be an advance of money.

For the process of the conversion of a UPE to a loan, there must be an advance or a deemed advance of the amount of the loan from the beneficiary to the trustee. Such conversion could be effected by:

- the beneficiary:
 - disposing of the UPE in consideration of the amount of the UPE in full. From a CGT perspective, this disposal will either trigger CGT event A1 or C2; and
 - the beneficiary then advancing the amount of the loan to the trustee; or
- the UPE being satisfied or discharged by the conversion being effected by the acknowledgment of a debt by the trustee in favour of the beneficiary of an amount equal to the amount of the UPE.

Assignments of UPEs

An assignment, or effectual transfer, of a UPE could be made:

- to effect a gift;
- by repayment through a set off against a debit loan in the trust in which the assignor has the UPE; or
- in consideration of the transfer of an asset or payment of money.

These transactions can be effected under a written or oral agreement between the beneficiary and the trustee (including, where relevant, an acknowledgement by the trustee). Journal entries should then

be made in the financial accounts of the trust to correctly reflect the transactions.

In the case of an assignment of a UPE, it is the Commissioner's view that CGT event A1 occurs as it cannot be said that any such assignment was to facilitate the distribution of income from the trustee to a beneficiary.⁸

Subject to compliance with the relevant legislation in each jurisdiction, it is possible for a legal owner of an equitable interest to make a complete and perfect gift of that interest. For example, the Victorian *Property Law Act 1958* provides an assignment of a chose in action must be made absolutely and in writing and involve the transfer of all rights of the assignor in the chose in action.⁹ As such, in the author's view, the Commissioner's view is correct on the basis that CGT event A1 requires there to be a change of legal ownership of the asset, including the beneficial ownership. A valid statutory assignment of a UPE would trigger CGT event A1.¹⁰

Quantifying the CGT

When quantifying CGT, the first question for consideration on the discharge of a UPE via payment by the trustee or release or surrender by the beneficiary (in which event CGT event C2 will happen) or assignment by the beneficiary (in which event CGT event A1 will happen) is: what is the cost base of the UPE?

The first element of the cost base is the total of the money paid (or required to be paid) and the market value of any other property you gave (or are required to give) in acquiring the CGT asset.¹¹

In relation to this issue, the Commissioner takes the view that, prior to the creation of the UPE, the beneficiary never had any legal right to payment of the amount of the UPE as against the trustee. The UPE not being a debt, the amount of the UPE cannot be said to have been given (or required to be paid or given) to the trustee, by the beneficiary, to acquire the equitable right to demand and receive payment.¹² On a beneficiary becoming presently entitled to an amount from a trust estate, they will have an equitable right to that amount but not, without more, as a result of any debtor-creditor relationship.¹³ The rights arising under a present entitlement could, in certain circumstances, become or crystallise into an equitable debt (such as where, in the case of a UPE, the beneficiary calls for payment of their entitlement) but

the right that comes into existence on creation of the present entitlement is not a debt.¹⁴

Under the market value substitution rule, if you do not incur any expenditure to acquire a CGT asset, the first element of the cost base of the asset will be its market value except where CGT event D1 occurs or the acquisition results from another entity doing something that did not constitute a CGT event occurring.¹⁵ CGT event D1 occurs on the creation of a UPE and, accordingly, its market value will not be substituted as the first element of the cost base; the cost base of the UPE will only comprise any expenditure incurred by the beneficiary in whose favour it has been created. A further exception to the market value substitution rule may apply by reason of the assignment of the UPE having been made without payment (or the giving of anything) and the right not having been acquired by way of any assignment from another entity.¹⁶

The capital proceeds from a CGT event are the total of the money a person received (or is entitled to receive) in respect of the event happening and the market value of the other property the person received (or is entitled to receive) in respect of the event happening.¹⁷ Where there is no consideration for the assignment of a UPE, the assignor will be taken to have received the market value of the CGT asset that is the subject of the assignment.¹⁸

Usually, the market value of a UPE at the time of a CGT event in respect of it will be the face value of the UPE. However, where the UPE comprises an interest in specific assets of the trust (for example, where funds specifically held for the beneficiary entitled to the UPE have been applied or invested by the trustee for the benefit of the beneficiary), the market value of the UPE may be more than its amount on creation.¹⁹ In this instance, it is necessary to consider whether CGT event E5 may happen. CGT event E5 happens if a beneficiary of a trust becomes absolutely entitled to an asset of the trust as against the trustee of the trust.²⁰ Once a beneficiary becomes absolutely entitled to an asset as against a trustee, the asset will be treated as an asset of the beneficiary and all acts of the trustee were acts of the beneficiary.²¹ This means, for example, any subsequent distribution to the beneficiary would not have CGT consequences.

Section 118-20 of the *Income Tax Assessment Act 1997* (Cth) seeks to

prevent double taxation by reducing the capital gain a taxpayer makes from a CGT event if, because of the event, an amount is included in their assessable income or exempt income in any income year.²² This section operates to reduce a capital gain made from a CGT event by an amount included in the assessable income or exempt income of a taxpayer in relation to a CGT asset as if the amount were so included because the CGT event would also be taken into account in working out the amount of a capital gain made by the taxpayer.²³

In relation to UPEs, s 118-20 will apply to the extent that, in respect of an assignment of a UPE, an amount has been included in the assessable income of the assignor beneficiary. Therefore, any capital gain made by the beneficiary on the waiver or assignment of that UPE will be reduced by those amounts that may have been included in the beneficiary's assessable income under s 118-20 on the UPE's creation.²⁴

Where no amount was included in the taxpayer's assessable income as a result of the creation of a UPE, such as by reason of the UPE arising from the distribution of a non-assessable amount of capital to the beneficiary for no consideration, then s 118-20 will have no application.

Conclusion

While the taxation consequences of assigning or transferring UPEs should always be considered, the commercial and practical consequences should be of paramount consideration. The Commissioner has, up to this point in time, taken an often contentious view on the CGT treatment of UPEs. Although tax considerations should not override the goal of any restructuring of these types of interests, such restructuring can lead to unforeseen CGT liabilities if care is not taken when these interests are dealt with.

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Reference

- 1 TR 2010/3 and PS LA 2010/4.
- 2 TD 2015/D5, TD 2015/20 and TR 2015/4.
- 3 S 108-5(1) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).
- 4 S 104-35 ITAA97.
- 5 PBR 1012648073225 and PBR 101257117732.

- 6 *FCT v Dulux Holdings Pty Ltd & Orica Ltd* [2001] FCA 1344.
- 7 PBR 1012648073225.
- 8 PBR 1012571177732.
- 9 S 134 of the *Property Law Act 1958* (Vic).
- 10 S 104-10(2) ITAA97.
- 11 S 110-25(2) ITAA97.
- 12 PBR 1012571177732 and PBR 1012557133149.
- 13 TR 2010/3, para 34.
- 14 *Commissioner of Inland Revenue v Ward* (1969) 1 ATR 287 at 313.
- 15 S 112-20(1)(a)(i) and (ii) ITAA97.
- 16 S 112-20(3), item 1 ITAA97; PBR 1012571177732.
- 17 S 116-20(1) ITAA97.
- 18 S 116-30(1) ITAA97.
- 19 PBR 1012571177732.
- 20 S 104-75(1) ITAA97.
- 21 S 106-50 ITAA97.
- 22 S 118-20 ITAA97.
- 23 S 118-20(1A) ITAA97.
- 24 PBR 1012571177732.

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