THE TAX INSTITUTE

Division 7A Day

Issues when dealing with loans and unpaid present entitlements

WA Division

Thursday, 22 November 2018

Crown Perth

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CONTENTS

1 Introduction

As soon as the business or investment structure involves entities such as companies, it is inevitable that there will be intra-group loans arising from either:

- deliberate choices in respect of financing particular investments and the extraction of capital from the group on short or long-term arrangements; or
- unintentional loans arising from the operation of the group over time and the movement of funds often undocumented as at call loans appearing only in the financial statements of the entities.

When trusts are involved in these structures, unpaid present entitlements (UPEs) further add to the complicated group structures.

A UPE arises where the trust has made an appointment of income or capital to a beneficiary but has not paid, or applied, the full amount of the appointment. This may have arisen where the trust does not have sufficient cash or fungible assets to use in discharging the entitlement created by the appointment or it is applying the amount in the continued operation of the trust through investing in assets or working capital. This results in an entitlement that may be called for by the beneficiary immediately upon its creation and hence the description “unpaid present entitlement”.

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.

The presence of loans and UPEs in a group structure presents many challenges both in the day to day administration of the business or investment structure and in respect of estate and succession planning. Dealings with loans and UPEs may trigger many various unintended consequences pursuant to Division 7A of the Income Tax Assessment Act 1936 (ITAA 36). Further, failure to carefully manage those dealings when addressing Division 7A concerns can trigger tax consequences under other provisions of the tax law.[1] Finally, failure to correctly identify the loans and UPEs and incorporate those into financial accounts, business decisions and succession plans may result in significant unintended outcomes.

This paper is focused on dealing with loans and UPEs in the context of daily business. This is intended to be a practical explanation of the key taxation risks associate with loan accounts and UPEs. The paper begins with a brief recap of Division 7A and the traps this poses when dealing with loans from trusts. We will then review issues in identifying loans and UPEs in the business and risk and exposures these pose to a business’ assets. The paper will explore practical solutions to deal with both loans and UPEs in a tax effective manner whilst maintaining flexibility for the business.

In this paper references to ITAA 36 are to the Income Tax Assessment Act 1936 and references to ITAA 97 are to the Income Tax Assessment Act 1997.

[1] The particular taxation liabilities that arise may not always benefit from anti-overlap provisions in the tax law such that transactions in respect of the loans and UPEs may trigger multiple exposures to tax

2 A brief recap on Division 7A and the traps to note when dealing with loans from trusts

It is beyond the scope of this paper to include a comprehensive analysis of Division 7A of the ITAA 36 and address the many issues involved with Division 7A and its implications for trusts. A number of these issues will be dealt with in other papers during the course of the WA Division 7A Day event. The paper will address the day-to-day practical issues that taxpayers face when dealing with loans and UPEs, primarily in the business context. A brief overview of the relevant Division 7A provisions are included below to assist with this.

Division 7A operates to prevent profits or assets being extracted from companies and provided to shareholders or their associates (through payments, loans or forgiven debts) where income may have benefited from the lower corporate tax rate rather than the potentially higher individual marginal income tax rate. Division 7A is a particular concern for complex family groups, as the liability triggered pursuant to the provisions is an unfranked deemed dividend - a significant penalty for tax purposes.

Standard loans from a company to the shareholder in the company or an associate of that shareholder do not trigger liabilities pursuant to Division 7A of ITAA 36 where they are subject to loan agreements complying with the provisions of section 109N of ITAA 36. The compliant loan agreement, in simple terms, is either a seven-year loan with principal repayments each year and interest at a statutory rate, or a 25-year loan (secured by a registered mortgage over real property to the value of 110% of the loan) with principal repayments due each year and interest at a statutory rate.

Subdivision EA of Division 7A of ITAA 36 extends the potential operation of Division 7A to arrangements where a trust makes a payment or loan to a beneficiary who is the shareholder or associate of the shareholder in a company and that company has a UPE in the trust.

Those trust arrangements were further extended by various provisions including section 109XI of ITAA 36. Section 109XI deems there to be a relationship between the trust making the payment or loan to the beneficiary (who happens to be the shareholder or an associate of the shareholder in a company) and the relevant company even though there may not be a direct UPE relationship between those two entities. If there are interposed entities between the primary trust making the loan or payment and the ultimate corporate beneficiary that has a UPE indirectly traced to the primary trust, the Division 7A implications will be triggered.

Finally, as a result of Australian Taxation Office (**ATO**) interpretation of the tax law as published in Taxation Ruling TR 2010/3 and Practice Statement Law Administration (**PSLA**) 2010/4, UPEs that have not been called for by their entitled beneficiaries (subsisting UPEs) that are not held for the sole benefit of the beneficiary will be treated as loans for the purposes of Division 7A of ITAA 36. The ATO interpretation does not apply to UPEs that existed prior to the ATO's first announcement of their change in interpretation on 16 December 2009. Further, it is possible to demonstrate that the subsisting UPE is held for the sole benefit of the company by putting in place an investment agreement arrangement that complies with PS LA 2010/3. Under that practice statement, an option one complying investment arrangement is an interest only arrangement for seven years and an option two complying investment arrangement is an interest only arrangement for 10 years. Different interest rates apply to the option one and option two arrangements. A further option to demonstrate that the UPE was held for the sole benefit of the beneficiary is where the UPE is directly traced to specific assets and all the benefits and income derived from those assets is directly attributed under the sub trust to the beneficiary holding the UPE.

These arrangements are all likely to be reviewed and potentially changed as a result of anticipated amendments to the legislation due to commence 1 July 2019. Further detail of the potential changes to the legislation are outlined in the section 3 below.

3 Proposed changes to the Division 7A regime

The Government first announced amendments to Division 7A as part of the "Ten Year Enterprise Tax Plan" in the May 2016 Federal Budget. The amendments proposed intended to incorporate recommendations from the 2014 Board of Taxation's final report on the 'Post Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936'. The start date was to have been 1 July 2018, although the Government in the 2018 Federal Budget deferred the start date to 1 July 2019.

Whilst the exact amendments are yet to be finalized, and a recent consultation paper released by Treasury departs from the Board of Taxation's recommendations, any paper presented in respect of loans and UPEs in 2018 should give consideration to these announced amendments. The history and the current state of those amendments is considered below.

3.1 Federal Budget 2016-17– Ten Year Enterprise Tax Plan

Amendments to the Division 7A regime were first announced as part of the "Ten Year Enterprise Tax Plan" in the May 2016 Federal Budget. The relevant extract from the budget papers is outlined below.[2]

Ten Year Enterprise Tax Plan — targeted amendments to Division 7A

Revenue ($m)

	2015-16	2016-17	2017-18	2018-19	2019-20
Australian Taxation Office	-	-	-	-	*

The Government will make targeted amendments to improve the operation and administration of Division 7A of the *Income Tax Assessment Act 1936* (an integrity rule for closely held groups).

These changes will provide clearer rules for taxpayers and assist in easing their compliance burden while maintaining the overall integrity and policy intent of Division 7A. It includes a self-correction mechanism for inadvertent breaches of Division 7A, appropriate safe-harbour rules to provide certainty, simplified Division 7A loan arrangements and a number of technical adjustments to improve the operation of Division 7A and provide increased certainty for taxpayers.

These changes draw on a number of recommendations from the Board of Taxation's Post-implementation Review into Division 7A and will apply from 1 July 2018.

This measure is estimated to have an unquantifiable cost to revenue over the forward estimates period.

This measure forms part of the Government's Ten Year Enterprise Tax Plan, which will encourage Australians to work, save and invest.

Further clarity was provided in the May 2018 Federal Budget. The relevant extract from the budget papers is outlined below.[3]

[2] Budget Measures 2016-17 — Part 1: Revenue Measures, p42.
[3] Budget Measures 2018-19 — Part 1: Revenue Measures, p41.

Tax Integrity — clarifying the operation of the Division 7A integrity rule

Revenue ($m)

	2017-18	2018-19	2019-20	2020-21	2021-22
Australian Taxation Office	-	-	*	*	*

The Government will ensure that unpaid present entitlements come within the scope of Division 7A of the *Income Tax Assessment Act 1936* from 1 July 2019. This will apply where a related private company is made entitled to a share of trust income as a beneficiary but has not been paid that amount, known as an unpaid present entitlement.

Division 7A is an integrity rule that requires benefits provided by private companies to related taxpayers to be taxed as dividends unless they are structured as Division 7A complying loans or another exception applies. This measure will ensure the unpaid present entitlement is either required to be repaid to the private company over time as a complying loan or subject to tax as a dividend.

The Government will also defer the start date of the *Ten Year Enterprise Tax Plan – targeted amendments to Division 7A* measure that was announced in the 2016-17 Budget from 1 July 2018 to 1 July 2019. This will enable all Division 7A amendments to be progressed as part of a consolidated package.

This measure is estimated to have an unquantifiable impact on revenue over the forward estimates period.

3.2 Post-Implementation Review of Division 7A

The Federal Budget announcement provided very little detail as to how the new proposed rules would operate. The announcement simply noted that it would draw on a number of recommendations from the Board of Taxation's Post-Implementation Review into Division 7A.

This review has had a long history as illustrated below.

18 May 2012	Post-implementation review of Division 7A announced.
20 December 2012	The Board of Taxation released its first discussion paper.
30 June 2013	Report due to be complete.
8 November 2013	Extension to terms of reference and reporting date.
25 March 2014	The Board of Taxation released its second discussion paper.
31 October 2014	Extended report completion date.
12 November 2014	Post-implementation review of Division 7A completed.
4 June 2015	The Government announced the release of the report.
3 May 2016	Budget statement regarding 1 July 2018 introduction.
8 May 2018	Budget statement regarding UPEs and 1 July 2019 introduction.

3.3 The Board of Taxation's proposed rules for pre-existing loans and UPEs

There were alternative models proposed by the Board of Taxation in its report. However, it was generally understood that the Government was favouring the introduction of a model that would comprise the "Amortisation Model" together with a structure for a "Business Income Election".

In brief, the amortisation model was proposed to involve the following elements:

- The statutory interest rate would be the Reserve Bank of Australia's indicator lending rate for a small business; variable; other; overdraft for the month of May immediately before the start of that income year.
- The maximum loan term would be 10 years.
- The prescribed maximum loan balances during the term of the loan (including any accumulated interest) would be as follows:
- 75 per cent of the original loan by the end of year three;
- 55 per cent of the original loan by the end of year five;
- 25 per cent of the original loan by the end of year eight; and
- 0 per cent of the original loan (that is, fully repaid) by the end of year 10.
- Subject to meeting the maximum loan balances, there would be no specified annual principal repayments.
- Interest would be able to be accrued annually but would have to be paid by the end of years 3, 5, 8 and 10.

The business income election arrangement is best summarised by the illustration below taken from the Board of Taxation's report.[4]

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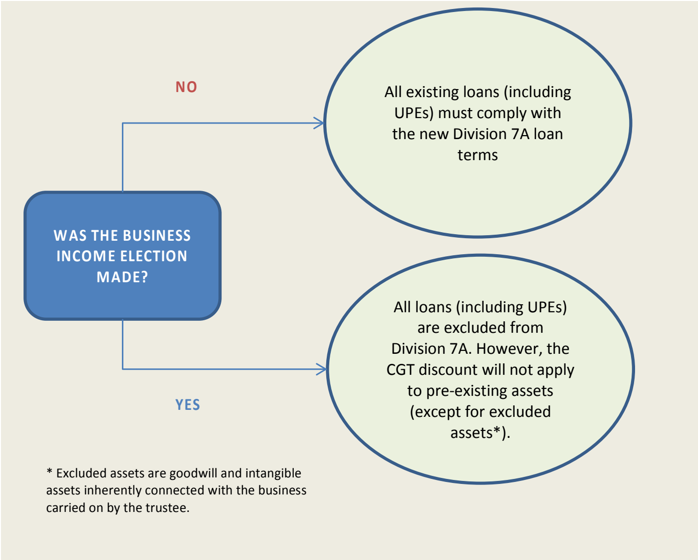
[4] Board of Taxation, Post Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936 (November 2014), p48.



One key element of the Board of Taxation's recommendations was that all existing loans and UPEs (except for complying 25-year loans) would enter the new amortisation and business income election system. The table below summarises the Board of Taxation's proposed transitional rules for existing loans and UPEs.[5]

Table 2

Proposed rules for pre-existing loans and UPEs

Pre-1997 loans	Repayable with interest over 10 years from the date of enactment in accordance with new complying loan rules.
Pre-2009 UPEs	
Post-2009 UPEs	
Complying seven-year loans	Term extended to 10 years, repayable with interest, in accordance with new complying loan rules.
Complying 25-year loans	Repayable in accordance with existing terms (that is, grandfathered).

3.4 Treasury's Consultation Paper

On 22 October 2018 Treasury released a Consultation Paper to seek stakeholder views on proposed amendments to Division 7A that draws on, but includes **significant departures** from, the recommendations in the Board of Taxation's Post-Implementation Review into Division 7A (**the earlier report**).

Some key elements of the proposed new regime outlined in the Consultation Paper include:

[5] Board of Taxation, Post Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936 (November 2014), p34.

1. New “simplified” single ten-year loans with interest charged at the Reserve Bank overdraft rate for small business (which is higher than the current Division 7A rate – for September 2018 it was 8.3% compared with 5.20% for the current Division 7A rate).
2. Not adopting the amortisation model with principal repayments at the 3, 5, 8 and 10 years from the earlier report. Instead requiring annual interest and principal payments.
3. Regardless of when a repayment occurs during the income year, interest will be for the full year.
4. The transitioning of both 7 and 25-year loans under Division 7A into the new regime. The earlier report had recommended grandfathering (preserving) 25-year loans under the existing arrangements.
5. Both existing 7 and 25-year loans will be subject to the new higher overdraft interest rate as from 1 July 2019.
6. Existing 7-year loans will keep their current outstanding term when transitioned into the new regime, but existing 25-year loans must be put on new 10 year complying loan arrangements prior to the lodgment day of the company tax return for the 2021 income year.
7. Both pre-4 December 1997 loans (with the benefit of a two-year grace period) and unpaid present entitlements (UPEs) arising on or after 16 December 2009 must be put on new complying ten-year loans. The proposal does not address pre-16 December 2009 UPEs (which appear quarantined under the proposed new regime).
8. The removal of the concept of distributable surplus such that there is no limit to the amount that may trigger a deemed dividend under Division 7A.
9. The extension of the review period for Division 7A to 14 years after the end of the income year in which the loan, payment, or debt forgiveness triggered, or would have triggered, a deemed dividend.
10. The earlier report’s recommendation for a once-and-for-all election to exclude loans from companies (including UPEs owing to companies) from the operation of Division 7A (the ‘business income election’) is not included in the proposed regime, despite the earlier report noting that the election to be excluded from Division 7A should accompany the new loan model.

The Consultation Paper takes a “pick and choose” approach from the earlier report, removing the ability to choose to be excluded from the Division 7A regime, while introducing many of the penal aspects.

There are several further proposed amendments relating to:

- non-resident private companies;
- new safe harbour measures for the use of assets by a corporate taxpayer;
- amendments to the timing rules in section 109CA(2);
- amendments to the interaction between debt forgiveness and loans;
- amendments to section 109M that addresses loans made in the ordinary course of business;

- removing some of the restrictions around the interposition of entities in 109T to extend the operation of this provision; and
- the integration of Division 7A and fringe benefits tax and deductibility of payments.

The significant departures Treasury has taken from the Board of Taxation's earlier report, present a number of challenges for businesses in respect of cash flow and funding of business activities.

Submissions on Treasury's proposals are due by 21 November 2018. In light of the substantial departure from previous proposals, and in the absence of any statement from the Government that there has been a change in policy on Division 7A, it is anticipated that the proposed 1 July 2019 start date may not be realistic. However, whilst much consultation and discussion on the proposals are needed, this may not necessarily occur. It is therefore imperative that businesses carefully consider the implications should Treasury's proposed changes be enacted in the form proposed.

3.5 Division 7A proposed changes – What does it mean to your existing loan?

One of the key elements of the proposed new regime consists of transitioning existing 7 and 25-year loans under Division 7A into 10-year loans.

If the amendments outlined in the Consultation Paper become law, they will apply from 1 July 2019.

3.5.1 The new benchmark interest rate

As noted above, the interest on the 10-year loans will use the Reserve Bank of Australia overdraft rate for small business (the **RBA Rate**), currently 8.30%, which is higher than the current Division 7A rate of 5.20% (the **Division 7A Rate**).

3.5.2 What does the single 10-year loan model mean to those who have an existing 25-year loan?

The Consultation Paper states that all existing 25-year Division 7A loans as at 30 June 2019 will be exempt from most of the proposed changes for two-years until 30 June 2021 (the **Transitional Period**). However, the interest rate payable on loans during the Transitional Period must equal or exceed the RBA Rate rather than stay at the Division 7A Rate.

After the Transitional Period, the outstanding principal will give rise to a deemed dividend of that amount unless a 10-year compliant loan is put in place prior to the lodgment day for the 2021 income year.

In practice, this means that those who have existing 25-year loans in place have approximately 3 years after the start date of 1 July 2019 until they are forced to decide whether they pay the outstanding loan amount or convert such amount into a 10-year compliant loan. The impact of that will depend on when the 25-year loan began.

For example, if the 25-year loan began in 2001, by 2021 the loan will have been in place for 20 years. It appears that the remaining principal (if not repaid) could be put on a 10-year compliant loan giving a combined loan period of 30 years. Conversely, if the loan began in 2016, the combined term of the original 25-year loan that is replaced by a 10-year loan in 2021 will be 15 years. That is, a reduction of 10 years.

3.5.3 What does the 10-year loan model mean to those who have a 7-year loan?

The Consultation Paper states that all existing 7-year Division 7A loans as at 30 June 2019 will retain their existing outstanding term, but the interest rate during the Transitional Period must equal or exceed the RBA Rate rather than stay at the Division 7A Rate.

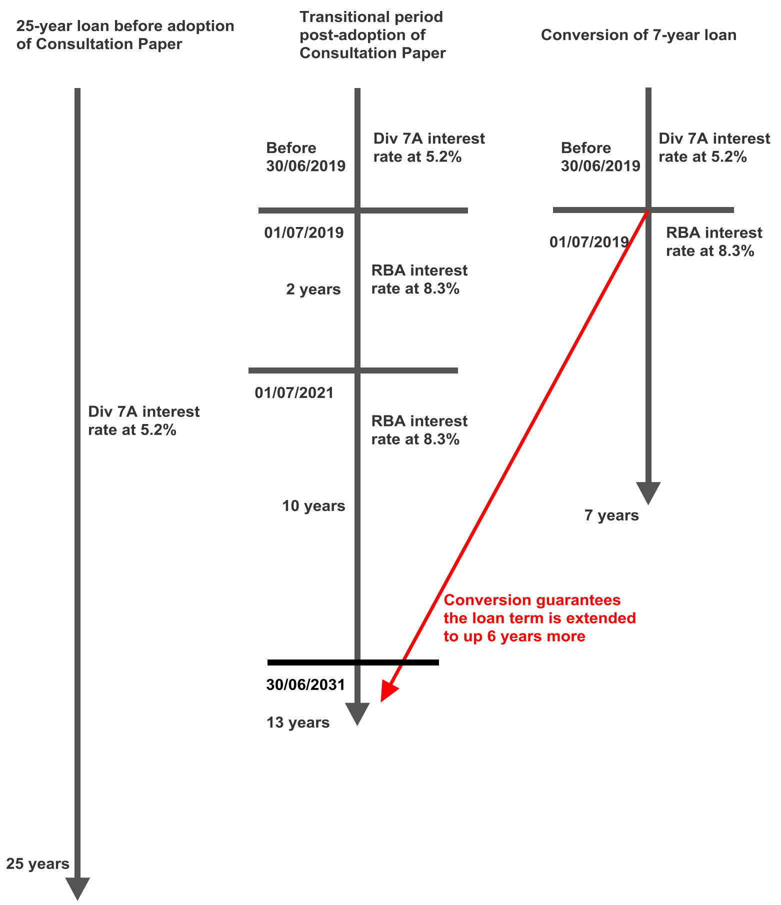
For instance, the Consultation Paper uses the example of 7-year loans maturing on 30 June 2021. The loans will continue to mature on that date. However, from 1 July 2019 interest will be at the RBA Rate.

3.5.4 Why convert your 7-year loan into a 25-year loan before 30 June 2019?

If you have an existing 7-year loan and real property which could serve as security, you may want to consider refinancing it into a 25-year loan before the proposed regime starts on 1 July 2019.

For instance, if you borrowed under a 7-year loan in the 2018 income year, your loan will mature in the 2025 income year. If you convert such a loan into a 25-year loan agreement before 30 June 2019, the balance of the 25-year loan will become a 10-year loan in 2021, with the loan fully repaid in 2031. The conversion from a 7 to 25-year loan means that repayment of the loan occurs over 13 years, as opposed to the original 7-years.

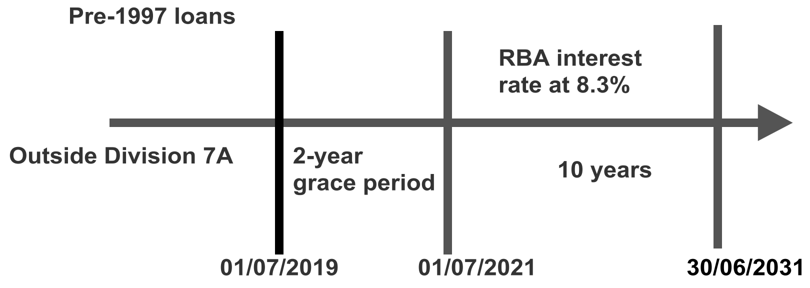
The chart below illustrates the treatment of 7 and 25-year loans under Division 7A and under the regime proposed in the Consultation Paper.



3.5.5 What does the single 10-year loan model mean to pre-1997 loans?

For outstanding pre-1997 loans as at 30 June 2018, the proposed regime will provide borrowers with a grace period of 2 years before the first repayment is due with repayment due over the following 10 years.

This means that prior to the lodgment day for the 2021 income year, taxpayers must decide to either pay the outstanding loan amount or convert such amount into a 10-year complying loan agreement.



3.6 Strategies

As a consequence of the proposed new rules and the start date of 1 July 2019, businesses need to start considering how they will address existing loans and UPEs within the new regime.

An option (***although this will require immediate attention***) is to put certain arrangements on complying 25-year loan terms. Although those 25-year loans will **not** be grandfathered from the operation of these new measures (as recommended under the earlier report), putting loans and UPEs on 25-year complying arrangements may provide a better means of managing complex cash flow requirements of businesses. This is on the basis that the business will have an extended period to manage repayments as compared to current seven-year loans entering the new regime.

As an example, consider a current Division 7A loan with 5 years remaining on its term.

If the loan was a complying 7-years, then as at 30 June 2019 it must comply with the new proposed loan model and new benchmark interest rate. However, the loan will retain its existing outstanding term. As such, in addition to interest charged at the new benchmark interest rate, the full repayment of the loan would be due by 30 June 2024.

If, however, the loan was a complying 25-year loan, then it will be exempt from most changes until 30 June 2021. Interest will be payable during this time at, at least, the benchmark interest rate. From 30 June 2021, provided a complying loan agreement is put in place before the lodgment of the 2020-21 company tax return, the loan will then be transitioned to a 10-year loan. As a result, the business would have until 2031 to ensure the loan is fully repaid.

One of the requirements to substantiate a complying 25-year loan is the registered security over real property. Steps will need to be taken immediately to ensure you have sufficient time to negotiate arrangements with other secured lenders over those properties in order register the necessary security.

One area where there is some misunderstanding in relation to the operation of the 25-year secured loan arrangement is who can provide that security. In a series of “frequently asked questions” published by the ATO at the time of the implementation of the then new Division 7A measures, the ATO specifically addressed these issues. The comments from that frequently asked questions document (now since removed from the ATO website) are outlined below:

> **47. Can the registered mortgage security be provided by an entity other than the shareholder or shareholder’s associate?**
>
> Yes. An entity other than the shareholder or shareholder’s associate can provide the registered mortgage security for a loan. However, for Division 7A purposes, the giving of security constitutes a guarantee. Consequently, if the entity providing the security is a private company and the borrower is a shareholder or shareholder’s associate of that private company, the provision of security may be treated as the payment of a dividend under sections 109U and 109UA.
>
> …
>
> **48. Can the security provided for a loan to a shareholder or shareholder’s associate be a registered second, third or fourth mortgage over real property?**
>
> Yes. This is provided that 100% of the value of the loan is secured by the registered mortgage and, when the loan is made, the market value of the property less the amounts of any other liabilities secured over that property in priority to the loan, is at least 110% of the value of the loan.

3.7 Conclusion on Division 7A Changes

The proposed changes to Division 7A currently create uncertainty for taxpayers and have the potential to significantly impact the funding and cash flow of businesses. Whilst we await further discussion and consultation from Treasury, this provides an opportunity for businesses to ‘clean up’ existing loans in preparation to ensure the impact the new regime on their business is minimized. This may means anticipating shorter repayment terms and increased repayments and making provisions in cash flow or moving loans to complying 25-year agreements.

It is noted however, that when undertaking either approach it is important to consider the asset protection elements of the existing structure and not solely the taxation consequences. If undertaking steps to discharge, release, forgive or assign amounts between entities, taxpayers should ensure that such steps are consistent with the business’ succession plan. However often asset protection and succession planning objectives can’t both be achieved.

There is no one simple solution to these challenges. The key task is to identify the issues for the business and work with the business, the relevant shareholders and their associates as well as their advisors, to create a plan that achieves the best balance of asset protection, taxation efficiency and succession planning. This will need to consider both the current day issues and the future structuring of the business’ investments. We discuss asset protection considerations in further detail at part 5.

4 Identifying loans and UPEs in a business

Whereas tangible assets rarely shift between entities, loans and UPEs may vary from year to year and throughout the year. Further, the main source of information in respect of the existence of the loans and UPEs (the financial statements) is very much an historical record rather than a current recording of the existence of the amounts.

Whilst practitioners can look to management accounts and other contemporaneous records of movement of funds to determine the current status of the loans and UPEs those statements themselves may be misleading noting that the amounts may ultimately be set off against other entitlements, or extinguished through payments, distributions or declaration of dividends before the end of the relevant financial year.

That said, advisers can only work with the information they have available to them. In that respect, some practical guidelines to assist in identifying loans and UPEs in a business include the following:

- Do not rely on the client's recollection.
- Get access to the financial statements for the last three financial years to enable identification of movements in the amounts over those periods.
- Review all entities in case the loan or UPE amount only appears in one set of accounts.
- Review both the assets and liabilities of the business.
- Note that sometimes there is a "negative" asset or liability shown in the financial statements, i.e. $1,000 vs ($1,000).

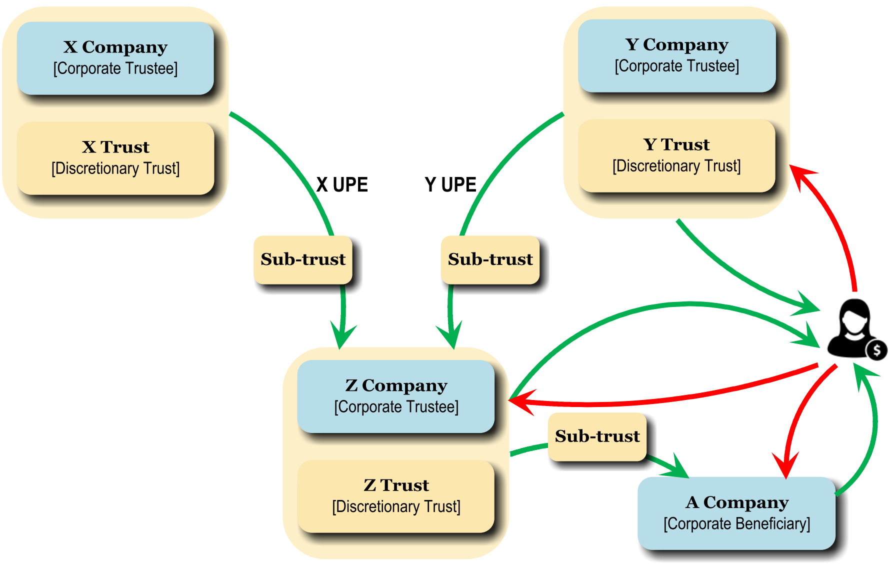
5 Asset protection

5.1 Identifying risk exposure and balancing objectives

If a business intends to “clean-up” the loans and UPEs, it is important to consider the asset protection elements of the existing structure, not simply the taxation consequences. This issue is becoming particularly relevant in 2018 in light of the proposed changes to the Division 7A which may be prompting a number of businesses to address existing loans and UPEs.

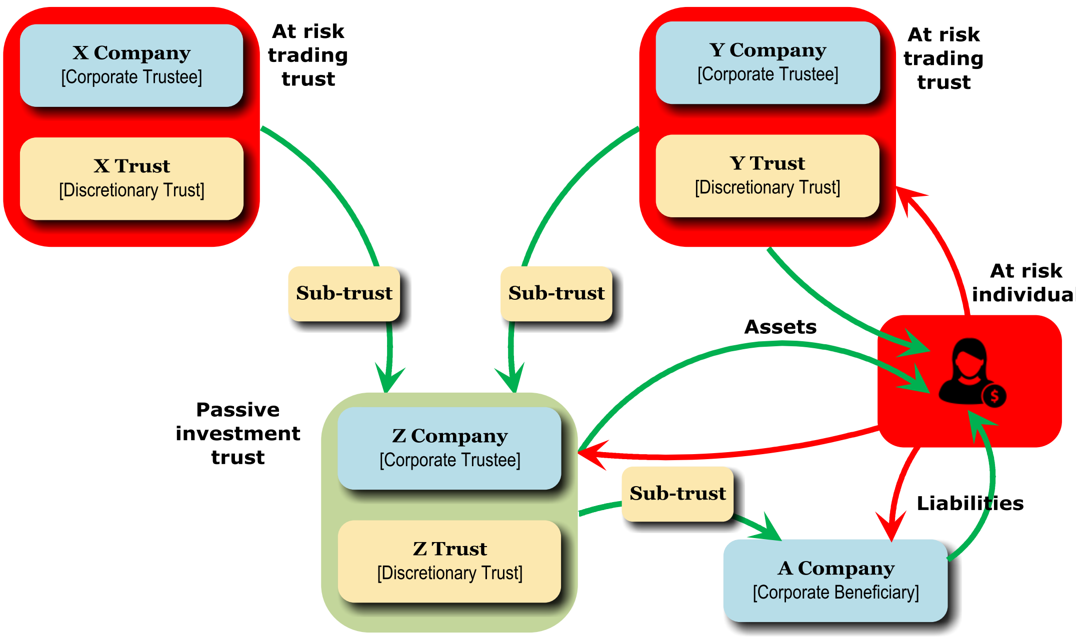
For advisors, as part of this “clean-up” process it is important to assist clients in identifying parts of the structure that are exposed to risks as a result of the loans and UPEs.

The risk exposure becomes particularly relevant when considering succession planning. In the example illustrated below, there are two trusts that are trading with the public and therefore have an element of exposure to risk through that activity. The exposure could range from product liability claims on goods manufactured, negligence claims for consulting advice, liabilities to pay for orders for product, or PAYG liabilities for employees as some examples. Similarly, the key individual may be exposed to risk through numerous activities such as providing personal guarantees for finance to trading entities through to exposure as a director for liabilities incurred by trading trusts.



Depending upon the nature of the business and the objectives being sought, it may be desired to release an individual from any liabilities it has to the passive investment trust (the Z Trust in the illustration below), the at risk trading trust (Y Trust) and the corporate beneficiary (A Company), whilst retaining the assets being the amount due to be paid to the individual by A Company and the UPEs in the Y Trust and the Z Trust. This will enable the business to pass the assets (being the debt owed by A Company and the UPEs owed by Y Trust and Z Trust) through to one or more testamentary trusts.

However, from an asset protection perspective, dealing with the loan accounts and UPEs leaves the trust and a company exposed to risk (even though they are otherwise not trading with the public or have any direct exposure) through the risks to which the testator is exposed. Claims made against the testator may then indirectly expose the assets in Z Trust and A Company.



Alternatively, if the loans are addressed with a focus on asset protection, then this may not achieve the business' planning objectives. That is, removing the assets from the at-risk individual during their lifetime leaving them only with the liabilities may limit the ability to get assets into testamentary trusts. Getting assets into testamentary (discretionary) trusts may be more effective for the business' succession planning and ultimate asset protection and taxation efficiency after the death of the at-risk individual.

5.2 Corporate beneficiaries

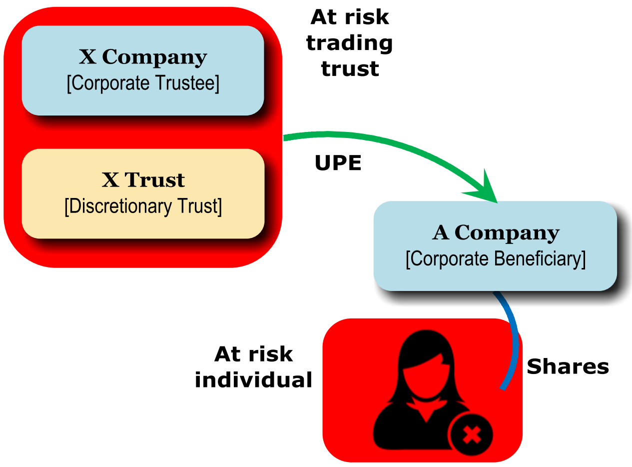
Corporate beneficiaries are one of the key problems faced by businesses when addressing the taxation implications of dealing with loans and UPEs. The tax law is designed to ensure that companies are not manipulated in such a way that enables income that has been taxed at the favourable corporate rate to be applied directly or indirectly for benefit to non-corporate taxpayers, such as individuals or trusts.

The involvement of the corporate beneficiary does not need to be direct to trigger potential taxation liabilities. The presence of the corporate beneficiary at any point within the chain of distribution of income will be sufficient to potentially trigger a tax liability.

From a structuring perspective, many older corporate beneficiaries have individual taxpayers holding the shares. This is particularly problematic when the person holding the shares is exposed to risk. Not only will the shares themselves be exposed to the risks to which the individual is exposed, but also all dividends paid on those shares will be paid to the at-risk individual.

As many of these arrangements have seen substantial UPEs to the corporate beneficiary built up over time, the shares in the corporate beneficiary may have significant market value but little cost base. Therefore, it is not simply an exercise in transferring the shares in a corporate beneficiary to a better structure for asset protection tax efficiency such as a discretionary trust as that could trigger significant capital gains tax liabilities.

Estate and succession planning may provide opportunities to address these problems by passing the shares through the estate to testamentary trusts. These issues are further considered at part 7.12 of the paper below.



6 Dealing with loans

6.1 Forgiven debts treated as dividends

Division 7A of ITAA 36 contains specific provisions which address the forgiveness of debts where a private company forgives the debt of a shareholder or its associate.

If the forgiveness triggers the operation of Division 7A then the amount of the loan forgiven may be treated as a deemed dividend[6] (subject to the amount of the distributable surplus[7] of the company).

Section 109F(3) of Division 7A of ITAA 36 provides that the amount of a debt is forgiven if, and when, the amount would be forgiven under section 245-35 or 245-37 of the ITAA 97 (the commercial debt forgiveness provisions).

There are a number of other circumstances that may trigger debt forgiveness for the purposes of Division 7A:

- a loan may be treated as forgiven where it is transferred to an entity where a reasonable person would conclude that entity is not going to require payment of the debt (debt parking).[8]
- a loan may be treated as forgiven by a failure to rely on obligation to pay.[9]

The first instance of forgiveness triggers the operation of the provisions.[10] For example, a debt may be forgiven by the entering into a deed of forgiveness, the ability to recover the amount due under the loan becoming statute barred (see section 6.3 of the paper below) or by a failure to rely on the obligation to pay. Although each of these events may trigger the forgiveness of the debt for the purposes of Division 7A, the first to occur may be the failure to rely on the obligation to pay.

Debt forgiveness is not treated as a dividend where:[11]

- it's made in favour of another company, unless the other company owed the debt in its capacity as trustee;
- the debt is forgiven because the debtor becomes bankrupt or because of Part X of the *Bankruptcy Act 1966;*
- the debt or part of a debt results from a loan that has been treated as a Division 7A dividend in the current or previous income years; or
- the Federal Commissioner of Taxation (**the Commissioner**) exercises his discretion to not treat the debt forgiveness as a dividend.

[6] Sections 109F and 109Z ITAA 36.
[7] The concept of “distributable surplus” is addressed in section 109Y ITAA 36.
[8] Subsection 109F(5) ITAA 36.
[9] Subsection 109F(6) ITAA 36.
[10] Subsection 109F(8) ITAA 36.
[11] Section 109G ITAA 36.

6.2 Assigning a Division 7A loan

In addition to forgiveness of debts, the assignment of a Division 7A loan can also create issues for businesses and is something to be mindful of.

The terms of section 109F(5) of ITAA 36 could be easily overlooked and should therefore be kept in mind. The section states:

> (5) An amount of debt an entity (the debtor) owes a private company is also forgiven for the purposes of this Division if:
>
> (a) the private company assigns the right to receive payment of the amount to another entity (the new creditor) who is either:
>
> (i) an associate of the debtor; or
>
> (ii) a party to an arrangement with the debtor about the assignment; and
>
> (b) a reasonable person would conclude (having regard to all the circumstances) that the new creditor will not exercise the assigned right.

Therefore, where a debtor remains the same, but the creditor changes this section could apply. This may arise where a private company assigns its rights in respect of a debt to a family trust.

Where the loan that is assigned remains on Division 7A terms and continues to be serviced by the borrower, it is unlikely to trigger this section. However, where the terms of the loan are reset to “at call and interest free” this section could apply. “At call and interest free” loans are common arrangements within private groups and therefore should be considered.

In the circumstance where a business assigns a loan for consideration then an additional Division 7A may also arise. The entity acquiring the debt will have an amount payable to the original lender (the consideration amount). Where this amount remains unpaid a Division 7A issue will result.

6.3 Statute barred loans

6.3.1 Background

As evidenced by the number of cases run on disputes as to the issue, there is a great deal complexity around the concept of statute barred loans.

The central concept of a loan being statute barred is that the creditor either loses its right to sue for recovery of the debt or is unable to enforce its right for recovery of the debt due to the operation of a statute of limitations. The length of the limitation period and the consequences of the expiration of the limitation period, varies between the different States and Territories, In *Brisbane South Regional Health Authority v Taylor*[12], the rationales of the limitation regimes were described by McHugh J:

> 6. The effect of delay on the quality of justice is no doubt one of the most important influences motivating a legislature to enact limitation periods for commencing actions. But it is not the only one. Courts and commentators have perceived four broad rationales for the enactment of limitation periods. **First**, as time goes by, relevant evidence is likely to be lost. **Second**, it is oppressive, even "cruel", to a defendant to allow an action to be brought long after the circumstances which gave rise to it have passed. **Third**, people should be able to arrange their affairs and utilise their resources on the basis that claims can no longer be made against them. Insurers, public institutions and businesses, particularly limited liability companies, have a significant interest in knowing that they have no liabilities beyond a definite period. As the New South Wales Law Reform Commission has pointed out: "The potential defendant is thus able to make the most productive use of his or her resources and the disruptive effect of unsettled claims on commercial intercourse is thereby avoided. To that extent the public interest is also served." Even where the cause of action relates to personal injuries, it will be often just as unfair to make the shareholders, ratepayers or taxpayers of today ultimately liable for a wrong of the distant past, as it is to refuse a plaintiff the right to reinstate a spent action arising from that wrong. The **final rationale** for limitation periods is that the public interest requires that disputes be settled as quickly as possible. [13]
> [Emphasis added]

6.3.2 How to determine if a debt is statute barred.

In practice, the following key issues arise when determining whether a debt is statute-barred[14]:

- what is the relevant limitation period;
- when was the beginning of the limitation period;
- has the limitation period has been extended or re-started.

The limitation period is generally six years (except for the Northern Territory where it is three years) from the date that the right to sue to recover commences.

At call loans present an interesting challenge in respect of determining the commencement of the limitation period. Generally, the courts have found that the limitation period commences upon the date of advance of the at call loan unless there is some other condition that must be satisfied before the call may be made for recovery.

Where loans between entities are not documented, they will generally be simple at call loans where the limitation period commences upon the loan first being advanced. If the loan is documented in a formal loan agreement, conditions may be placed in respect of the loan to ensure that the limitation period only commences upon the call actually being made.

The limitation period can be extended if the debtor acknowledges that debt or makes a part payment of the debt.[15] Where loans are between entities within a commonly controlled group, the loan appearing

[12] *Brisbane South Regional Health Authority v Taylor*, 186 CLR 541.
[13] Ibid p. 553.
[14] ASIC (Australian Securities & Investments Commission), 'Collecting statute-barred debts', Report 55 (September 2005), p. 6.
[15] *Fischer v Nemeske Pty Ltd* [2015] NSWCA 6.

in the accounts of both the creditor and debtor entity will often be sufficient to evidence the continued acknowledgement of the debt such that the limitation period continues to be extended.

Where one of the parties does not prepare financial accounts (such as an individual) then the failure to have that party acknowledge the continued existence of the debt may mean the limitation period is extinguished at the earlier time. The acknowledgement must be by both parties. There is some complexity where the individual is also the director of the company or corporate trustee that signed the accounts acknowledging the existence of the debt. Barrett JA addressed one such scenario in the Court of Appeal decision of *Fischer v Nemeske Pty Ltd*[16]:

> 4. In particular, a right of action at law derived from the deed of 30 August 1995 but became statute-barred in August 2007 unless, before that date, Nemeske had acknowledged the cause of action in accordance with s 54 of the Limitation Act.
>
> 5. The Directors' Declaration dated 25 May 2004 in respect of the financial statements of Nemeske for the year ended 30 June 2003 constituted such an acknowledgment.
>
> 6. Because of that acknowledgment and the effect of s 54, the debt action brought by Mr Nemes's estate (he being the survivor of himself and his wife) was not statute-barred when the cross-claim initiating that action was filed on 26 September 2013.

6.3.3 The Western Australian provisions

The Limitations Act 2005 (WA) (**the 2005 Act**) which came into operation on 15 November 2005 and its companion Act, the Limitation Legislation Amendment and Repeal Act 2005 (WA), brought substantial changes to the limitation of actions in Western Australia.

In contrast to most of the other jurisdictions which renewed and modified their legislation between 1955 and 1985, Western Australia continued to use the Limitation 1935 Act (WA) which reproduced old English legislation which was enacted between the 17th and 19th century. This led to great discrepancies, for example, while the courts have the power to extend the ordinary limitation period in a personal injury case in every other State and Territory, this was not possible for Western Australian courts before 2005.

The 2005 Act indirectly results from the 1997 report of Law Reform Commission of Western Australia (LRCWA) on Limitation and Notice of Actions.

The 2005 Act includes two general innovations. First, the general limitation period in section 13 of the 2005 Act. The general or 'catchall' limitation period applies in all cases for which no specific limitation periods are provided and is six years in Western Australia. Because of the introduction of a general limitation period, specific provisions for a large number of actions are not required anymore, for example actions on a judgment.

[16] *Fischer v Nemeske Pty Ltd* [2015] NSWCA 6, para 114.

Section 13 provides as follows:

13 General limitation period — 6 years

(1) An action on any cause of action cannot be commenced if 6 years have elapsed since the cause of action accrued.

(2) Subsection (1) does not apply to an action if Division 3 provides for a different limitation period for that action.

The period for causes of action founded on a deed is 12 years.

18 Deeds — 12 years

An action on a cause of action founded on a deed cannot be commenced if 12 years have elapsed since the cause of action accrued.

Second, the 2005 Act introduced section 38 which `allows a court to extend the limitation period (up to three years) in cases of fraud or improper conduct. In contrast to other modern Acts, the 2005 Act grants the courts the power to extend the limitation period instead of just delaying the running of the period or limiting the provisions to certain cases.

In Western Australia, the limitation period can be extended where the cause of action is confirmed. Section 47 of the 2005 Act states:

47. If a cause of action lies against a person (either solely or with other persons) and the person confirms the cause of action —

(a) after the limitation period provided for under this Act for the cause of action begins to run; and

(b) before that limitation period expires,

the time during which the limitation period runs before the confirmation is made does not count in the reckoning of the limitation period for an action on the cause of action by a person having the benefit of the confirmation against a person bound by the confirmation.

Section 46 of the 2005 Act determines the meaning of confirmation as follows:

46 (1) For the purposes of this Act, a person confirms a cause of action if the person —

(a) acknowledges, to a person having the cause of action (***person A***), person A's right or title, even though the acknowledgment does not disclose a promise to pay;

(b) makes, to a person having the cause of action (***person B***), a payment in relation to person B's right or title and makes the payment in circumstances not inconsistent with an acknowledgment of that right or title; or

(c) makes, to a person having a cause of action to foreclose the equity of redemption of mortgaged property or to recover possession of mortgaged property (***person C***), a payment of principal or interest secured by the mortgage or a payment to person C otherwise in relation to person C's right or title to the mortgage.

(2) In subsection (1) a reference to a person having a cause of action is a reference to the person having the cause of action either solely or with other persons.

6.3.4 Expiration of the limitation period

A fundamental difference exists between the legislation of Western Australia (and other States and Territories) and the legislation of New South Wales. In Western Australia (and other States and Territories), the debt will still exist after the limitation period has expired. In New South Wales the debt is extinguished after the limitation period has expired.

Thus, whilst in Western Australia (and other States and Territories) the creditor may sue the debtor for recovery of the amount, the debtor can use the expiration of the limitation period as a defence.

However, in New South Wales, a debt is wholly extinguished when the limitation period expires. Section 63 of the Limitation Act 1969 (NSW) states:

> (1) Subject to subsection (2), on the expiration of a limitation period fixed by or under this Act for a cause of action to recover any debt damages or other money, the right and title of the person formerly having the cause of action to the debt damages or other money is, as against the person against whom the cause of action formerly lay and as against the person's successors, extinguished.
>
> (2) Where, before the expiration of a limitation period fixed by or under this Act for a cause of action to recover any debt damages or other money, an action is brought on the cause of action, the expiration of the limitation period does not affect the right or title of the plaintiff to the debt damages or other money:
>
> > (a) for the purposes of the action, or
> >
> > (b) so far as the right or title is established in the action.
>
> (3) This section does not apply to a cause of action to which section 64 or section 65 applies.

6.3.5 Division 7A implications for statute barred loans

An interesting issue arises regarding the different consequences for statute-barred debts in Western Australia (where a debt will still exist) and New South Wales (where a debt is wholly extinguished), when it comes to section 109F of the ITAA 36.

Section 109F(3) of the ITAA 36 Act states:

> (3) An amount of a debt is forgiven for the purposes of this Division if and when the amount would be forgiven under section 245-35 or 245-37 of the Income Tax Assessment Act 1997, assuming the amount were a debt to which Subdivisions 245-C to 245-G of that Act apply.

The following legislative example is provided in section 109F of the ITAA 97:[17]

> Subsection (3) of this section provides that a debt is forgiven if it has not been paid by the time a statute of limitations prevents recovery of the debt. (It does this by applying paragraph 245-35(b) of the Income Tax Assessment Act 1997.) The debt might already have been forgiven under subsection (6) of this section (because a reasonable person

[17] In accordance with s.950-100 ITAA 97 examples form part of the Act.

> would have concluded earlier that the private company was not going to insist on payment). This section would apply to the forgiveness under subsection (6) but not the forgiveness under subsection (3).

Section 245-35(b) of the ITAA 97 determines:

> A debt is forgiven if and when:
>
> (b) the period within which **the creditor is entitled to sue for the recovery of the debt ends**, because of the operation of a statute of limitations, without the debt having been paid.
>
> [Emphasis added]

There is an inconsistency between the provisions.

The legislative example to section 109F states that "a debt is forgiven if it has not been paid by the time a statute of limitations **prevents recovery** of the debt". This would apply to treat debts where the relevant limitation period has expired as having been forgiven.

However the operative part of section 109F(3) requires the debt to be forgiven within the meaning of paragraph 245-35(b) ITAA 97. As noted above that section requires the "period within which the creditor is **entitled to sue** for the recovery of the debt" to end. This may **not** treat debts where the relevant limitation period has expired as having been forgiven (save for those governed by the New South Wales legislation) as the creditor could still sue for recovery of the debt. It is just that the debtor could use the defence of the expiration of the limitation period.

6.3.6 Practice Statement Law Administration (General Administration) PS LA 2006/2 (GA) and pre-1997 loans

The Practice Statement Law Administration (General Administration) PS LA 2006/2 (GA) addresses the complexity in these state based limitation period laws for pre-1997 loans that have become statute-barred. It is explained, that statute-barred loans made prior to the enactment of Division 7A will not be treated as giving rise to a deemed dividend under Division 7A. In achieving that outcome the PSLA states:

> 3. The **ATO view** is that a loan by a private company to a shareholder, or a shareholder's associate, **will be deemed to be a forgiven debt merely by the fact that the statutory period under the relevant Limitations Act ends**. This also applies to relevant loans made by trustees which become statute barred. Subsequent refreshment of a loan after the statutory period under the relevant Limitations Act ends does not create a new loan to which Division 7A of the ITAA 1936 applies.

However, as PS LA 2006/2 (GA) only deals with pre-1997 loans and from the perspective of not taking active compliance action. Post 1997 loans (and pre-1997 loans if the Commissioner determines to alter his position) based on either:

1. continued confirmation by payment or acknowledgement; or
2. technical deficiencies in the operation of s109F(3) when read with paragraph 245-35(b) ITAA 97 only treating those debts with expired limitation periods governed by New South Wales law as having been forgiven;

may still be in existence for Division 7A purposes.

PS LA 2006/2 (GA) alludes to this possibility in paragraph 6 where the Commissioner notes that the matter is not entirely free from doubt:

> 9. The ATO view is that a loan by a private company to a shareholder, or a shareholder's associate, will be deemed to be a forgiven debt merely by the fact that the statutory period under the relevant Limitations Act ends. However, for the reasons outlined above it is also recognised that the **matter is not entirely free from doubt**.

This is relevant in light of the Treasury Consultation Paper that provides that pre-1997 loans that have not been forgiven must be paid out or put onto complying loan terms after a transitional period. The paper states at page 7:

> For outstanding pre-1997 loans (i.e. **those loans which have not already been forgiven** and continue to be reported in tax returns), the proposed transitional rule will provide an affected borrower with a two year grace period before the first repayment is due, with the loan to be repaid over the subsequent 10 years.
>
> Under the transitional rules, pre-1997 loans will be taken to be financial accommodation as at 30 June 2021. The taxpayer will have until the lodgment day of the 2020-21 company tax return to either pay out the amount of the loan or put in place a complying loan agreement, otherwise it will be treated as a dividend in the 2020-21 income year. The first repayment will be due in the 2021-22 income year.[18]

There are potentially two approaches to this issue.

First, the Commissioner's reasoning outlined in PS LA 2006/2 (GA) may used for an argument justifying the taxpayer (using the Commissioner's own words) "as a matter of practical compliance and sensible administration" adopting an interpretative approach that confirms the debt has been forgiven. Paragraphs 4 and following of PS LA 2006/2 (GA) extracted here identify those issues.

> 4. However, this decision not to treat statute barred loans as giving rise to a deemed dividend recognises a number of factors. These include:
>
> - the complexity of Division 7A of the ITAA 1936 and the fact that this particular issue arises from the **interaction of two quite separate codes of law**. The state and territory based limitation of action provisions impact on parts of the income tax law, that is, the commercial debt forgiveness provisions, which in turn affect Division 7A, giving rise to an adverse tax outcome. This means that taxpayers may have been unaware of the effect of this issue on their tax affairs.
> - the **complexity provided by variation in state and territory limitation of action provisions**, leading potentially to differing results across Australia. It is also arguably unclear how provisions in some state and territory laws that 'revive' statute barred debts will apply.
> - the general scheme of Division 7A of the ITAA 1936 to 'grandfather loans' made before its introduction, and the doubt this brings to an interpretation leading to the **outcome that mere inaction would cause a significantly unfavourable tax outcome**.
> - this issue provides no ongoing risk to the tax system. Current provisions in Division 7A of the ITAA 1936 mean that a loan would be brought to account as a deemed dividend at a point in time before it could be deemed forgiven merely by expiration of the statutory period under a relevant Limitations Act.

[18] The Treasury "Targeted amendments to the Division 7A integrity rules", October 2018.

- issues of **inequity amongst taxpayers** arise because of the significantly differential treatment that limitations in the operation of the amendment provisions at section 170 of the ITAA 1936 cause. Action to amend assessments would necessarily be limited to only a small proportion of loans taken out shortly before enactment of the provisions in Division 7A.

- the fact that taxpayers first confronted this issue at a time when they and their tax advisers were dealing with a range of new laws of high volume and complexity. Analysis of old arrangements at this time would be difficult and involve high compliance costs for taxpayers.

5. Therefore, as a **matter of practical compliance and sensible administration**, the Commissioner has decided to take no active compliance action on private company and trustee loans made prior to the enactment of Division 7A of the ITAA 1936 deemed to be forgiven in consequence of the operation of subsection 109F(3) of the ITAA 1936, merely because the period within which the creditor is entitled to sue for recovery of the debt ends by the operation of a statute of limitations.

6. Loans from private companies that have become statute barred after 4 December 1997 **would not, on this basis alone, meet the criteria for application of the general anti-avoidance rule at Part IVA** of the ITAA 1936, or constitute fraud or evasion, or be subject to amendment under section 108 of the ITAA 1936.

[Emphasis added]

Secondly, using the provisions outlined at the start of this part 6, it may be possible to consider the potential to treat the amount as a forgiven debt by a failure to rely on obligation to pay[19] noting that the first instance of forgiveness triggers the operation of the provisions.[20]

6.3.7 Trustees right to recover trust property

Even if the loan is statute barred, there may be other avenues available to creditors to recover the amount. One such instance is where a trust is involved. The trustee may have a right to recover trust property.[21] White J addressed such a situation in the Federal Court decision of *Breakwell v Commissioner of Taxation*[22]:

40. In a case like the present, being an action by a trust to recover trust property, there is no limitation period. That is the effect of s 32(1) of the LAA, which provides:

(1) In any action or other proceeding against a trustee or any person claiming through him, except where the claim is founded on any fraud or fraudulent breach of trust to which the trustee was party or privy, or is to recover trust property, or the proceeds thereof still retained by the trustee, or previously received by the trustee and converted to his use, the following provisions shall apply:

[19] Subsection 109F(6) ITAA 36.

[20] Subsection 109F(8) ITAA 36.

[21] The relevant trust legislation in each state would need to be considered to determine the ability to rely on such a right of recovery.

[22] *Breakwell v Commissioner of Taxation* [2015] FCA 1471, para 40 ff.

(a) All rights and privileges conferred by this Act shall be enjoyed in the like manner and to the like extent as they would have been enjoyed in the action or other proceeding if the trustee or person claiming through him had not been a trustee or person claiming through him.

(b) If the action or other proceeding is brought to recover money or other property, and is one to which no other provision of this Act applies, the trustee or person claiming through him shall be entitled to the benefit of and be at liberty to plead lapse of time as a bar to the action or other proceeding, in the like manner and to the like extent as if the action or other proceeding had been an action for money had and received; and that so this Act shall run against a married woman entitled in possession for her separate use, whether with or without a restraint upon anticipation, but shall not begin to run against any beneficiary unless and until the interest of such beneficiary is an interest in possession.

…

(Emphasis added)

41. Any action by the ABFT against Mr Breakwell to recover the pre-1998 loan would be an action to recover trust property. The LAA does not prescribe any limitation period in respect of claims of that kind.

42. Thus, for this reason too, the contention that the pre-1998 loan was statute-barred and did not have to be brought into account in the calculation of the MNAVT must be rejected.

6.4 Commercial debt forgiveness

"Commercial debt"[23] provisions[24] are aimed at scenarios where the creditor has a tax loss in respect of the debt forgiven and the debtor has claimed deductions in respect of the interest incurred on the loan. The provisions operate by identifying the "net forgiven amount"[25] and adjusting the tax outcomes[26] of the debtor by that amount.

The provisions do not apply to a debt forgiveness treated as a dividend under Division 7A to the extent it is included in a shareholder's or their associate's assessable income.

If not all of the debt forgiven is included in a shareholder's or their associate's assessable income because the amount treated as a dividend is reduced by the private company's distributable surplus, the commercial debt forgiveness provisions may apply to the amount of the debt forgiven that was not included in their assessable income.

Commercial debt forgiveness rules don't apply where the **forgiveness is for reasons of natural love and affection**.[27]

[23] The meaning of commercial debt is outlined in section 245-10 ITAA 97 and in essence relates to a debt where if interest is or had been charged the interest expense is or would have been deductible for income tax purposes.
[24] Division 245 ITAA 97.
[25] Section 245-85 ITAA 97.
[26] Tax losses; net capital losses; expenditures and cost bases of certain CGT assets pursuant to sections 245-115 to 245-195 ITAA 97.
[27] Subsection 245-40(e) ITAA 97.

This has also extended to a commercial debt forgiven by a company because of the company directors' love and affection towards the debtor.[28] However this only extends to the part of the debt that is recoverable at that time.[29]

Importantly, in an estate planning context, the commercial debt forgiveness rules do not apply where the **forgiveness is effected by a will**.[30]

6.5 Capital gains/loss implications

Where the loan is a commercial debt and not a personal use asset[31], and the forgiveness is due to an estate planning objective rather than a capacity to pay, the market value substitution rules[32] may deem capital proceeds for the forgiveness equivalent to the face value of the loan such that there is no capital loss upon the forgiveness.

If it wasn't for the operation of the market value substitution rules then the creditor may have a capital loss equivalent to the difference between the proceeds actually received upon the forgiveness (assume nil) and the cost base of the loan (assume that is the face value of the loan).

If the debt is assigned, again the market value substitution rules[33] may deem capital proceeds for the assignment equivalent to the face value of the loan such that there is no capital loss. However, assignment raises the debt parking issues noted earlier.

6.6 Executor

All real and personal property of the deceased are deemed to have passed to and become vested in the executor as from the death of the individual.

The deceased's property is held absolutely by the legal personal representative for the duration of the administration of the shareholder's estate.

Following the Grant of Probate, the legal personal representative immediately assumes liability to pay the deceased's debts.

6.7 ATO ID 2012/77 and ATO ID 2002/741

In the decision in **ATO ID 2012/77**, the Commissioner states:

…section 109F of the ITAA 1936 operates to deem a private company to have paid a dividend to a deceased's legal personal representative in circumstances where a private company is taken to have made an amalgamated loan to a

[28] ATO Interpretative Decision ATO ID 2003/589.
[29] ATO Interpretative Decision ATO ID 2003/590.
[30] Subsection 245-40(d) ITAA 97.
[31] Subsection 108-20(2)(d) ITAA 97 provides that a debt is a personal use asset where it arises other than in the course of gaining or producing the taxpayer's assessable income; or from the taxpayer carrying on a business.
[32] Section 116-30 ITAA 97.
[33] Section 116-30 ITAA 97.

> shareholder who dies before the amalgamated loan is repaid, and the private company forgives that loan while the shareholder's estate is in administration.

In the reasons for decision, the Commissioner states:

> Because the loan made by the private company to the shareholder satisfied the conditions in subsection 109E(3), it is taken to be an amalgamated loan for the purposes of Division 7A of Part III.

ATO ID 2002/741 considers a scenario where the company made a loan to the shareholder before he died. In finding that private company is not taken to have paid a dividend to the taxpayer (the executor of the deceased estate of the shareholder) for the purposes of Division 7A, the Commissioner states:

> The entity to whom the private company is taken to have paid the dividend must be the same entity to whom the private company made the amalgamated loan.
>
> For subsection 109E(1) of the ITAA 1936 to apply, the private company must have made the loan to the executor of the deceased estate.
>
> Accordingly, as the private company made the loan to the shareholder, the executor of the shareholder's deceased estate is not treated as having received a deemed dividend in respect of the amalgamated loan.

On the ATO's Let's Talk platform practitioners have sought clarity regarding the apparent conflicts between the two interpretive decisions and the general lack of clarity as to how Division 7A operates in respect of deceased estates. The question put to the ATO was in the following terms[34]:

> Guidance on Div7A and deceased estates (ATO ID 2002/71 [sic] and ATO ID 2012/77) Both ATO IDs appear to be contradictory on the same matter. Clarity is needed regarding situations where a loan is made during an income year but the shareholder dies in the following income year before the company's lodgement due date and no actions were undertaken in relation to the loan. Other scenarios such as amalgamated loans, prior to or after probate, should also be included. No clarity right now which ID is the latest. ATO ID 2002/741 last reviewed on 10 June 2014. ATO ID 2012/77 published on 17 September 2012.

The ATO responded to the query noting that they do not believe that there is any inconsistency between the two interpretive decisions but that further clarity would be provided in the future. They stated[35]:

> We've received feedback on ATOID 2002/741 and ATOID 2012/77. While we are of the view that both are correct, and not contradictory, we acknowledge the need to take a closer look at how we can provide clearer guidance on the issues. We'll provide an update here once we have considered this further.

At this time, there has been no further clarification provided by the ATO respect of the two IDs and the apparent conflicts in how they have been expressed.

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[34] ATO Let's Talk- Public advice and guidance community https://lets-talk.ato.gov.au/PAG
[35] ATO Let's Talk- Public advice and guidance community https://lets-talk.ato.gov.au/PAG

7 Dealing with unpaid present entitlements

7.1 Creation of the UPE

A UPE is created when the trustee of a trust makes a determination, pursuant to the terms of the relevant trust deed, to appoint (distribute) income or capital to a beneficiary of the trust. Generally, 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.[36]

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.[37]

7.2 Satisfaction/discharge of the UPE

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. Therefore, on the discharge of a chose in action (such as a UPE) by payment, CGT event C2 will occur.

In private rulings, the Commissioner 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.[38]

The Commissioner finds support for the look-through approach from the Full Federal Court decision of *Dulux Holdings*.[39] 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" pursuant to the then section 160U ITAA 36. 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 that was validated by the Commissioner looks 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.[40]

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[36] Subsection 108-5(1) ITAA 97.

[38] PBR 1012648073225 and PBR 1012571177732.
[39] *FCT v Dulux Holdings Pty Ltd & Orica Ltd* [2001] FCA 1344.
[40] *PBR 1012648073225.*

7.3 Conversion into a loan

It is 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 affected 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.

7.4 Release, waiver or assignment of UPE by beneficiary – non-CGT issues

It is noted that, for Division 7A purposes, the consequences of assigning a UPE are comparable to the consequences resulting from the assignment of a loan, discussed at 6.2. However, save for the implications arising from reimbursement agreements and section 100A of ITAA 36 this paper will not spend a significant amount of time on the non-CGT issues arising from the release and waiver, as well as the assignment of a UPE, by a beneficiary. Fortunately, that process is made easy by private binding rulings directly on point that address these specific issues.

The key questions asked in the rulings are outlined below.

- Does release, waiver or assignment of a UPE by a beneficiary give rise to a forgiven debt for purposes of Division 245 (ITAA 97)?

  No[41]

- Does release, waiver or assignment of a UPE by a beneficiary trigger the application of s.100A (ITAA 36) reimbursement agreement?

  No (*if it is an ordinary family or commercial dealing*)[42]

[41] Private Binding Ruling (PBR) 101257177732 Issue 1, Q1 and Private Binding Ruling (PBR) 1012648073225, Q2.
[42] Private Binding Ruling (PBR) 101257177732 Issue 2, Q1.

- Does release, waiver or assignment of a UPE by a beneficiary cause an amount of ordinary income under s.6-5 (ITAA 97) for any of the parties?

  No[43]

Taxation Determination TD 2016/19 deals with the question whether a beneficiary of a trust is entitled to a deduction under section 25-35 of ITAA 97 for a UPE to trust income that the beneficiary has purported to write off as a bad debt. The Commissioner stated that the equitable obligation on a trustee to pay the amount of a UPE to a beneficiary is not generally a debt at law.[44]

Further, regardless of whether the reference to a debt is intended in section 25-35 of the ITAA 97, the Commissioner has determined that a deduction is nonetheless not available on the following basis:

- A UPE is not included in the beneficiary's assessable income under Division 6 of Part III of ITAA 36 as required by section 25-35(1)(a) ITAA 97.
- The Trustee's equitable obligation to pay a UPE is not a debt at common law.

Advisors therefore need to be mindful that, if a UPE turns bad a tax deduction for it as bad debt is not available for clients.

The proposed changes in Treasury's consultation paper will treat UPEs under a loan model. Whilst section 109F generally provides that a private company will be taken to pay a dividend to an entity if the company forgives a debt owed by the entity and the entity was either a shareholder or an associate of a shareholder at that time, it is unlikely that the modified Division 7A rules would be captured by this. This is on the basis that the exception contained in section 109G(3) would apply. Pursuant to this subsection, a forgiven debt will not give rise to a dividend if the loan that resulted in the debt gave rise to a deemed dividend under section 109D.

Further, the Consultation Paper states that subsection 109G(3) will be amended to ensure this exception only applies where the earlier dividend that the company was taken to have paid has been taken into account in the income tax assessment of an entity or entities.

7.5 Reimbursement agreements – s100A ITAA36[45]

7.5.1 Preliminary comments as to concerns

This paper does go into significant detail in relation to the operation of section 100A ITAA 36.

This may seem out of proportion in respect of the issues to be addressed given the simple "no" response outlined above to the question asked in the private binding rulings.

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[43] Private Binding Ruling (PBR) 101257177732 Issue 4, Q1.
[44] TD 2016/19, paragraph 12.
[45] See for a comprehensive paper on the topic by the author, Daniel Smedley, Trusts – Current Risk Areas, The Tax Institute 30th National Convention, 18-20 March 2015.

The issue advisors need to be aware of is that the key reason why section 100A has not been applied in these situations is that the arrangement is not considered to be a reimbursement agreement where it is part of an "**ordinary family dealing**". This issue is explored further below.

The challenge for advisors is that the Commissioner has an **indefinite period** to amend an assessment in respect of a taxation liability arising from section 100A. Therefore, if the Commissioner alters his interpretation of what is an ordinary family dealing in the future, all of these potential transactions that were thought to fall outside of the operation of section 100A may then be found to create exposures to taxation liabilities.

As is noted below, the ATO have been reluctant to provide greater clarity as to what constitutes an ordinary family dealing. Indeed, in recent speeches given at industry conferences, there is a further "movement "in the ATO position in respect of these matters evident in comments that have been made. For example, officers of the ATO have been known to state that they have never seen the corporate beneficiary appearing in the family's Christmas photo!

7.5.2 Introduction

Section 100A of the ITAA 36 was introduced in 1979 specifically to counter tax avoidance schemes commonly referred to as "trust stripping" arrangements that were designed to enable trust profits to be stripped to a taxpayer in a tax-free manner.

There are four basic conditions that need to be satisfied for section 100A to be applied:

1. There must be an agreement[46] (which the provisions name as being a "reimbursement agreement").[47] The term "agreement" is broadly defined but that definition specifically excludes an agreement that had not been entered into with an avoidance purpose[48] or that was entered into in the course of ordinary family or commercial dealings.[49]

2. A beneficiary must become presently entitled to income of the trust estate which must arise under the agreement.[50]

3. There must be the payment of money or the transfer of property to, or the provision of services or other benefits for, a person or persons other than the beneficiary or the beneficiary and another person or other persons.[51]

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[46] The term "agreement" is defined in subsection 100A(13) ITAA 36 as "any agreement, arrangement or understanding, whether formal or informal, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceeding…".
[47] The term "reimbursement agreement" is defined in subsection 100A(7) ITAA 36.
[48] See subsection 100A(8) ITAA 36.
[49] Subsection 100A(13) ITAA 36.
[50] The decision of Cooper J in *BRK (Bris) Pty Ltd v Commissioner of Taxation* (2001) ATC 4 111 emphasizes present entitlement as being the key issue in determining whether section 100A is applicable. In this particular case, Cooper J found there was no question as to whether section 100A of the Act applies as the beneficiary in question was not a beneficiary presently entitled to income under the Trust in any income year.
Similarly, Hill J in *East Finchley Pty Ltd v FCT* 89 ATC 5280 stated that "it is clear that if the present entitlement is to arise out of a reimbursement agreement the reimbursement agreement must have occurred first before the present entitlement arose". Hill J, however, recognises a different scenario where the agreement occurs concurrently with the creation of the present entitlement.
[51] Subsection 100A(7) ITAA 36.

4. The agreement must have been entered into for purposes of securing that the liability to income tax of any person in respect of any year of income is reduced or eliminated.[52] Therefore, evidence of what the taxpayer might have otherwise done is crucial to determine whether the requisite purpose existed.[53]

Where these conditions are satisfied, section 100A is applicable and the beneficiary shall, for the purposes of this Act[54], be deemed not to be, and never to have been, presently entitled to the relevant trust income[55], rather, the taxable income is assessable in the hands of the trustee at the top marginal rate of tax under section 99A ITAA 36.

In line with relevant features typical of the tax avoidance schemes described in the EM, the types of arrangements that section 100A was designed to counter are mainly those where the trustee appoints income to a beneficiary that is a previously unrelated entity that either qualifies for exemption of its income or is a loss entity. In these arrangements, there is no or little tax payable and the beneficiary does not receive the full financial benefits of those appointments of income.

7.5.3 Tax Avoidance before the Courts

The arrangements where section 100A has been applied by the courts were unambiguously of a nature that the section was designed to target. It is possible to note, by reading the below cases, the courts had no difficulty in qualifying the arrangements as tax avoidance schemes.

***Raftland Pty Ltd as Trustee of the Raftland Trust v FC of T* (2008) HCA 21**

The court held section 100A applied to the arrangement even though the entitlements were invalid under ordinary trust principles, and thus the default beneficiaries were entitled to the income. It was held that there was a sufficient connection with a reimbursement agreement to attract section 100A ITAA 36. As a result, the trustee was assessed on the income at the highest marginal tax rate under section 99A.

***Idlecroft Pty Ltd v Commissioner of Taxation* [2005] FCAFC 141**

Although the beneficiaries' entitlements arose by operation of the trust deed, section 100A was held to apply because the relevant provisions in the deed were triggered because of the reimbursement agreement. In conclusion, the court held the beneficiary entitled to the trust income does not necessarily have to be a party of the reimbursement agreement. The ATO confirmed this position in its fact sheet.

***Federal Commissioner of Taxation v Prestige Motors Pty Limited as trustee of the Prestige Toyota Trust* 98 ATC 4241**

The court found a reimbursement agreement for a trust yet to be formed. It was held the present entitlement of a beneficiary to trust income arises out of an act or transaction that occurred because of

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[52] Subsection 100A(8) ITAA 36.
[53] There is an extensive analysis of the purpose test in Alexis Kokkinos, "Trusts – The state of play" (paper presented at The Tax Institute Trusts Masterclass, Melbourne 27 May 2014) 60.
[54] This only operates for the purposes of the taxation law. At trust law, the identified beneficiaries would remain entitled to the amount appointed to them in accordance with the trust deed and trust law concepts.
[55] Subsection 100A(1) ITAA 36.

a reimbursement agreement, although the agreement predated the creation of the trust. This view was also adopted by the ATO fact sheet, which is analysed below.

7.5.4 The ATO Fact Sheet

The fact sheet released by the ATO on 3 July 2014 indicates the anti-avoidance rule may have broader application in relation to circumstances where trust income is appointed but not paid to a beneficiary, and not just more aggressive arrangements involving exempt charities.

The fact sheet recognises section 100A as falling outside the normal timing limits on the Commissioner's amendment powers, as the Commissioner has an unlimited period within which the Commissioner can review assessments to give effect to section 100A.

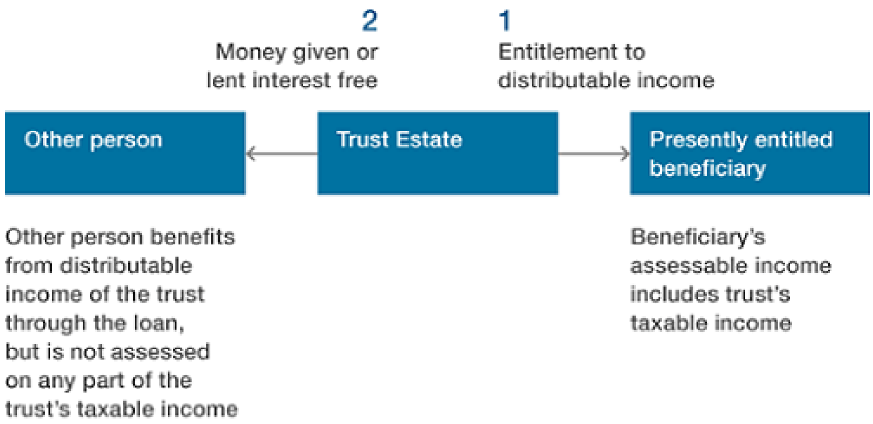
This is a particular concern in an estate planning context. Whereas most of any questionable treatment of transactions for taxation purposes by the deceased will be cured by the passing of time, incorrect treatment of matters in respect of transactions that could be caught by section 100A ITAA 36 will remain open to be examined by the Commissioner **indefinitely**.

The ATO provides examples as to when section 100A is likely to apply and outlines scenarios where section 100A may or may not apply, depending on the facts.

Example 1: Trust estate

In the first example, the trustee of a trust estate makes a beneficiary entitled to distributable income.

However, instead of paying the amount of distributable income to the beneficiary, the trustee gives, or lends on interest-free terms, the money to another person, who benefits from the distributable income of trust but is not assessed on any part of the trust's taxable income.



Source: ATO fact sheet: Trust taxation – reimbursement agreement

This beneficiary may pay less tax than the person who actually benefits from the distributable income, or no tax, because it:

1. is a tax-exempt entity;
2. is a foreigner resident and the assessable income of the trust includes foreign source income or income subject to withholding tax;

3. has tax losses or excess deductions or capital losses or an unapplied net capital loss; or

4. is subject to a lower rate of tax.

The ATO asserts that arrangements with the above features will generally be deemed to be reimbursement agreements if not entered into ***in the course of an ordinary family or commercial dealing***, and if it was intended that the beneficiary who was made presently entitled to the distributable income "pay a lower amount of tax than would otherwise have been payable – for example, by the person who actually enjoyed the economic benefits of that income".[56]

This example somewhat skews the anti-avoidance aspect of subsection 100A(8). Rather than a mere comparison of the position of the presently entitled beneficiary and other parties, the legislation requires consideration as to whether the presently entitled beneficiary "would be liable to pay less income tax in respect of that year of income than that person would have been liable to pay if the agreement had not been entered into".[57] So the legislation requires a "but for" type of analysis where it needs to be established that the presently entitled beneficiary would have a lower income tax liability than that person would have had, if the agreement had not been entered into.

Example 2: Ordinary commercial dealing

This example considers a discretionary trust controlled by Charles and administered for the benefit of Charles and his family. The trustee of the Charles Family Trust makes Charles Co Pty Ltd, an Australian resident company owned by Charles, presently entitled to the trust's distributable income.

The Charles Family Trust ensures that all entitlements of Charles Co Pty Ltd, are placed on Div. 7A complying loan terms or sub-trust arrangements that comply with the options of annual repayments made over seven or ten years outlined in PS LA 2010/4. The trustee then uses the fund as working capital for the business.

The ATO clarifies that where the funds are lent back to the trust under a Div. 7A complying loan or unpaid entitlements held on terms described in PS LA 2010/4, the funds retained in the trust are used as working capital. In this circumstance, the ATO would consider this arrangement to be in the course of an ordinary commercial dealing and section 100A will not apply.[58]

Nonetheless, if there are any factors that take the arrangement outside of what would be considered to be an ordinary commercial dealing, the agreement will not qualify for the exclusion from the definition of reimbursement agreement in section 100A(13) and the section may apply.

Example 3: Ordinary family dealing

This example is about a trust established under a will, entitling a 15-year-old grandson of the deceased to all the income of the trust. The income is not to be paid to him until he is 25 years old. Thus, the income is then used by the trustee to make further income-producing investments.

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[56] ATO, Trust taxation - reimbursement agreement https://www.ato.gov.au/General/Trusts/In-detail/Distributions/Trust-taxation---reimbursement-agreement/.
[57] Subsection 100A(8) ITAA 36.
[58] In relation to this, the ATO fact sheet states: "The Commissioner has not sought to apply Division 7A to mere unpaid entitlements created before 16 December 2009. The Commissioner will also not devote compliance resources to the application of section 100A to these entitlements where the relevant funds are retained as working capital of the trust."

Section 100A does not apply where the beneficiary is a minor. Furthermore, the Commissioner states that even after the grandson ceased to be a minor, the arrangement (without any other extraneous factors which are not outlined in this example) is an ordinary family dealing. Thus, it is not considered to be a reimbursement agreement.

Example 4: Ordinary family or commercial dealing (hybrid)

This example considers circumstances where the arrangements that were entered into were both ordinary family and commercial dealings.

The ATO illustrates this hybrid structure by considering a discretionary trust controlled by Charlene and administered for the benefit of Charlene and her family.

The trustee of the Charlene Family Trust makes individual Australian resident beneficiaries entitled to the trust's distributable income every year. The entitlements remain unpaid, except for the necessary amount to enable the beneficiaries to pay their taxation liability on their share of the trust's taxable income. The unpaid balances build up over time and the trustee then lends the remaining cash to Charlene on commercial terms.

In this context, the ATO clarifies that arrangements made on commercial terms, requiring payment of principal and interest over time, prevent section 100A being applied.

It is disappointing that this example didn't take the opportunity to tackle the issues relating to "ordinary family dealings". In one version of this example originally considered by the Trust Working Group, the amount loaned was done so on an interest free basis but to members of a family group as a result of the trust having made a family trust election.[59] The purpose of that variant of the example was to address the exclusion for ordinary family dealings. In the draft version of this example considered by the working group the conclusion was that section 100A could apply to the arrangement if specific factors were prevalent:

- the parties intended that no demand for payment of the entitlement would be made or that such demand would be delayed;
- the use made of the unpaid distributions: for example, the fact that the funds are lent on a non-commercial basis to other family members and there is no likelihood that they will be repaid to the trust might suggest that there was never an intention that the presently entitled beneficiary actually benefit from the distributable income; and
- the tax position of the beneficiaries and family members receiving the loaned funds.[60]

No doubt such an example attracting the operation of section 100A would be of great concern to many tax practitioners. This example was ultimately removed from the fact sheet. However, the replacement example addressing loans on interest-bearing terms as meeting the requirement for being an "ordinary

[59] Alexis Kokkinos, "Trusts – The state of play" (paper presented at The Tax Institute Trusts Masterclass, Melbourne 27 May 2014) 51 and 88.
[60] *Ibid* 51.

commercial dealing" does not aid in clarifying the issue, nor assists tax practitioners to identify where arrangements similar to the above may be excluded as ordinary family dealings.

It is also concerning that when asked questions regarding seeking further clarification in relation to the ordinary family dealings exclusion, the ATO's response has been guarded and refers to the difficulty in providing such guidance given the "fact specific nature of section 100A". [61] The ATO has indicated that there may be scope for litigation in relation to these kinds of issues.[62]

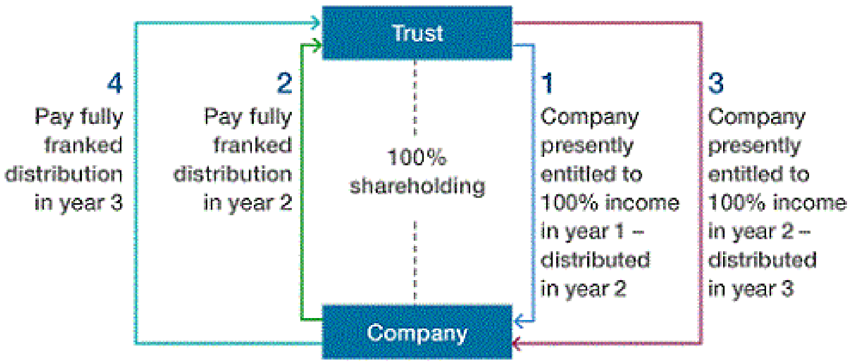
Example 5: Commissioner considers section 100A applies

In this last example, the ATO considers a reimbursement agreement results in funds benefiting persons other than the beneficiary. The agreement in this context is not deemed to be an ordinary commercial dealing because of the ownership structure and perpetual circulation of funds.

In this arrangement, the trustee of a trust owns all of the shares in a private company, which is also a beneficiary of the trust, and undertakes no activity, but derives a small amount of bank interest on its own account. The directors for both the trustee company and the beneficiary company are the same individuals.

The trustee makes the company presently entitled to all, or some part of the distributable income of the trust at the end of year 1. The company includes its share of the trust taxable income in its assessable income for year 1 and pays tax at the corporate rate (not the higher rate applicable to income accumulations within a trust). This income is distributed to the company in year 2, and because the company's entitlement is paid prior to the lodgement of the company's income tax return for the year in which the entitlement arose, Division 7A ITAA36 doesn't apply.

The company then pays a fully franked dividend to the trustee in year 2, sourced from the trust income, which will form part of the distributable income and taxable income of the trust in year 2. The trustee makes the company presently entitled to all, or some part of, the income of the trust at the end of year 2 and the arrangement is repeated.



Source: ATO fact sheet: Trust taxation – reimbursement agreement

In this scenario, the reimbursement agreement is the circular arrangement where a trust distributes income to a company beneficiary that is owned by the trust, with the company paying dividends

[61] ATO, Live Chat: Tax Avoidance Arrangements, 5 November 2014 <http://lets-talk.ato.gov.au/live-chats/news_feed/tax-avoidance-arrangements>.
[62] *Ibid*.

subsequently and repeating the arrangement annually, resulting in accumulated funds within the trust, but only incurring tax at the corporate rate.

7.5.5 Ordinary family and commercial dealings analysis – the exclusions from section 100A

Section 100A outlines two safeguard exclusions in subsections 100A(8) and 100A(13) – arrangements that do not have a tax avoidance purpose[63] and arrangements that are entered into in the course of ordinary family and commercial dealings. The first exclusion has been identified by the courts as seen in the above case studies. However, the second exclusion has been generating a high degree of concern and uncertainty in the tax practitioner community.

In this aspect, the ATO fact sheet does not significantly address this issue:

- There is no definition of ordinary family or commercial dealings. Whether a particular agreement comes within that exclusion will depend on all of the relevant facts. The courts have made it clear that the exclusion must be considered having regards to all steps comprising the reimbursement agreement – not merely components of it.

  And:

- An agreement will not necessarily be considered to have been entered into in the course of an ordinary family dealing merely because all of the entities involved are members of the same "family group".

On one hand, the ATO leaves open any kind of definition to the term "ordinary family and commercial dealings", requiring exclusions to be analysed together with the relevant facts of each case. On the other hand, the ATO clarifies that the main question is whether the arrangements were "entered into the course of" rather than whether the agreement itself is an ordinary family or commercial dealing.

The statements by the ATO confirm the general understanding of tax practitioners.

For instance, in PBR 1012113065944, the debt forgiveness transactions involved in an estate planning arrangement were concluded to be executed "in the course of ordinary family or commercial dealing". It was found that although debt forgiveness transactions may not be an "ordinary" transaction that occurs day to day by family members, the arrangement was entered into in the course of ordinary family or commercial dealings, as being part of the estate planning.

Background

The term "ordinary family and commercial dealings" derives from *FC v Newton*[64] in the context of the purpose test contained in section 260 (the general anti-avoidance provision).

[63] See above n 48.
[64] [1958] 98 CLR 1.

In this case, the ordinary family or commercial dealing test was used as a basis for determining whether the purpose of the agreement was to avoid tax according to section 260.

In addition to statements in *Newton's case*, the High Court of *Australia in FCT v Gulland*[65] clarified that the test is not intended to be an exhaustive exception to determine whether or not the arrangement is a tax avoidance arrangement. *Gulland's decision* recognises that an arrangement could be "outside of the ordinary" but may have been done for purposes other than tax avoidance.

Although the purpose test contained in section 100A is different to that contained in section 260 (mainly because of the 'reimbursement agreement' requisite contained in section 100A), the choice principle of entering into an agreement with the purpose to avoid tax is equally relevant for both sections.

7.5.6 The interaction between section 100A and other provisions and what could constitute an "ordinary family and commercial dealing"

Division 7A

The ATO fact sheet acknowledges that both section 100A and Division 7A could apply in certain circumstances. Arrangements that could constitute an ordinary family and commercial dealing for Division 7A purposes could raise some uncertainty as to whether section 100A applies.

To ease some concerns, in the fact sheet the ATO state:

> Where a loan from a beneficiary to a trust is placed on Division 7A complying terms (or an unpaid entitlement is held by the trust on terms described in PS LA 2010/4) and the funds retained in the trust are used as working capital, the Commissioner would consider this arrangement, without more, to be in the course of an ordinary commercial dealing.
>
> …
>
> Where Division 7A has application in respect of an unpaid entitlement created on or after 16 December 2009 and the retained funds are used as working capital of the trust, the Commissioner will not generally seek to devote compliance resources to considering the question of whether or not section 100A would also apply to that arrangement.

And yet, this is immediately contradicted below where the ATO state:

> The compliance approach outlined above does not apply if the trustee owns shares in the beneficiary company – see example 5 for such an ownership structure. But this does not mean that mere ownership of a corporate beneficiary will trigger the application of section 100A.

The trust loss provisions

Schedule 2F ITAA 36 allows family groups to utilise trust losses if they make a family trust election where distributions are made specifically to family group members with losses and no payments are made outside the group. The ATO fact sheet does not allay tax practitioners' fears that section 100A

[65] [1985] HCA 83.

could apply to these circumstances, despite Schedule 2F specifically allowing family groups to transact in this manner.

The ATO position

The ATO's purpose in this regard is to ensure that the facts will be analysed case by case and no tax will be avoided through schemes that at first seem to have "ordinary family dealings' features".

7.5.7 The concept of "ordinary family and commercial dealings" before the courts

The purpose of trust structures have been analysed by the Courts when faced with the challenge of drawing the line between what it is and what it is not an ordinary family or commercial dealing.

FC of T v Rippon[66]

In *FC of T v Rippon* the taxpayer established an engineering consultancy business and sought legal advice as to an appropriate business structure.

In accordance with that advice, the following structure was adopted: two shelf companies were acquired, one John T. Rippon Pty Ltd (JTR) becoming the trustee of a unit trust, the other John T. Rippon Holdings Pty Ltd (Holdings), becoming the trustee of a discretionary trust which had, as its objects, members of the taxpayer's family, excepting the taxpayer.

The taxpayer's reasons to adopt this structure were, as he alleged, "to provide maximum flexibility"' for the future. The taxpayer justified the tax efficiencies achieved by the trust structure by arguing that there were commercial reasons for the arrangements.

This case was found to be a "borderline" case most likely due to the personal services type income. Notwithstanding, the transaction satisfied the test in *Newton's case* that *"you must be able to predicate — by looking at the overt acts by which [the arrangement] was implemented — that it was implemented in that particular way so as to avoid tax".*

The appeal was dismissed as the court concluded the arrangement was an ordinary business and family dealing for section 260 purposes.

Although the tests in section 260 and section 100A are different, the findings by the court in *Rippon's case* are of importance in determining what is ordinary family and commercial dealing, as definition is absent in legislation.

On the other hand, when trust structures are used for the purpose of diverting personal exertion income, the arrangements are not deemed to be "ordinary family or commercial dealings".

Tupicoff v Federal Commissioner of Taxation[67]

In *Tupicoff v Federal Commissioner of Taxation* the taxpayer resigned the appointment as commission agent for an insurance company and in his stead a company in the capacity of trustee of a newly formed discretionary trust was appointed. The beneficiaries of this trust were the taxpayer and members of his

[66] [1992] FCA 487.
[67] [1984] FCA 353.

family, and insurance selling activities previously carried out on his own behalf as an individual agent were now carried out by the trust. As a result, the sum of $10,492.00 being the net income of the Gary Tupicoff Family Trust, was not included as part of the assessable income of the taxpayer.

The taxpayer alleged the arrangements were capable of explanation by reference to ordinary family and commercial dealings. However, the court found the real purpose of the arrangement was the splitting of the taxpayer's income between the members of his family and applied section 260.

***FCT v Gulland*[68]**

This case considered the operation of section 260 where a medical practitioner, who had formerly been carrying on practice either in partnership and on his own, commenced to carry on the practice as an employee of a unit trust. As a result, some of the income, which would otherwise have been his, was found to be diverted into the hands of the beneficiaries of the unit trust, particularly members of his family.

On that occasion the High Court held the trust structure to be used for the purpose of diverting personal exertion income.

Although we have substantial jurisprudence defining what would be "an ordinary family or commercial dealing" for section 260 purposes, there is a lack of definition of what would be an "agreement entered into in the course of ordinary family dealing" for section 100A purposes.

The absence of definition in legislation and the ATO's position in not defining the concept leads to a case by case analysis of relevant facts. In this context, the definition of "an ordinary family or commercial dealing" given in *Newton's case* and following cases is essential when analysing trust structures that could fall within section 100A. However, this analysis has to consider that is not the agreement itself that that needs to be an "ordinary family or commercial dealing", but that the agreement needs to be "entered into the course of ordinary family or commercial dealings".

7.6 Release of a UPE triggers Division 7A - Taxation Determination TD 2015/20

In Taxation Determination TD 2015/20 the Commissioner takes the position that a private company that releases all, or part, of its UPE "credits" an amount within the meaning of that word in paragraph 109C(3)(b) of ITAA 36 to the extent that the release represents a financial benefit to an entity.

There are a couple of exceptions to the position taken in the taxation determination.

At paragraph 3, the ATO states that the determination does not apply to the extent that an amount is included in the assessable income of the entity in favour of whom the UPE is released because of the application of another provision of Division 7A in respect of the UPE.

[68] [1985] HCA 83.

Further, the ATO states that the determination does not apply to the extent that the UPE has been converted to a debt to which section 109F may apply.

In relation to the comment that the amount is a credit only to the extent that the release represents a financial benefit to an entity, the ATO provide a couple of examples.

In example 2 of the taxation determination, the ATO illustrates a scenario where the release is not a payment within the meaning of Division 7A as there is not an amount recoverable from the entity released.

However, the ATO illustrates that a financial benefit is provided in example 3 where the entity providing the release still has a cause of action in equity to make a claim against the entity being released.

The ATO's view in the taxation determination is controversial. It is adopting a position where they appear to be stretching the purpose of the inclusion of the word “credits” in the definition of payment pursuant to section 109C of Division 7A.

Despite this, the ATO state that their position applies regardless of:

- The doctrine of merger of estates.
- Whether the UPE is held in the main trust or a sub-trust.
- Whether the release is conditional or unconditional.
- Whether or not the UPE is released voluntarily or at the direction of a court order.

Further, the ATO stated that the position in the taxation determination applies both before and after its date of issue, and in relation to both pre and post-16 December 2009 UPEs.

7.7 Release, waiver or assignment of UPE by beneficiary – CGT

In a similar manner as to how the paper address the non-CGT issues arising from release or waiver of a UPE by beneficiary at paragraph 7.4 of the paper above, extracts from private binding rulings addressing the questions on CGT issues are outlined below.

- Does cancellation, release or waiver of a UPE trigger CGT Event C2?

  Yes[69]

- Does the assignment of a UPE trigger CGT Event A1?

  Yes[70]

[69] Private Binding Ruling (PBR) 101257177732 Issue 3, Q2.
[70] Private Binding Ruling (PBR) 101257177732 Issue 3, Q3 and Private Binding Ruling (PBR) 1012648073225, Q3.

The ATO take the view that these transactions will trigger CGT events whereas the satisfaction or discharge of the UPE would not trigger a CGT event (CGT event C2) as outlined above at paragraph 7.2 of the paper.

The ATO reach this conclusion on the basis that the release, waiver or assignment of the UPE is **not** incidental to and facilitating of a distribution of income from a trustee to a beneficiary. The ATO's position that the UPE would not trigger a CGT event (CGT event C2) upon satisfaction/discharge as outlined above at paragraph 7.2 of the paper is based on its interpretation of the decision in *Dulux*[71] and that the performance of the contract does not give rise to the secondary CGT event. The distinction in respect of the release, waiver or assignment is that those actions do not occur in respect of the performance of the appointment of income or capital that gave rise to the UPE and the initial CGT event D1.

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.[72] 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.[73]

7.8 Anti-overlap provisions for CGT

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.[74] 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.[75]

In relation to UPEs, section 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 section 118-20 on the UPE's creation.[76] It is important to note that as a result of the difference between income for trust law purposes and taxation purposes, even where the UPE has only arisen as a result of distributions of income, the anti-overlap provisions may not apply to the entirety of the UPE.

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[71] *Commissioner of Taxation v Dulux Holdings Pty Ltd & Ors* [2001] FCA 1344.
[72] Section 134 of the Property Law Act 1958 (Vic).
[73] Subsection 104-10(2) ITAA 97.
[74] Section 118-20 ITAA 97.
[75] Subsection 118-20(1A) ITAA 97.
[76] Private Binding Ruling (PBR) 1012571177732, Issue 3, Q4.

To the extent that an amount was not 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 section 118-20 will have no application.

7.9 Cost base for CGT purposes

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.[77]

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.[78] 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.[79] 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.[80]

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.[81] 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.[82]

7.10 Capital proceeds for CGT purposes

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

[77] Subsection 110-25(2) ITAA 97.
[78] Private Binding Ruling (PBR) 1012571177732 and Private Binding Ruling (PBR) 1012557133149.
[79] Taxation Ruling TR 2010/3, para 34.
[80] *Commissioner of Inland Revenue v Ward* (1969) 1 ATR 287 at 313.
[81] Subsection 112-20(1)(a)(i) and (ii) ITAA 97.
[82] Subsection 112-20(3), item 1 ITAA 97; Private Binding Ruling (PBR) 1012571177732.

received (or is entitled to receive) in respect of the event happening.[83] 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.[84]

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 for the benefit of the beneficiary), the market value of the UPE may be more than its amount on creation.[85] 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.[86] 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.[87] This means, for example, any subsequent distribution to the beneficiary would not have CGT consequences.

7.11 Dealing with the UPE in the will

The presence of loans and UPEs in the group structure presents many challenges in respect of estate and succession planning. Failure to correctly identify the loans and UPEs and incorporate those in a will may result in significant unintended outcomes from the estate planning.

As a simple example, consider an estate plan where one child is provided with the complete and unfettered control of a trust structure and the other child is provided with all of the personal estate assets through the will. If there are significant UPEs in the financial statements of the trust in favour of the testator (perhaps closely approximating the value of the actual tangible assets held by the trust), then upon the testator’s death, those entitlements now pass to the child with the estate assets. If that child calls upon the payment of the UPEs, the child with the control of the trust will be left with nothing.

The example is obviously oversimplified and there may be other remedies available to the children to attempt to equate the estate assets through claims made under various state legislation in respect of the drawing of the will and the distribution of the estate assets. However, the example illustrates the challenges presented by loans and UPEs in a complex family group.

Even if the loan accounts and UPEs are identified, it is critical that great care is taken in dealing with them through the estate plan. There are taxation liabilities that may be triggered in dealing with loans and UPEs. These potential taxation liabilities arise under various different parts of the taxation law. Further, the particular taxation liabilities that arise may not always benefit from anti-overlap provisions in the tax law such that the transactions in respect of the loans and UPEs may trigger multiple exposures to tax.

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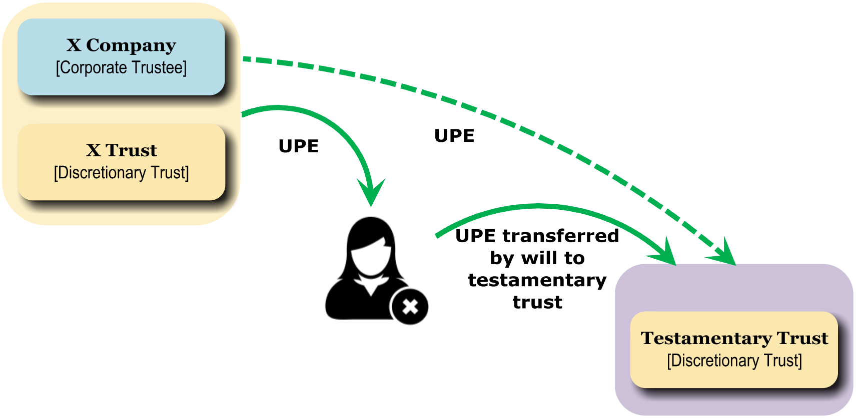
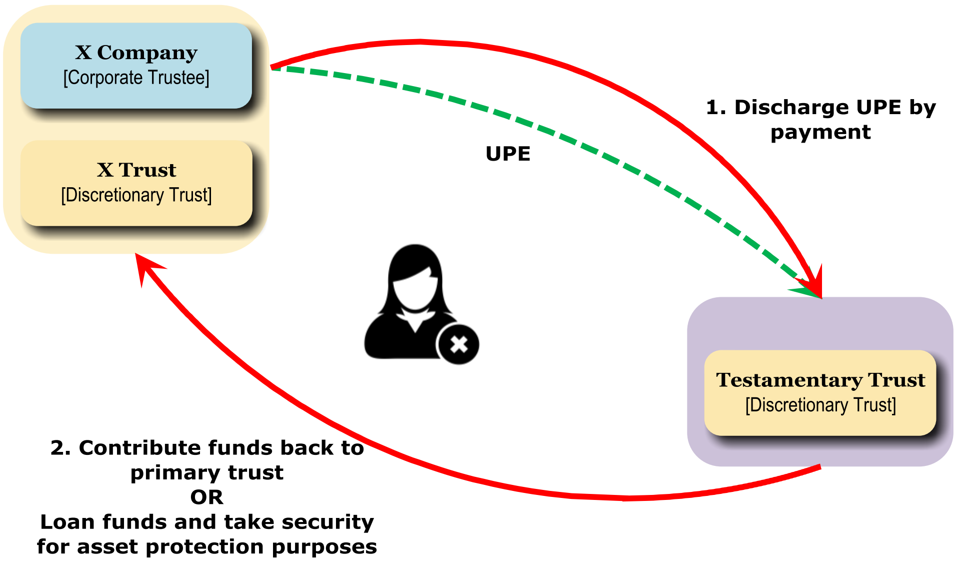
[83] Subsection 116-20(1) ITAA 97.
[84] Subsection 116-30(1) ITAA 97.
[85] Private Binding Ruling (PBR) 1012571177732.
[86] Subsection 104-75(1) ITAA 97.
[87] Section 106-50 ITAA 97.

Subject to the potential operation of the anti-overlap provisions outlined above (which would require an analysis of the nature of the distribution that gave rise to the UPE) the simplest approach to dealing with the UPE may be to pass it via the will to a testamentary trust as illustrated below.



A discussion of the operation of testamentary trusts is beyond the scope of this paper, but in essence, once the testamentary trust holds the UPE, the UPE could be discharged by payment and the testamentary trust could loan those funds back to the primary trust potentially taking security for the loan if that would aid the family group's asset protection purposes.



This type of conversion to loan arrangement may not be possible during the lifetime of the testator due to the asset protection concerns and the at-risk nature of the particular individual.

In relation to the transfer of the UPE by the will to the testamentary trust, if the deceased acquired the asset on or after 20 September 1985, the beneficiary's acquisition cost will be determined in accordance with items 1, 2, 3 or 3A of the table in subsection 128-15(4) of ITAA 97.

Similarly, the same analysis as outlined above to the look through approach to the testamentary trust on the discharge of the UPE such that there is no CGT event C2 implications should apply. Applying the concepts from *Commissioner of Taxation v Dulux Holdings Pty Ltd & Ors* [2001] FCA 1344, the

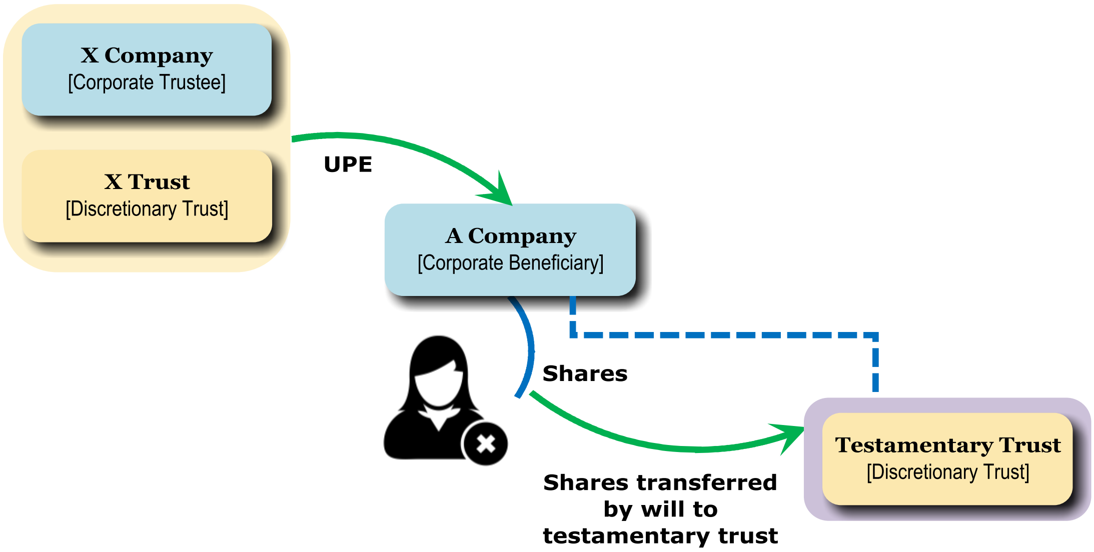
UPE has been applied in merely facilitating the distribution from the original trust. As per Lindgren J in *Dulux*:

> My construction of s 160U
>
> 50. It is not, and could not reasonably be, challenged in the present case:
>
> · that the payments which MMBW made from time to time to the Trustee, were made under the Orica Assumption Agreement; or
>
> · that the making of those payments was not, and did not give rise to, a disposal of an asset (other than, of course, the money paid) in accordance with general law concepts.
>
> But just as clearly, Orica establishes that by reason of the operation of par 160M(3)(b) of the Act, upon the making of those payments, there were deemed, for the purposes of Pt IIIA, to be disposals of an asset. The question before us is whether subs 160U(3) is, on some proper basis, to be construed so as not to refer to those deemed disposals.
>
> 51. In my opinion, the chief purpose and object of subs 160U(3) is to express the legislature's choice between two possibilities, one of which would give the benefit of indexation in respect of the period from contract to completion to the purchaser and the other of which would give that benefit to the vendor. Under the choice made, indexation of the vendor's cost base comes to an end at the date of the making of the contract rather than the later date of the change in ownership under the contract, whereas, when the purchaser eventually sells, indexation of its cost base commences from the date on which it contracted to purchase, rather than from the later date when its purchase was completed.
>
> 52. Accordingly, subs 160U(3) applies where there is a potential for the asset in question to be disposed of, both at the time of the making of the contract and at the time of the later disposal. But there is no scope for subs 160U(3) to express the legislative choice to which I have referred, where, as in the present case, the asset is a chose in action created by the very contract, the due performance of which gives rise to the discharge constituting the deemed disposal. The concept of indexation is simply quite foreign to such circumstances, and there is no scope for subs 160U(3) to apply to them.
>
> [Emphasis added]

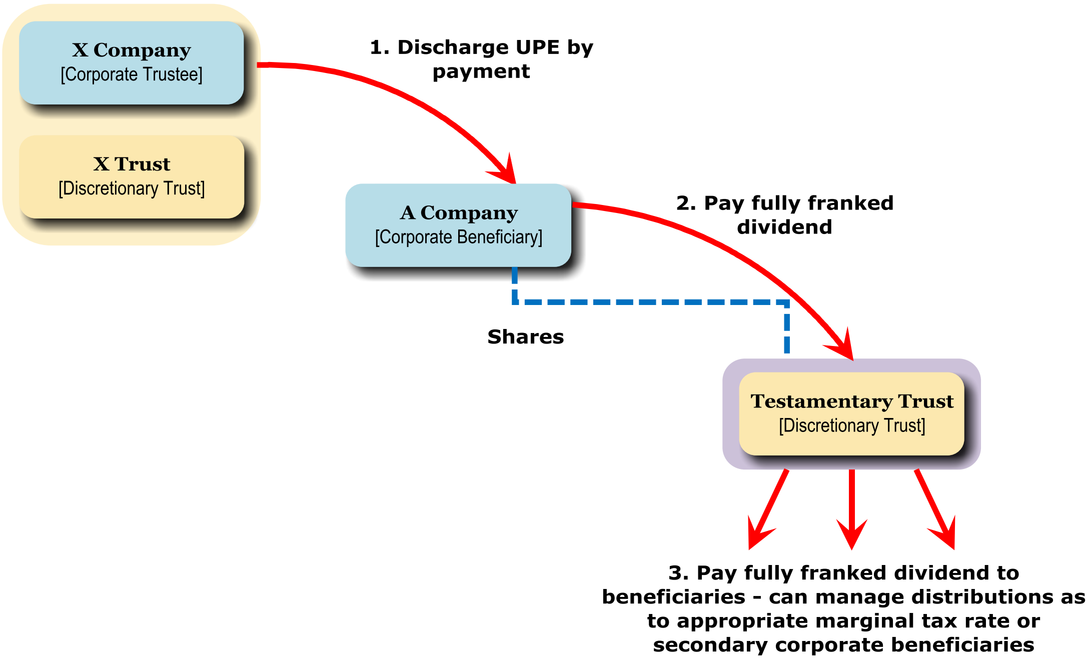
Further, support for treating the testamentary trust in the same manner as the beneficiary of the estate is provided in Practice Statement Law Administration PS LA 2003/12 "Capital gains tax treatment of the trustee of a testamentary trust".

7.12 Dealing with the shares in the corporate beneficiary in the will

The problem identified earlier (paragraph 5.2 above) in respect of structures involving corporate beneficiaries where at-risk individuals hold the shares in a corporate beneficiary may also be resolved through the estate planning process.



The shares may be transferred from the testator to a testamentary trust created by the testator's will upon their death.



Then, depending upon the financial needs of the group, the UPE may be discharged by payment to the corporate beneficiary. The corporate beneficiary may then pay fully franked dividends to the testamentary trust. Finally, the testamentary trust can pay a fully franked dividend to beneficiaries which may include a secondary corporate beneficiary. The timing of the payment of the dividends may be managed to match the needs of the beneficiaries to income and the effective tax rates that would be payable in respect of the receipt of the fully franked dividends.

8 Conclusion

The introduction of additional companies or the use trusts in business groups inevitably gives rise to loan both loan accounts and UPEs.

Advisors need to consider a range of issues in dealing with loans and UPEs in the daily business of clients and the potential Division 7A traps they pose. Issues include the need to balance the asset protection, taxation efficiency and succession planning objectives of the business, whilst maintaining the flexibility needed for it to operate successfully.

The advisor's task is made even more difficult by the challenge in finding and identifying the particular loans and UPEs within the group as well as keeping one eye on the horizon for the potential legislative changes that are foreshadowed for private company loans and UPEs.

The best way to both mitigate the risks and to maximise the opportunities is for all advisors to work together in a collaborative approach to providing the solutions.

15 November 2018

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Acknowledgements

The author acknowledges the assistance of **Laura Spencer** (overview of paper), **Sam Campbell** (CGT issues with UPEs) and **Patricia Martins** (100A reimbursement agreements). However, any errors are the author's own.

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