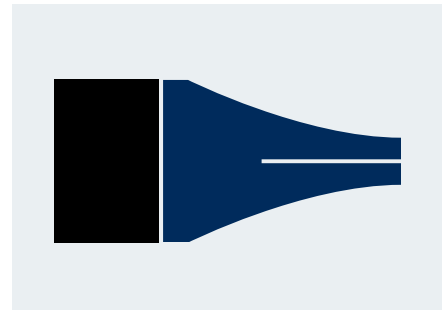


# UPEs and the maximum net asset value test

by Renuka Somers, CTA, Sladen Legal

This article discusses the effect of UPEs on the maximum net asset value test where a trust seeks to access the small business CGT concessions.



## Introduction

This article discusses the complexity associated with a trust satisfying the maximum net asset value test for the purposes of accessing the capital gains tax (CGT) small business concessions where it is unclear whether an unpaid present entitlement (UPE) would be classified as a liability relating to the CGT assets of the trust.

Adverse taxation consequences arising as a consequence of these complexities could be managed through careful planning and the preparation of appropriate documentation.

Unless otherwise stated, all legislative references in this article are to the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

## Background

In order to access the CGT small business concessions<sup>1</sup> in Div 152, an entity must be a “small business entity”<sup>2</sup> or satisfy the “maximum net asset value test” defined in s 152-15.

An entity is a “small business entity” pursuant to s 328-110 if it carries on business and satisfies the \$2m aggregated turnover test.

## The maximum net asset value test

Section 152-15 states:

“**152-15** You satisfy the maximum net asset value test if, just before the \*CGT event, the sum of the following amounts does not exceed \$6,000,000:

- (a) the \*net value of the CGT assets of yours;
- (b) the net value of the CGT assets of any entities \*connected with you;
- (c) the net value of the CGT assets of any \*affiliates of yours or entities connected with your affiliates (not counting any assets already counted under paragraph (b)).”

Section 152-20 defines the “net value of the CGT assets of yours” as:

“**152-20(1)** The *net value of the CGT assets* of an entity is the amount (whether positive, negative or nil) obtained by subtracting from the sum of the \*market values of those assets the sum of:

- (a) the liabilities of the entity that are related to the assets; and
- (b) the following provisions made by the entity:
  - (i) provisions for annual leave;
  - (ii) provisions for long service leave;
  - (iii) provisions for unearned income;
  - (iv) provisions for tax liabilities.

### Assets to be disregarded

**152-20(2)** In working out the *net value of the CGT assets* of an entity:

- (a) disregard \*shares, units or other interests (except debt) in another entity that is \*connected with the first-mentioned entity or with an \*affiliate of the first-mentioned entity, but include any liabilities related to any such shares, units or interests; and
- (b) if the entity is an individual, disregard:
  - (i) assets being used solely for the personal use and enjoyment of the individual, or the individual’s \*affiliate (except a \*dwelling, or an \*ownership interest in a dwelling, that is the individual’s main residence, including any adjacent land to which the main residence exemption can extend because of section 118-120); and
  - (ii) except for an amount included under subsection (2A), the \*market value of a dwelling, or an ownership interest in a dwelling, that is the individual’s main residence (including any relevant adjacent land); and
  - (iii) a right to, or to any part of, any allowance, annuity or capital amount

payable out of a \*superannuation fund or an \*approved deposit fund; and

- (iv) a right to, or to any part of, an asset of a superannuation fund or of an approved deposit fund; and
- (v) a policy of insurance on the life of an individual.”

## Associated challenges

Where the taxpayer is a trust, determining whether to include a UPE as a liability “related to the assets” of the trust can be particularly challenging and is the focus of this article.

## Is a UPE a liability that is “related to” the CGT assets of a trust for the purposes of the maximum net asset value test?

### What is a UPE?

A UPE is a distribution from a trust to a beneficiary that has not been physically paid by the trustee to the beneficiary by way of the transfer of cash or assets or set-off of an amount owed by the beneficiary to the trust. The beneficiary has an equitable right to the amount represented by the UPE. UPEs are often used as “working capital” in businesses that are operated through trusts.

### What is a “liability”?

Although s 108-5(1) defines “CGT asset” as “any kind of property” or “a legal or equitable right that is not property”, the ITAA97 does not define “liability”, “CGT liability” or “the liabilities of the entity that are related to the assets” in the context of s 152-20.

The Australian Taxation Office (ATO) attempted to provide guidance on what liabilities are included in the calculation of the net value of the CGT assets of an entity

in the context of s 152-20(1) in TD 2007/14<sup>3</sup> stating:

"1. The term 'liabilities' in the context of subsection 152-20(1) of the *Income Tax Assessment Act 1997*<sup>7</sup> has its ordinary meaning. 'Liabilities' extend to legally enforceable debts due for payment and to presently existing obligations to pay either a sum certain or ascertainable sums. It does not extend to contingent liabilities, future obligations or expectancies ...

...

17. The term 'liabilities' is not defined for the purposes of the 'net value of the CGT assets' definition. Accordingly, it has its ordinary meaning reflecting the context in which it is used. *The Macquarie Dictionary*, revised 3rd edition, defines liability to mean: 'an obligation, especially for payment; debt or pecuniary obligation'.

18. In the context of subsection 152-20(1), 'liabilities' extend to *legally enforceable debts due for payment and to presently existing obligations* to pay either a sum certain or ascertainable sums. *The term does not extend to contingent liabilities, future obligations or expectancies.*

...

**Liabilities that are related to the assets**

21. The 'liabilities of the entity that are related to the assets' in subsection 152-20(1) include *liabilities directly related to particular assets that are themselves included in the calculation*, for example, a loan to finance the purchase of business premises.

22. The 'liabilities of the entity that are related to the assets' also include *liabilities that, although not directly related to one particular asset, are related to the assets of the entity more generally, for example, a bank overdraft or other short term financing facility that provides working capital for the operation of the business.*" (emphasis added)

In its Interim Decision Impact Statement in relation to *FCT v Byrne Hotels Qld Pty Ltd*,<sup>4</sup> the ATO stated that its position in TD 2007/14 in relation to contingent liabilities would be reviewed.

**The decision in FCT v Byrne Hotels Qld Pty Ltd**

The Full Federal Court decision in *FCT v Byrne Hotels Qld Pty Ltd*<sup>5</sup> (*Byrne Hotels*) concerned whether contingent liabilities — represented by a real estate agent's commission and solicitors' fees relating to the sale of land and business that was the subject of the underlying capital gain — should be excluded from the maximum net asset value calculation.

It is arguable that the reasoning adopted by Bennett J (with Greenwood and Dowsett JJ agreeing) in that case has broader implications as it included equitable obligations that are related to the CGT assets within the definition of "liability" for the purposes of the maximum net asset value test.

Her Honour stated:

"12. Section 108-5 of the Act defines the meaning of 'CGT asset'. It relevantly provides:

'(1) A **CGT asset** is:

- (a) any kind of property; or
  - (b) a legal or equitable right that is not property.
- (2) To avoid doubt, these are **CGT assets**:
- (a) part of, or an interest in, an asset referred to in subsection (1);
  - (b) goodwill or an interest in it;
  - (c) an interest in an asset of a partnership;
  - (d) an interest in a partnership that is not covered by paragraph (c).

Note 1: Examples of CGT assets are:

- land and buildings;
- shares in a company and units in a unit trust;
- options;
- debts owed to you;
- a right to enforce a contractual obligation;
- foreign currency ...'

53. In my view, the Commissioner has advanced no sufficient basis to deny the words of s 108-5 their clear meaning. *There is no logical reason, in the context of Division 152, for there to be a mismatch between assets and liabilities. If contingent assets can be included in the net CGT asset value calculation in s 152-20(1) on the basis that they meet the definition of CGT assets in s 108-5, then contingent liabilities should also be included in that calculation, provided that they are related to the CGT assets and can be classified as 'any kind of property' or 'legal or equitable obligations that are not property'.* This would include obligations existing at the relevant time under a contract which can be enforced by the other party or parties to a contract ..." (emphasis added)

Based on Her Honour's analysis:

- (1) an equitable right such as a UPE owing to a trust would be included in the maximum net asset value calculation in s 152-20(1) on the basis that it meets the definition of a CGT asset in s 108-5 and provided that it is not excluded under s 152-20(2)(a) as "other interests (except debt)". Such

interests are envisaged to be equity type investments that are not recorded as liabilities or debts<sup>6</sup>, and in any event, if the ATO does hold that a UPE is a "debt" for the purposes of s 152-20(2) (a)<sup>7</sup>, would not be disregarded from the net asset value test.

- (2) similarly, a beneficiary to whom the UPE is owed would include the value of the UPE when determining the net value of their CGT assets for the purposes of the maximum net asset value calculation; and
- (3) correspondingly, a UPE owed by a trust would arguably be (as indicated in the authorities discussed below) a liability, either as a legally enforceable debt or, at the very least, an equitable obligation — which, although not directly related to one particular asset of the trust, is related to the assets of the trust more generally in that it provides working capital for the operations of the trust — and on this basis, should also be included as a liability of the trust for the purposes of the maximum net asset value calculation. Such an interpretation seems, at first, to also be consistent with that adopted by the ATO in the context of Div 7A of the *Income Tax Assessment Act 1936* (Cth). TR 2010/3<sup>8</sup> and PS LA 2010/4<sup>9</sup> state that UPEs represent the provision of "financial accommodation" or an in-substance loan.

This would be a logical conclusion after all, if there is "no logical reason for there to be a mismatch between assets and liabilities".

**A legally enforceable debt?**

In Private Binding Ruling (PBR) 83508, the ATO concluded that the term "liabilities" in the calculation of the "net value of the CGT assets" of an entity in s 152-20(1) would include a loan by the beneficiary which is represented as a UPE if the beneficiary is not connected with, or an affiliate of, the trust. In this Ruling, the ATO seems to have focused on the beneficiary not being connected with, or an affiliate of, the trust for the UPE to not be excluded under s 152-20(2)(a). While this is arguably a misinterpretation of s 152-20(2)(a) in that it operates to "add back" debt interests (by disregarding "other interests (except debt)" in an entity that is connected with, or an affiliate of, the taxpayer, what is of interest in the present context is the acceptance of the ATO of the UPE as a "debt". The loan was provided by the beneficiary to

the trust for working capital. There was no loan agreement in place and the loan was a related party loan and a long-term loan. The ATO concluded that “Although there is no formal agreement in place the loan would still be a legal [*sic*] enforceable debt and therefore under para 18 of TD 2007/14 could be included in the calculation of liabilities”.

This reasoning is also consistent with *Chianti Pty Ltd v Leume Pty Ltd*<sup>10</sup> (*Chianti*) and *Gusdote Pty Ltd v Ashley; In the Matter of Gusdote Pty Ltd*<sup>11</sup> (*Gusdote*). In both cases, the trustee had resolved to distribute the profits of the trusts to beneficiaries and the amount of those distributions were shown in the books and records of the trusts as loans by the beneficiaries to the trusts. The loans had not been paid to the beneficiaries at the time the beneficiaries commenced proceedings to recover payment of the amounts owed.

In *Chianti*, Buss JA (with whom Martin CJ and Pullin JA agreed) stated:

“[70] In my opinion ... the Trust deed, the resolutions, the financial statements ... and the evidence ... establish that as at the critical date, the appellant held the distributed amounts upon trust for the respondent absolutely. The respondent’s interest in the distributed amounts was not subject to any contingency or condition which might defeat its entitlement. Rather, the respondent’s interest in the distributed amounts was vested in interest and possession. The statutory demand ... was effective to require the appellant to pay the distributed amounts to the respondent, notwithstanding that the demand was, in form, made as a creditor against a debtor for the payment of a debt rather than by a beneficiary against a trustee for the payment of amounts in respect of which the beneficiary had an absolutely vested entitlement. The court should not adopt a construction of the statutory demand which is narrow or unreal ...”

In *Gusdote*, Foster J stated:

“129. The reasoning of Buss JA in *Chianti Pty Ltd* is applicable to the present case. I think that it is correct. I intend to apply that reasoning to the present case ...”

Here, the Financial Statements ... make perfectly clear that the trust distributions have actually been made as shown in those records. Each of [the beneficiaries] was a creditor of Madeas, in its capacity as the trustee of the Willows Unit Trust ...”

However, ATO ID 2013/15<sup>12</sup> states:

“Whilst the rights arising from a present entitlement can, in some circumstances, become,

or crystallise into an equitable debt (for example, upon calling for payment of that entitlement), the right that arises on the creation of a present entitlement is not a debt.”

The ATO’s recent conclusion in PBR 1012370686783 that the UPEs payable by a trust were not liabilities for the purpose of calculating the net value of CGT assets on the basis that they were equitable obligations rather than legally enforceable debts of the trust is also inconsistent with the reasoning in *Byrne Hotels*, *Chianti*, *Gusdote* and PBR 83508. This is despite Bennett J’s reasoning in *Byrne Hotels* clearly indicating that liabilities that are related to the CGT assets and can be classified as “any kind of property” or “legal or equitable obligations that are not property” should be included for the purposes of the maximum net asset value test.

### PBR 1012370686783

PBR 1012370686783 applies for the period 1 July 2012 to 30 June 2013 and considered the following question:

#### “Question 6

Is an Unpaid Present Entitlement (UPE) a ‘liability 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?

#### Advice/Answers

No”

In its detailed reasoning, the ATO stated:

“... In this case we are examining whether a discretionary trust’s UPE’s [*sic*] would be included as part of the liability for the purposes of calculating the net value of the CGT asset. Therefore regard to whether a UPE is a legally enforceable debt is considered.

The legal technical meaning of the word ‘debt’ is defined in *Butterworths Australian Legal Dictionary 1997*, (Butterworths):

‘2 ... A debt is a sum of money which is now payable or will become payable in the future by reason of a present obligation. It is a right which a creditor has to enforce by taking action’ [emphasis added]

Generally a beneficiary becomes presently entitled to an amount from a trust pursuant to a direct term of the relevant trust deed, or as a result of the trustee of the trust exercising a power under the trust deed to make the beneficiary so entitled (usually by resolution). In situations where the funds to which the beneficiary is made presently entitled continue to be held on trust for that

beneficiary until such time as the beneficiary calls for payment, is commonly referred to as a UPE.

Taxation Ruling TR 2010/3 confirms at paragraph 34:

‘When a beneficiary is presently entitled to an amount from a trust estate, it has an equitable right to that amount. That is, the beneficiary has rights in equity and not, without more, as a result of any debtor-creditor relationship.’

The key difference between a UPE and a debt is that the UPE does not result in an enforceable obligation imposed by law (as distinct from the rights that attach to a creditor). Rather, the rights of an unpaid beneficiary arise in equity only - and not in law. It is for this reason that an unpaid beneficiary cannot sue for their entitlement.

To ‘sue’ is ‘to bring a civil proceeding against a person’; and a ‘civil proceeding’ is a proceeding or an action ‘commenced in the civil jurisdiction of a court of law’ (both definition [*sic*] from *Butterworths*).

A beneficiary’s cause of action is in the equitable jurisdiction of a court (a beneficiary’s interest not being recognised at law). While the rules of law and equity may be administered concurrently in the various State Supreme courts in Australia, a clear distinction between equitable and legal causes of action remains. Case law supports this also in the *Federal Court decision of Euroasian Holding Pty Ltd v Ron Diamond Plumbing Pty Ltd (in liquidation) 1996 64 FCR 147* where it was confirmed that a UPE was not a debt.

The resolutions of the Trust have been provided for the years ended 30 June 2009-2012 and clearly specify the distributions to the beneficiaries. Where these distributions represent UPE’s [*sic*] 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 [*sic*] 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 ...”

### The mismatch

In PBR 1012370686783, the distinction drawn by the ATO is that a UPE is an equitable obligation only until a debtor/creditor relationship exists. This conclusion is inconsistent with its previous position in PBR 83508 that such a loan would be a “legal [*sic*] enforceable debt”.

However, based on its reasoning in TR 2010/3 and PS LA 2010/4 (and despite recognition of a UPE being an equitable obligation), in the context of Div 7A the ATO

will deem a debtor/creditor relationship to exist where the UPE is treated as a “section 2 loan” or a “section 3 loan” where it is payable to a corporate beneficiary or is otherwise subject to Subdivs EA and EB. The debtor/creditor relationship is deemed to exist by the ATO where:

- (1) there is an express or implied loan agreement between the trustee and the beneficiary, including agreed set-off, the trustee crediting a loan account in the name of the beneficiary and the beneficiary acquiescing to that treatment;<sup>13</sup>
- (2) the trustee crediting a loan account in the name of the beneficiary and exercising its power under the trust deed to do so;<sup>14</sup> or
- (3) the beneficiary has knowledge that funds representing the UPE are being used by the trustee for trust purposes (rather than being held and/or used for that private company’s sole benefit) and does not call for payment of the UPE, thereby providing the trustee with “financial accommodation”.<sup>15</sup>

Based on the ATO’s reasoning in PBR 1012370686783 however, in the context of the maximum net asset value test, it is questionable as to whether such a deemed debtor/creditor relationship (without more) would be sufficient to convert a UPE into a “loan” so as to create a liability for the purposes of s 152-20(1)(a). The UPE would continue to be excluded for this purpose unless the trustee makes a conscious decision to enter into a written loan agreement or sub-trust investment agreement with the beneficiary in relation to the use of the funds represented by the UPE.

Tax practitioners now encounter the difficult situation where:

- (1) the legislation is adopting a particular stance in relation to one side of the CGT small business concessions “equation”;
- (2) the courts are adopting a logically progressive interpretation in relation to the other side of that equation; and
- (3) the ATO is adopting contrary interpretations in relation to both these approaches in different contexts of the taxation legislation.

Based on the ATO’s view, if the value of the UPE is excluded from the liabilities of the trust for the purposes of the maximum net asset value test, then a beneficiary recipient of the UPE should not need to include the monetary value of the UPE

in their assets for the purposes of the test as there would be no debtor/creditor relationship in the absence of the trustee and the beneficiary executing a written loan or sub-trust investment agreement. However, for the beneficiary, adopting this approach would mean contravening s 108-5 (if the UPE is not disregarded under s 152-20(2)(a) as “other interests (except debt)”) as the beneficiary’s right to enforce the UPE is an equitable right (which as a debt interest, would not be excluded under section 152-20(2)(a)) and would therefore constitute a CGT asset.

This mismatch is illustrated in Diagram 1 and Table 1.

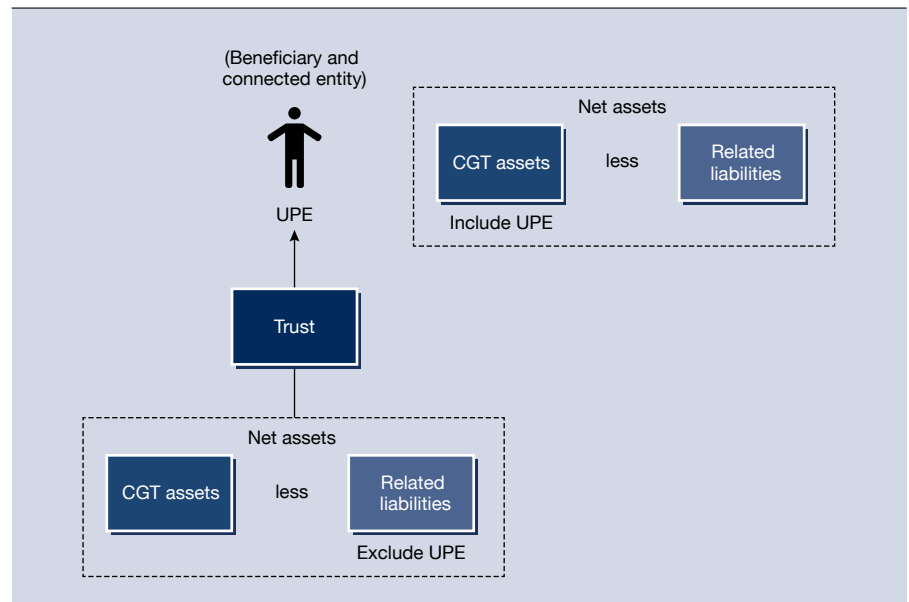
**How does a taxpayer resolve this mismatch?**

Despite the Full Federal Court indicating that equitable obligations that are related to CGT assets should be included when calculating the net asset value, in order to satisfy the ATO’s interpretation of what constitutes a

liability for the purposes of the maximum net asset value test, taxpayers are essentially required to convert an equitable obligation into a “legal” obligation. The conversion of a UPE into a loan pursuant to a written loan agreement or sub-trust investment agreement could create the necessary liability as it results in a debtor/creditor relationship with the resultant debt existing pursuant to a legally enforceable contractual obligation — although a formal conversion into a loan arrangement was *not* required in order for the UPEs to be recognised as legally enforceable debts in the cases of *Chianti* and *Gusdote*.

This raises the question as to whether a formal conversion into a loan arrangement would only be recognised as a legally enforceable contractual obligation for the purposes of the maximum net asset value test where the funds represented by the UPE/loan are related to the CGT assets of the trust that are included for the purposes of the maximum net asset value test. This

**Diagram 1**



**Table 1**

Maximum net asset value test	Trust	Beneficiary (Connected entity/affiliate)
CGT assets		Include UPE owed by trust
Less related liabilities	Exclude UPE owed to beneficiary	
= net value of assets	Overstated by the value of the UPE	Overstated by the value of the UPE



would require that the funds be reinvested in a business being conducted by the trust or used by the trustee to purchase CGT assets. Identifying the purpose of the loan, the relevant CGT assets of the trust that loan liability is related to and the timing of the use of the funds is critical following the recent decision in *Bell v FC of T*.<sup>16</sup> In that case, the Full Federal Court held that a loan obtained by a family trust to effect a capital distribution resolution was not “related” to the assets of the trust and was therefore excluded from the maximum net asset value test. When the trust resolved to make a distribution of capital, the decision to borrow funds related to the liability arising from the borrowing and the funds borrowed from a related entity. However, the purpose of the loan was effected once the funds were disbursed:

“41. The error into which the primary judge fell, in our respectful view, was to regard the Trust’s purpose – that of preserving its existing assets – as dispositive of the question arising under s 152-20. In a situation in which the trustee of the Trust had resolved to make a distribution of capital, his decision to borrow funds rather than to use the existing resources of the Trust gave rise to a relation between the liability arising from the borrowing and the borrowed funds in the hands of

the Trust. But, that purpose having been effected by disposing of the cash which represented the borrowing, there was not, in our view, a relevant ongoing relation between the liability and the generality of the assets of the Trust for no other reason than that the decision to borrow was made in the alternative to using existing resources ...”

### Conclusion

Despite the Federal Court’s willingness to recognise a UPE as a legally enforceable debt and the Full Federal Court’s willingness to include equitable obligations as liabilities for the purpose of the maximum net asset value test where those obligations are related to the assets of the trust, the ATO is apparently reluctant to do so on the basis that UPEs are not legally enforceable debts. This inconsistency can result in unintended and adverse taxation consequences for a trust taxpayer seeking to apply the CGT small business concessions. These consequences may be avoided by carefully planning the timing and use of the funds and the execution of a written loan or sub-trust investment agreement by the trustee and the beneficiary.

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### References

- 1 The small business 15-year exemption, the small business 50% reduction, the small business retirement exemption and the small business roll-over.
- 2 Defined in s 328-110 to be an entity that carries on a business and satisfies the \$2m aggregated turnover test.
- 3 TD 2007/14 Income tax: capital gains: small business concessions: what ‘liabilities’ are included in the calculation of the ‘net value of the CGT assets’ of an entity in the context of subsection 152-20(1) of the Income Tax Assessment Act 1997?
- 4 Released on 9 August 2012.
- 5 *FCT v Byrne Hotels Qld Pty Ltd* [2011] FCAFC 127.
- 6 See A Kokkinos, “Trusts - the state of play”, The Tax Institute 29th National Convention, March 2014, 34.
- 7 *Id.*
- 8 TR 2010/3 Income tax: Division 7A loans: trust entitlements.
- 9 PS LA 2010/4 Division 7A: trust entitlements
- 10 [2007] WASCA 270. See also R Jorgensen, “Unpaid present entitlement or loan – a Division 7A analysis”, (2009) 13(1) *The Tax Specialist* 2.
- 11 [2011] FCA 250.
- 12 ATO ID 2013/15 Income tax: deductions and expenses: unpaid present entitlement and bad debt deduction.
- 13 See TR 2010/3, paras 9 to 10, and PS LA 2010/4, paras 18 to 23.
- 14 See PS LA 2010/4, para 24.
- 15 See TR 2010/3, paras 19 to 26, and PS LA 2010/4, paras 40 to 48.
- 16 [2013] FCAFC 32.

## OBITUARY

# Vale John Campbell Ross

## Head of Tax, Pitcher Partners NSW

John Ross was born on 7 August 1956. John was a true gentleman, a dedicated man; dedicated to his family, dedicated to the profession, dedicated to his clients. He was a loving man, truly caring for all those around him, including his colleagues.

Sadly, John suffered a major heart attack on the evening of 17 February 2014. He had been his usual jovial self throughout the course of that day; and his usual strong willed and determined self as he fought so hard to recover. He unfortunately lost this battle on February 23.

John always maintained a bright outlook on life; he lived life to the fullest, laughed at adversities, called things as he saw them and generally kept a light-hearted attitude toward life, sharing his witty

remarks whenever the opportunity presented itself.

John made an enormous contribution to the tax profession. Often a presenter at The Tax Institute functions and always an active participant in networking events, professional discussions and professional committees, including most recently the NSW Business Chamber. He advised clients on a broad range of tax issues for more than thirty years. John challenged the norm and always worked hard to obtain the best possible outcome for clients by taking the time to truly understand their business.

A man of great passion; whether debating the merits of a particular ruling, his spirited presentations or motivating others to become involved in his beloved sport, dragon boating, John’s energy

and enthusiasm for whatever he was involved in inspired many.

His other passion was educating, mentoring and creating opportunities for others.

Travelling extensively, John worked in five countries, making plenty of friends along the way.

His positive outlook, wicked sense of humour and ability to find an excuse to wear a kilt at any occasion will be missed by all who knew him.

We have lost a leader, mentor and true friend.

Our thoughts are with his wife Catherine and children James and Nerida.

*Scott Treatt*  
Director – Taxation  
Pitcher Partners