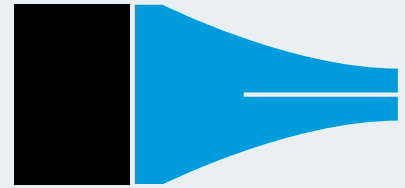


The ATO's proposed treatment of unpaid present entitlements: part 1

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Some unresolved issues and complexities remain despite the ATO's recent attempt to clarify the treatment of UPEs.

Introduction

This is the first of a two-part series discussing the proposed treatment of unpaid present entitlements (UPEs) by the Australian Taxation Office (ATO).

On 10 June 2015, the ATO released TD 2015/D5 and TD 2015/D4 discussing, respectively, the treatment of UPEs for the purposes of:

- bad debt write-offs in s 25-35 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) (s 25-35); and
- Div 7A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) (Div 7A).

On that day, the ATO also released TR 2015/D2 discussing the maximum net asset value test applicable to the capital gains tax small business concessions¹ (MNAV).

It was hoped that these publications would clarify the treatment of UPEs. However, there are still unresolved issues and complexities requiring review.

This article discusses the draft taxation determinations. Part 2 will discuss the draft taxation ruling in the September 2015 issue of this journal.

Background

What is a UPE?

A UPE arises as a result of a distribution from a trust to a beneficiary that has not been physically paid to the beneficiary by way of the transfer of cash or assets or set-off against an amount owed by the beneficiary to the trust.² The beneficiary has an equitable right to an amount equivalent to the UPE.²

The UPE legal landscape

The taxation treatment of UPEs has been inconsistent and confusing, particularly in relation to whether or not a UPE could

be classified as a debt, and in what circumstances.

The Supreme Court of Western Australia and the Federal Court of Australia have recently considered the issue of whether a UPE is an equitable or a legal debt.³

*Chianti Pty Ltd v Leume Pty Ltd*⁴ (*Chianti*) involved a claim by a beneficiary for an amount of a "distribution of trust income" by the trustee that had been assigned but not physically paid to the beneficiary. The Western Australian Supreme Court held that the distribution was a legally enforceable debt, and the trustee, as a result of distributing the income, was holding it "upon trust for the [beneficiary] absolutely".⁵ The relevant amounts were recorded and described in the financial statements as "current liabilities" accumulated in a "beneficiaries' loan account", a "beneficiaries' current account" or as an "unpaid beneficiary entitlement".⁶ The financial statements, when considered in the context of the relevant factual and legal background, constituted admissions by the trustee that the distributed amounts were owing to the beneficiary.⁷

In *Gusdote Pty Ltd v Ashley; In the matter of Gusdote Pty Ltd*⁸ (*Gusdote*), the distributions to the beneficiaries were disclosed as "unpaid trust distributions" and characterised as "current liabilities".⁹ Essentially, the Federal Court in *Gusdote* agreed with the reasoning in *Chianti*.¹⁰

These decisions triggered debate as to whether:

- (1) a UPE could constitute a deductible debt for the purposes of the bad debts deduction under s 25-35, as the beneficiary does in fact include the amount representing the UPE in their assessable income, despite never

physically receiving the benefit of that amount;¹¹ and

- (2) if a UPE could be a legal debt, then, for the purposes of the MNAV, it should be included as an asset of the beneficiary (which is excluded from being a "disregarded asset") and a liability of the trust.

The ATO's release of these draft publications is an attempt to clarify its position regarding UPEs.

No deduction when a UPE is written off as a bad debt: TD 2015/D5

Requirements of a deductible debt:

The term "debt" is not defined in the ITAA36 or the ITAA97. Section 25-35 outlines the requirements for a deductible debt:

- "(1) You can deduct a debt (or part of a debt) that you write off as bad in the income year if:
- (a) it was included in your assessable income for the income year or for an earlier income year; or
 - (b) it is in respect of money that you lent in the ordinary course of your *business of lending money."

Is a UPE that is written off a bad "debt" for the purposes of s 25-35?

In TD 2015/D5, the ATO states that, despite a trustee's equitable obligation to pay a UPE, a beneficiary is not entitled to a deduction under s 25-35 for a UPE that has been written off because that amount was not included in the beneficiary's assessable income in the relevant income year by virtue of it being a debt owing to the beneficiary. Rather, the beneficiary was assessed in that income year on "their share" of the taxable income of the trust:

“11. The equitable obligation on a trustee to pay the amount of a UPE to a beneficiary is not generally a debt at law. Whether or not the reference to a ‘debt’ in section 25-35 of the ITAA 1997 is intended, in context, to extend beyond common law debts to include relevant obligations due merely in equity, a deduction is nonetheless not available under that section for a UPE that has been ‘written off’. This is because paragraph 25-35(1)(a) requires that *the amount of the relevant debt* be included in the taxpayer’s income for that year or an earlier income year.

12. *The amount of a UPE is not included in a beneficiary’s assessable income. Rather the beneficiary is assessed on an amount determined under a statutory formula; that amount may be more or less than the amount of the entitlement.*

13. That is, a beneficiary who is presently entitled to a share of the income of a trust estate includes in their assessable income *that same share or proportion of the trust’s net income*: subsection 97(1) of the ITAA 1936 ...

14. As the High Court recognised in *[Bamford]*, a trust’s ‘income’ and ‘net income’ are two subject matters which do not correspond. ‘Once the share of the distributable income to which the beneficiary is presently entitled is worked out, the notion of present entitlement to trust income has served its purpose, and the beneficiary is to be taxed on that share (or proportion) of the taxable income of the trust estate’.

15. Even if the amounts of income and net income are the same numerically, *it is not their share of trust income that is included in a beneficiary’s assessable income.*” (emphasis added)

The Commissioner notes that the UPE has a different purpose in this context:¹²

“... [r]ather the entitlement is used to determine the amount (if any) of the net income of the trust (as determined under subsection 95(1) of the *Income Tax Assessment Act 1936* (ITAA 1936)) included in the beneficiary’s assessable income under Division 6 of Part III of the ITAA 1936.”

The High Court in *FCT v Bamford*¹³ stated that a trust’s “income” and “net income” are two subject matters which do not correspond in the context of s 97(1) ITAA36.¹⁴ This case involved the distribution of a trust’s income on two occasions. Although the circumstances and income in each distribution varied, the key issue was the contrast between the defined expression “net income of the trust estate” and the undefined expression “the income of the trust estate”.¹⁵ French CJ, Gummow, Hayne and Crennann JJ, in a joint judgment, held that the analysis in *Zeta Force Pty Ltd v FCT*¹⁶ should be relied on and followed in relation to this point:¹⁷

“The contrast between the expressions ‘share of the income of the trust estate’ and ‘that share of the net income of the trust estate’ shows that the draftsman has sought to relate the concept of present entitlement to distributable income, and not to taxable income, which is, after all, an artificial tax amount. Once the share of the distributable income to which the beneficiary is presently entitled is worked out, the notion of present entitlement has served its purpose, and the beneficiary is to be taxed on that share (or proportion) of the taxable income of the trust estate.”

In TD 2015/D5, the ATO has seemingly circumvented the issue of whether a UPE could be a “debt” per se by essentially stating that:

- (1) the trustee has as an equitable obligation to pay the amount of the UPE (Amount A) to the beneficiary;
- (2) the beneficiary includes their share of the taxable income of the trust (Amount B) in their assessable income for the relevant income year; and
- (3) regardless of whether Amount B is numerically the same as Amount A, the fact that Amount B has a different conceptual genesis from Amount A will distinguish it from Amount A

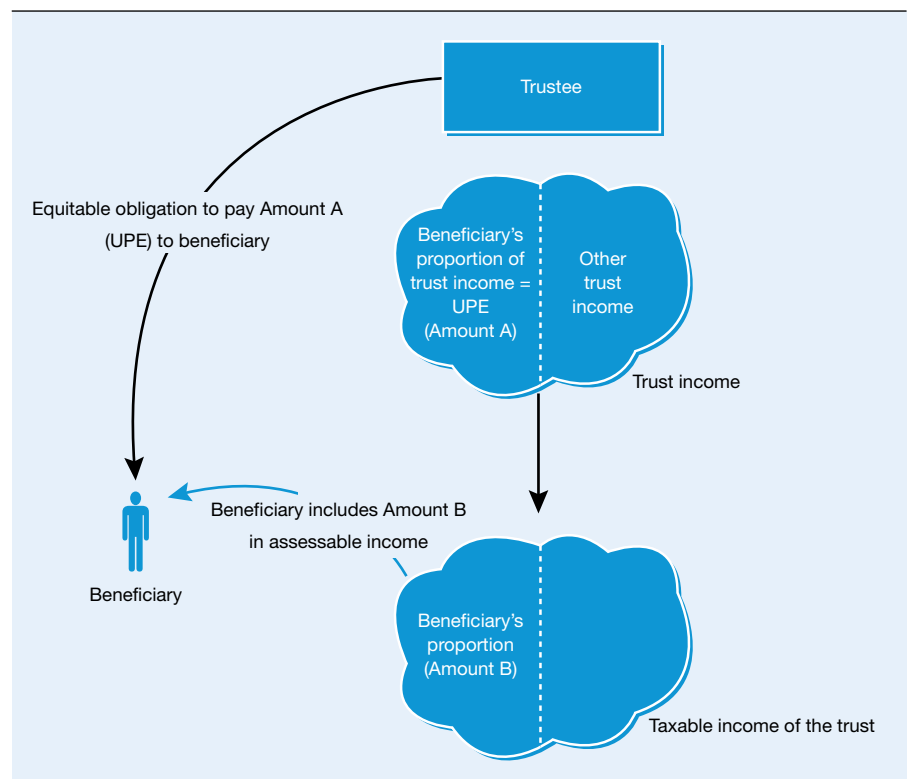
and prevent it from qualifying for a deduction under s 25-35(1)(a) (see Diagram 1).

An inequitable outcome

The ATO has adopted a literal and technical approach which could (in the absence of legislative amendment to s 25-35(1)(a) to encompass UPEs), lead to inequitable outcomes for beneficiaries where the amount representing the UPE has been included in their assessable income, despite the beneficiary subsequently never receiving the benefit of that amount.

It has also been suggested that, if a deduction is not available for a bad debt under s 25-35, recourse may be had under s 8-1 ITAA97,¹⁸ which allows a deduction for any loss or outgoing incurred in gaining or producing assessable income, or is necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income, provided that it is not of a capital, private or domestic nature.¹⁹ However, the Commissioner in ID 2001/301 stated that a taxpayer, who is a beneficiary of a trust, is not entitled to a deduction under either s 25-35 or 8-1 for a loan made to the trust that will not be repaid, as the beneficiary is not “carrying on a business” of lending

Diagram 1



money and such a loan is generally made in a private capacity.²⁰

A debt written off in these circumstances will therefore not be deductible, as the loan will not be regarded as an ordinary incident of the taxpayer's income-earning activities, and would also be excluded under the capital exclusion in s 8-1.

Release of a UPE by a corporate beneficiary constitutes a "payment" for Div 7A purposes: TD 2015/D4

"Payment" under Div 7A

A private company is taken to pay a dividend to a shareholder (or an associate of a shareholder) at the end of an income year if the company pays an amount to the entity during the year.²¹

Section 109C(3) ITAA36 defines "payment" as:

- (a) a payment to the extent that it is to the entity, on behalf of the entity or for the benefit of the entity; and
- (b) a credit of an amount to the extent that it is:
 - (i) to the entity; or
 - (ii) on behalf of the entity; or
 - (iii) for the benefit of the entity; and ..."
 (emphasis added)

In TD 2015/D4, the Commissioner states:

"1. ... A private company that releases its ... (UPE) credits an amount within the meaning of that word in paragraph 109C(3)(b) ... Such a crediting is taken to be a payment for the purposes of subparagraph 109C(3)(b)(iii) to the extent that the release represents a financial benefit to an entity ...

20. ... it is considered that the word 'credit' in paragraph 109C(3)(b) takes a wide meaning, and includes any action or dealing that would be properly reflected as a credit entry in the private company's books of account.

21. A UPE is an asset (an equitable interest) which stands as a debit entry in a beneficiary's books of account.

22. A release (by way of deed or agreement) constitutes a binding undertaking, which leaves the entity to whom the interest is released with full legal ownership, free of any separately identifiable equitable interest of the releasing beneficiary in the underlying property ...

23. To properly reflect the effect of the release in the beneficiary's books of account, the beneficiary would make a credit entry in the amount of the UPE released ...

25. ... Accordingly, the release of a UPE is a payment within the meaning of subparagraph 109C(3)(b)(iii).

26. This will be the case regardless of whether or not the UPE is held in the main (originating) trust or in a sub-trust (within the meaning in TR 2010/3), and whether or not the release is unconditional or conditional upon the property representing the UPE being paid for the benefit of a third party." (emphasis added)

Observations

Interaction with the commercial debt forgiveness provisions

In the absence of a sub-trust arrangement, a beneficiary's rights would relate to the UPE in the main trust. If the beneficiary was not absolutely entitled, there would be an "equitable debt" owing by the trustee to the beneficiary.²² The beneficiary would correspondingly have an equitable right to receive that amount. A release by the beneficiary of the trustee's obligations in this instance could not constitute a debt forgiveness for the purposes of s 109F ITAA36 as the commercial debt forgiveness provisions could not be applied to the release — the trustee could not deduct the interest paid to the beneficiary for the UPE unless and until the UPE had been converted into a "loan" (see Diagram 2).

Release with a sub-trust arrangement

TR 2010/3 recognises a loan being advanced from the sub-trust to the main trust for Div 7A purposes.²³ Consequently:

- (1) a release by the sub-trust of the loan to a main trust should have no Div 7A consequences if all income derived by the sub-trust has been paid to the beneficiary in accordance with the sub-trust arrangements (see Diagram 3);²⁴ and
- (2) if the private company beneficiary has a UPE in respect of the income of the sub-trust, the Div 7A loan between the sub-trust and the main trust could give rise to a deemed dividend under Subdiv EA if that income remains unpaid. In this case, the release by the beneficiary of a UPE relating to the unpaid income of the sub-trust could trigger a debt forgiveness for the purposes of s 109F. This is because the corpus of the sub-trust could be classified as a commercial debt for the purposes of Div 245 if the sub-trustee could deduct the interest paid to the beneficiary under the sub-trust arrangement.²⁵ However, if a beneficiary is not entitled to a bad debt deduction in respect of a UPE (as is proposed in TD 2015/D5), the commercial debt forgiveness provisions would not apply as there would be no loss duplication. Presumably, this is the rationale for the ATO addressing a release of a UPE by reference to a "payment" pursuant to s 109C(3)(b)(iii) (see Diagram 4).

Diagram 2

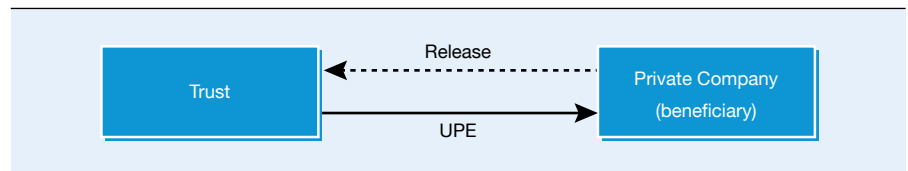


Diagram 3

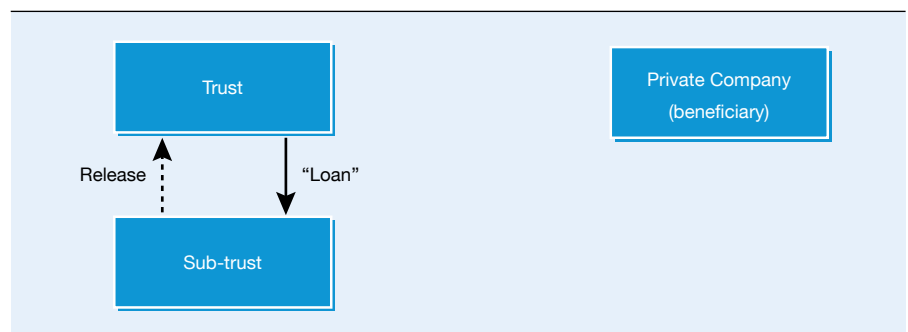
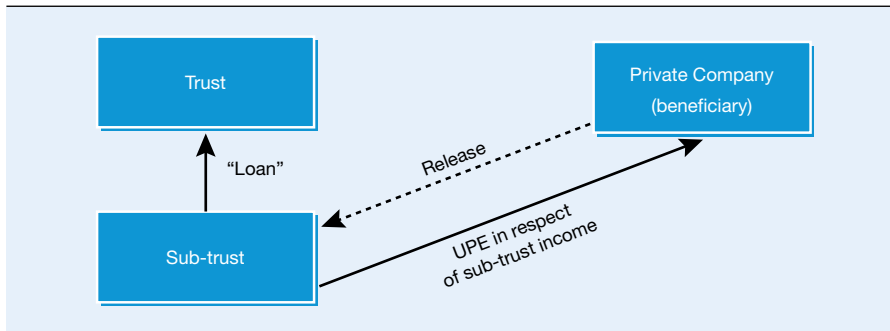


Diagram 4



Conclusion

What does the UPE landscape look like so far?

Bad debts

A UPE will not qualify for a deduction under either s 25-35 or 8-1. In the absence of legislative amendment to s 25-35, this situation will continue to create an inequitable outcome for beneficiaries who have included the amount of the UPE in their assessable income.

Division 7A

The release of a UPE could constitute a “payment” for the purposes of s 109C. This position seems reasonable as (based on the ATO’s proposed treatment of a UPE in the context of bad debts) such a release could not constitute a debt forgiveness under s 109F.

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References

- 1 Div 152 ITAA97.
- 2 R Somers, “UPEs and the maximum net asset value test”, (2014) 48(9) *Taxation in Australia* 522.
- 3 See, for example, *Chianti Pty Ltd v Leume Pty Ltd* [2007] WASCA 270, and *Gusdote Pty Ltd v Ashley; In the matter of Gusdote Pty Ltd* [2011] FCA 250.
- 4 [2007] WASCA 270.
- 5 [2007] WASCA 270 at [65].
- 6 [2007] WASCA 270 at [66].
- 7 [2007] WASCA 270 at [77].
- 8 [2011] FCA 250.
- 9 [2011] FCA 250 at [38]-[39].
- 10 A Kokkinos, “Trusts – the state of play”, paper delivered at The Tax Institute’s 29th National Convention, March 2014, p 32.
- 11 *Ibid* p 39.
- 12 TD 2015/D5, para 1.

- 13 [2010] HCA 10.
- 14 TD 2015/D5, para 14.
- 15 *FCT v Bamford* [2010] HCA 10 at [36].
- 16 (1998) 80 FCR 58.
- 17 *FCT v Bamford* [2010] HCA 10 at [45].
- 18 *FCT v Marshall and Brougham Pty Ltd* [1987] FCA 181; TR 92/18.
- 19 Treasury, *Improving the tax treatment of bad debts in related party financing*, discussion paper, July 2012. Available at www.treasury.gov.au/~media/Treasury/Consultations%20and%20Reviews/Consultations/2012/Bad%20Debts%20Ensuring%20Consistent%20Treatment%20in%20Related%20Party%20Financing%20Arrangements/Key%20Documents/PDF/Discussion%20Paper.ashx.
- 20 For a UPE that is “loaned back” from a beneficiary to the trust. It should be acknowledged, however, that, if not for this position, taxpayers could potentially avoid paying tax on a distribution entirely by writing off a UPE as a bad debt outside of the income tax return amendment period which may otherwise result in the trustee being assessed on that distribution.
- 21 TD 2015/D5, para 14.
- 22 This follows from the ATO’s reasoning in Pt C of TR 2015/D2 (which is discussed in part 2 of this article).
- 23 A loan between the sub-trust and the main trust is not, however, recognised by the ATO in the context of the MNAV test (refer to Pt B of TR 2015/D2). This issue is discussed in part 2 of this article.
- 24 The beneficiary not being presently entitled to an amount of the net income of the sub-trust that is unpaid at the time of the release. See s 109XA(3)(b) ITAA36.
- 25 S 245-10 ITAA97.

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