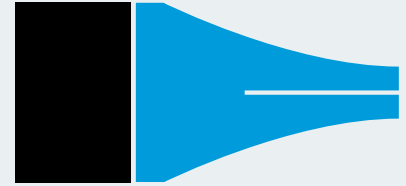


The ATO's proposed treatment of unpaid present entitlements: part 2

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Despite the release of TR 2015/D2, inconsistencies remain in the treatment of UPEs which require clarification.

Introduction

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

Part 1 (published in the August issue of the journal) discussed the proposed treatment of UPEs for the purposes of bad debt write-offs and Div 7A. Part 2 considers TR 2015/D2 which discusses UPEs in the context of the maximum net asset value test (MNAV).¹

What is a UPE?

As discussed in part 1, a UPE arises as a result of a distribution from a trust to a beneficiary that has not been 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.³

UPEs and the MNAV test

In order to access the CGT small business concessions in Div 152, an entity must be a “small business entity” or satisfy the MNAV test.³

The MNAV test seeks to treat a taxpayer and related entities as a single economic unit for the purposes of determining whether the net value of the CGT assets of the unit does not exceed the statutory threshold of \$6m.⁴ The net value of the CGT assets of an entity is, broadly, the amount obtained by subtracting from the sum of the market values of the CGT assets the sum of the liabilities of the entity that are related to the assets.⁵ When determining the net value of the CGT assets of an entity, “shares, units or other interests (except debt)” in an entity connected with, or affiliated with, the taxpayer are disregarded.⁶

There has been confusion as to whether, for the purposes of the MNAV:

- (1) a beneficiary should include the amount of a UPE as an asset when calculating the net value of its assets for the purposes of ss 152-15 and 152-20(2)(a) ITAA97; and
- (2) a trust should include a UPE as a liability “related to the assets” of the trust for the purposes of s 152-20(1)(a) ITAA97;² and
- (3) a UPE could be an “other interest”⁷ or “debt” for the purposes of the disregarded assets provision in s 152-20(2)(a) ITAA97.

The ATO's position

In TR 2015/D2, the ATO states that, where a connected beneficiary has a UPE, the value of that UPE will be included once in determining whether or not a trust satisfies the MNAV test.⁸ The way that the ATO proposes to treat the value of the UPE varies depending on the beneficiary's entitlement and whether or not the UPE has been placed on a sub-trust:⁹

“28. While the net outcome is the same in each case, the technical reasoning differs depending on whether:

- the connected beneficiary is absolutely entitled to one or more trust assets;
- the trustee has a presently existing obligation to pay the amount to which the connected beneficiary is entitled; and
- the trustee has set an amount aside on sub-trust for the connected beneficiary, such that the amount to which the connected beneficiary is presently entitled has become the corpus of a separate trust.”

The outcome in each of these scenarios is summarised in Table 1 and considered below.

Part A: where the connected beneficiary's UPE relates to an absolute entitlement

TR 2015/D2 states:

“30. Where the connected beneficiary's UPE comprises an absolute entitlement to one or more trust assets, *those assets are treated as the connected beneficiary's assets for various purposes including the maximum net asset value test ...*

Is the UPE a liability of the trust?

...

32. As the assets corresponding to the UPE are treated as held by the connected beneficiary rather than the trust, the trust is taken not to have a presently existing obligation to pay anything to the connected beneficiary in respect of the UPE. *Accordingly, the value of the UPE will not be included anywhere in the net value of the CGT assets of the trust as either an asset or a corresponding liability.*” (emphasis added)

In TR 2004/D25, the ATO discussed the meaning of “absolute entitlement” in the context of the CGT provisions, stating:

“10. The core principle underpinning the concept of absolute entitlement in the CGT provisions is the ability of a beneficiary, who has a vested and indefeasible interest in the entire trust asset, to call for the asset to be transferred to them or to be transferred at their direction. This derives from the rule in *Saunders v. Vautier* applied in the context of the CGT provisions ...”

In the part A scenario, the UPE is recognised as a liability of the trustee. As the assets corresponding to the UPE are treated as being held by the absolutely entitled beneficiary, the exclusion of the amount of the UPE from both the trust's assets and the trust's liabilities is consistent and avoids double counting.

Table 1

UPE	Main trust	Sub-trust	Beneficiary
Part A: where a beneficiary is absolutely entitled to the trust income	<ul style="list-style-type: none"> Exclude from assets Exclude from liabilities 	N/A	<ul style="list-style-type: none"> Include the amount of the UPE as an asset of the beneficiary
Part B: no absolute entitlement and UPE on sub-trust	<ul style="list-style-type: none"> Exclude from assets Exclude from liabilities 	<ul style="list-style-type: none"> Include the amount of the UPE as an asset of the sub-trust No corresponding liability 	<ul style="list-style-type: none"> The amount of the UPE is disregarded
Part C: no absolute entitlement and no sub-trust	<ul style="list-style-type: none"> Include the amount of the UPE in the assets of the main trust Offset by corresponding liability to pay a presently existing equitable obligation 	N/A	<ul style="list-style-type: none"> Include the amount of the UPE as an asset that is not disregarded

Part B: where the connected beneficiary is not absolutely entitled and funds representing the UPE are set aside on sub-trust

In the part B scenario, the ATO states that the UPE will form part of the assets of the sub-trust without any corresponding liability. The UPE is not taken into account in the net value of the CGT assets of the connected beneficiary, and is treated as an asset that is disregarded under s 152-20(2)(a) ITAA97. No amount is taken into account in the main trust as the funds representing the UPE are not considered to be relevant assets (or liabilities) of the main trust.

The key distinguishing feature for not recognising the amount of the UPE as a liability of the sub-trust is that there is no present entitlement in the form of a presently existing obligation on the part of the sub-trustee to pay the amount to the beneficiary of the sub-trust. The present entitlement of the beneficiary related to the main trust from which the funds were transferred. In TR 2010/3, the ATO defined “sub-trust” as:

“3. ... *sub-trust* means a separate trust arising in equity, in respect of which the *private company* is the sole beneficiary and upon which amounts that the *private company* is presently entitled to receive from another trust (called the main *trust*) are held;”

TR 2015/D2 states:

“44. *The property representing the UPE has left the main trust, and now forms part of the assets of the sub-trust. Accordingly, the main trust will not have any asset or liability in respect of the UPE ...*

45. Where the amount of a UPE is held on sub-trust, *there is no presently existing legal or*

equitable obligation on the sub-trustee to pay an amount to the connected beneficiary ...

46. The sub-trust therefore will not have any liability in respect of the UPE for the purposes of paragraph 152-20(1)(a). But as the amount of the UPE is sitting amongst the funds of the sub-trust, its value will be counted as part of the sub-trust’s assets ...

47. A beneficiary with a UPE held on sub-trust has an equitable right to call for payment of the corpus of that sub-trust ...

48. However, that asset is disregarded if it is an ‘other interest’ within the meaning of ... paragraph 152-20(2)(a) ...

54. Considering ‘shares, units or other interests’ as a complete phrase would suggest that ‘*other interests*’ takes on a meaning akin to ‘*shares*’ and ‘*units*’ ...

55. ... The interest of a connected beneficiary in a sub-trust therefore bears some similarity in nature to a ‘unit’ or ‘share’ and is a relevant ‘other interest’ for the purposes of paragraph 152-20(2)(a). The value of the interest is thus disregarded in calculating the net value of the CGT assets of the connected beneficiary.” (emphasis added)

The ATO’s reasoning in part B contradicts its position in TR 2010/3 (in the context of Div 7A), where it stated that the sub-trust has provided a loan to the main trust:

“115. In these circumstances, as the investment by the sub-trust into the main trust is the payment or advance of a sum with the entitlement and expectation of repayment (in addition to an entitlement to a return equal to all of the benefits from use), this investment is itself a Division 7A loan within the meaning of the extended definition in subsection 109D(3). However, without more, as the *Division 7A loan is from the sub-trustee to the trust* and not from the company itself, this

Division 7A loan is not a deemed dividend for the purposes of the Division ...” (emphasis added)

If the reasoning in TR 2010/3 was adopted, the main trust would then disclose a liability in the part B scenario that would offset the sub-trust’s asset. However, this would then result in the UPE being entirely excluded from the MNAV calculation.

In part B, the ATO also omits inclusion of the UPE in a connected beneficiary’s assets by interpreting the phrase “other interests” by reference to an “equity” or “ownership” type interest, but omits reference to the words “(except debt)” that immediately follow the words “other interests” in s 152-20(2)(a) ITAA97. If a UPE held on sub-trust qualified as a “debt” interest of the beneficiary (which it arguably could, given that the corpus of the sub-trust could be classified as a commercial debt for the purposes of Div 245 ITAA97 if the sub-trustee could deduct the interest paid to the beneficiary under the sub-trust arrangement¹⁰), it would then not be disregarded under s 152-20(2)(a). This position is not accepted by the ATO and is consistent with the ATO’s position in TR 2010/3 in which the ATO stated that a beneficiary of a sub-trust would not, for the purposes of Div 7A, be considered to have made a loan or provided financial accommodation to either the main trust or the sub-trust.¹¹

Part C: where the connected beneficiary is not absolutely entitled and there is no sub-trust

In the part C scenario, the amount of the UPE is reflected in the total assets of

the trust and offset by a corresponding liability to pay the amount of the UPE to the connected beneficiary, and that amount is included as an asset of the beneficiary that is not disregarded under s 152-20(2)(a) ITAA97:

"62. ... generally, an obligation to pay a UPE relates to trust assets within the meaning of paragraph 152-20(1)(a) ...

64. A connected beneficiary with a UPE has an equitable right to receive an amount of trust income or capital. That equitable right is a CGT asset ...

65. ... that asset is disregarded if it is an 'other interest' within the meaning of that term in paragraph 152-20(2)(a) ...

67. By nature, a UPE not held on sub-trust is therefore not sufficiently akin to the interests represented by shares and units ...

Is a UPE a 'debt'?

71. Even if a UPE that is not held on sub-trust is a relevant 'other interest' (which the Commissioner does not accept), it is still specifically excluded from the scope of paragraph 152-20(2)(a) if it is a relevant 'debt' ...

73. *The equitable obligation on a trustee to pay the amount of a UPE to a beneficiary is not generally a debt at law ... However, where a beneficiary has been made presently entitled to income or capital that has come home to the trust, the trustee will be under an equitable obligation to pay such amounts to the beneficiary ...* Such obligations on the trustee have been referred to by the courts as equitable debts ...

74. ... *In this context, the Commissioner considers that the reference to 'debt' in paragraph 152-20(2)(a) is intended to extend beyond common law debts to include relevant obligations due merely in equity.*

75. Accordingly, even if a UPE that is not held on sub-trust is an 'other interest' for the purposes of paragraph 152-20(2)(a) (which is not accepted), *it is a relevant 'debt' for the purpose of that provision. The UPE is therefore taken into account in working out the net asset value of the connected beneficiary.*" (emphasis added)

This represents a change from the position taken by the Commissioner previously:¹²

"Where these distributions represent UPE's they are not regarded as an enforceable debt and are not considered liabilities when calculating the net value of CGT assets. *Therefore, for the reasons provided, the Trust's UPE's are not considered liabilities of the entity related to the assets of the Trust for the purposes of calculating the net value of the CGT assets of the Trust under section 152-20 (1)(a) of the ITAA 1997.*" (emphasis added)

The ATO reiterates its position that a UPE is not a legal debt and distinguishes this reasoning from the decisions in *Chianti Pty Ltd v Leume Pty Ltd*¹³ and *Gusdote Pty Ltd v Ashley; In the matter of Gusdote Pty Ltd*¹⁴ by reference to the context of those cases, stating:

"84. In some circumstances, an action for money had and received might lie in respect of a UPE where there remains nothing for the trustee to do except pay the amount of the UPE to the beneficiary, or the trustee has admitted a debt on account of the UPE.⁴⁸ The cases of *Chianti v. Leume ...* and *Gusdote v. Ashley ...* have found that in such circumstances there exists a 'debt' ...

85. *However, this analysis does not extend automatically to other legislation, and particularly income tax statutes where 'debt' is used across a number of contexts ...*

87. The 'debt' recognised to support an action for money had and received is a personal obligation imposed by the law of restitution to correct an unjust enrichment, and is very different in nature to a debt that arises by agreement between parties acting in their own interests. *It is therefore considered that a UPE that gives rise to an action for money had and received is not, by that fact alone, a legal 'debt' for the purposes of paragraph 152-20(2)(a).*" (emphasis added)

As the value of the UPE is included as an asset at the trust, sub-trust or beneficiary level (depending on the part A, B or C analysis above), the treatment of the UPE may have implications for the ability to access the CGT small business concessions depending on the determination of connected entities.

Conclusion

So what does the UPE landscape look like now?

While the ATO in TR 2015/D2 distinguishes its position in relation to whether or not a UPE is a debt from that adopted by the Western Australian Supreme Court and the Federal Court in *Chianti* and *Gusdote*, the ruling does not address the inconsistencies with its prior publications in TR 2010/3 in the context of Div 7A and private binding rulings in the context of the MNAV. Further clarification is also required from the ATO as to the relationship between a sub-trust and the main trust.

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References

- 1 Applicable to the CGT small business concessions in Div 152 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).
- 2 R Somers, "UPEs and the maximum net asset value test", (2014) 48(9) *Taxation in Australia* 522.
- 3 Defined in s 152-15 ITAA97.
- 4 TR 2015/D2, para 24.
- 5 S 152-20(1)(a) ITAA97.
- 6 S 152-20(2)(a) ITAA97.
- 7 TR 2015/D2, paras 48-55.
- 8 TR 2015/D2, para 4.
- 9 TR 2015/D2, para 28.
- 10 See the discussion at p 92 of part 1 of this article, and s 245-10 ITAA97.
- 11 See TR 2010/3, example 6.
- 12 PBR 1012370686783. Website at www.ato.gov.au/rba/content/?ffi=/misc/rba/content/1012370686783.htm.
- 13 [2007] WASCA 270.
- 14 [2011] FCA 250.